



COVERSHEET

Minister	Hon Dr David Clark	Portfolio	Commerce and Consumer Affairs
Title of briefing	Economic Regulation and Consumer Protection in the Three Waters Sector	Date to be published	8 December 2022

List of documents that have been proactively released		
Date	Title	Author
June 2022	Economic Regulation and Consumer Protection in the Three Waters Sector	Office of the Minister of Commerce and Consumer Affairs
7 June 2022	Economic Regulation and Consumer Protection in the Three Waters Sector CAB-22-MIN-0207 Minute	Cabinet office
June 2022	Regulatory Impact Statement: Economic Regulation and Consumer Protection in the Three Waters Sector	MBIE

Information redacted

YES

Any information redacted in this document is redacted in accordance with MBIE's and MFAT's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Some information has been withheld for the reason of Confidential advice to Government.



Regulatory Impact Assessment: Economic Regulation and Consumer Protection for Three Waters Services in New Zealand

Coversheet

Purpose of Document	
Decision sought:	<i>Analysis produced for the purpose of informing Cabinet decisions</i>
Advising agencies:	<i>Ministry of Business, Innovation and Employment</i>
Proposing Ministers:	<i>Commerce and Consumer Affairs</i>
Date finalised:	<i>26 May 2022</i>
Problem definition	
<p>The Government's Three Waters Reform Programme involves the establishment of four new Water Services Entities (entities). These entities will be large natural monopolies delivering essential services without direct accountability to shareholders. Without fit-for-purpose economic regulation and consumer protection, there is a significant risk that the outcomes for consumers (in terms of price, service quality, infrastructure resilience and network reliability) could be worse than under the current system, which would undermine the outcomes that the reforms are intended to achieve.</p>	
Executive summary	
<h3>Background</h3> <p>In 2021, Cabinet made decisions to transform the current delivery of three waters services by territorial authorities by establishing four financially and operationally independent water services entities. These changes are intended to address current problems related to poor water quality and customer service, insufficient infrastructure investment and inefficient pricing practices. Cabinet has also agreed in-principle that an economic regulation regime be applied to the reformed three waters sector.</p> <p>This Regulatory Impact Assessment (RIA) focusses on the policy decisions required for implementing a fit-for-purpose economic regulation and consumer protection regime for three waters services. It considers options to address overarching issues relating to consumer welfare in natural monopoly markets, as well as implementation design issues for the proposed new regime.</p>	

Issue 1: Protecting consumer interests in monopoly markets

- Option A: Rely on existing competition and consumer law (status quo).
- Option B: Implement a sector-specific economic regulation and consumer protection regime for three waters (MBIE preferred).

Issue 2: Objectives of economic regulation

- Option A: Purpose statement based on promoting the long-term interests of water consumers with no additional objectives.
- Option B: Purpose statement based on promoting the long-term interests of water consumers, with additional objectives relating to obligations in respect of climate change, Te Tiriti, Te Mana o te Wai, and Treaty settlements (MBIE preferred).

Issue 3: Scope of economic regulation and consumer protection

- Option A: Include only the entities in the economic regulation and consumer protection regime (MBIE preferred).
- Option B: Include only the entities in the economic regulation regime, but also include some smaller suppliers in the consumer protection regime.

Issue 4: Initial forms of economic regulation

- Option A: Implement information disclosure initially but allow for quality-only and price-quality regulation in future.
- Option B: Implement information disclosure and quality-only regulation initially but allow for price-quality regulation in future (MBIE preferred).
- Option C: Implement information disclosure and price-quality regulation initially but allow for quality-only regulation in future.

Issue 5: Provision of a minimum service level code

- Option A: Regulator sets a minimum service level code (MBIE preferred).
- Option B: Industry sets its own minimum service level code with regulatory backstop.

Issue 6: Provision of an expert advocacy body

- Option A: Consumers advocate on their own behalf.
- Option B: Create a bespoke advocacy body made up of water sector experts.
- Option C: Extend the remit of an existing expert advocacy body (MBIE preferred).

Issue 7: Consumer dispute resolution

- Option A: Create a mandatory consumer dispute resolution scheme that complements the Taumata Arowai complaints framework (MBIE preferred).
- Option B: Create a voluntary disputes resolution scheme with a regulatory backstop.

The Department of Internal Affairs (DIA) is the agency responsible for the Three Waters Reform Programme and has undertaken impact analysis regarding the wider reform. The Ministry of Business, Innovation and Employment (MBIE) is solely responsible for the analysis and advice set out in this RIA, except as otherwise indicated.

Summary of benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

New Zealand consumers served by the new entities are expected to be the main beneficiaries of these proposals. The sector is currently inefficient (by comparison with international peers) and there are credible prospects of significant efficiency gains¹ While the Three Waters Reforms will go some way towards increasing the efficiency of the sector, significant gains are unlikely in the absence of economic regulation. Realising these substantial efficiency gains will mean lower prices and improved services for consumers compared to the status quo.

Economic regulation will ensure the entities make efficient and transparent investment decisions to upgrade three waters infrastructure, thereby helping to ensure that consumers receive reliable and high-quality water services at a reasonable price while being protected from undue price shocks. The consumer protection regime will also ensure that consumers have a stronger voice in decision-making, guaranteed minimum service levels, and access to a dispute resolution service if things go wrong.

Where do the costs fall?

The costs for this regime will largely fall on the entities and then be passed on to consumers. Developing the rules and processes underpinning economic regulation is likely to cost around \$10 million over two years. Implementation and ongoing costs of the economic regulation regime will be between \$7 million– \$10 million per year, depending on the nature of the economic regulation activity. These costs will be levied on the regulated entities. Modelling suggests that economic regulation will cost households between \$4-7 per household annually, depending on the nature of the economic regulation activity. The consumer protection proposals will cost around \$5.28 per household annually.

Do the benefits outweigh the costs?

MBIE's view is that the benefits of implementing economic regulation and consumer protection for the water sector outweigh the costs. Costs have been quantified and set out in this RIA and Cost Recovery Impact Statement (CRIS) where possible. Our assessment is largely based on qualitative analysis, including on stakeholder feedback and analysis of other economic regulation regimes in New Zealand and overseas water reforms.

Consultation and submitters' views

In the discussion paper released in December 2020, we set out our preliminary positions on the design of an economic regulation and consumer protection for three waters. In response, we received submissions from stakeholders in the local government sector, industry representatives, iwi/Māori groups, membership associations, government agencies, and advocacy groups. Several submitters requested to meet with us to discuss their submissions. In general, submitters and experts supported our proposals, and largely agreed on the need for economic regulation and consumer protection in the three waters sector.

Limitations or Constraints on Analysis

¹ The Water Industry Commission for Scotland (WICS) undertook analysis on the scope for efficiency in the New Zealand water sector, based on experiences in Scotland and across the United Kingdom of improving the levels of cost effectiveness and service performance. See WICS. (2021). Economic Analysis of Water Services Aggregation. [https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme/\\$file/Economic-analysis-of-water-services-aggregation-Stage-One-Report.pdf](https://www.dia.govt.nz/diawebsite.nsf/Files/Three-waters-reform-programme/$file/Economic-analysis-of-water-services-aggregation-Stage-One-Report.pdf).

Quality of the data and evidence used in developing this proposal

There is inherent uncertainty about how the entities will operate in the first few years of operation, given:

- the Three Waters Reforms represent a significant transition for the water sector
- the complex process involved in setting up these new entities, including transferring assets and becoming familiar with governance arrangements and regulatory requirements.

There is a lack of robust information available about the current state of the three waters sector, including the state of three waters network assets. Furthermore, the entities we are proposing to subject to economic regulation and consumer protection legislation have not yet been established. These limitations have been mitigated by engaging with councils and water industry experts, by the extensive analysis of the sector undertaken by DIA, and by ensuring the regulatory regime is flexible and allows for requirements to be implemented gradually.

Limitations on consultation, testing, and stakeholder engagement

There are moderate time constraints on this project, driven by the Government's direction to have legislation in place before 1 July 2024 to allow implementation of the first regulatory cycle to align with the 'go live' date of the new entities. These time constraints have prevented us from investigating distributional impacts of the problem on certain segments of New Zealand consumers, such as vulnerable consumers and traditionally under-served communities. However, this limitation is partially mitigated by the work DIA is undertaking on protections for vulnerable consumers.

Responsible Manager

Glen Hildreth
Acting Manager
Competition and Consumer Policy
Ministry of Business, Innovation and Employment

Quality Assurance

Reviewing Agency:	Ministry of Business, Innovation and Employment
Panel Assessment & Comment:	MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Impact Statement prepared by MBIE. The panel considers that the information and analysis summarised in the Impact Statement meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

Section 1: Diagnosing the policy problem

1.1 What is the context behind the policy problem and how is the status quo expected to develop?

In July 2020, the Government launched the Three Waters Reform Programme to reform water service delivery arrangements. In 2021, Cabinet made decisions to transform the three waters delivery system, including agreeing to the overall design and core components of the new service delivery model and approach to transition [CAB-21-MIN-0226; CAB-21-MIN-0227 and CAB-21-MIN-0228 refers]. This involves the creation of four statutory, publicly owned water services entities, which will take over responsibilities for service delivery and infrastructure from local authorities from 1 July 2024. These decisions are to be given effect through the Water Services Entities Bill and the Water Services Entities Amendment Bill (the Amendment Bill).

In December 2020, Cabinet agreed in-principle that an economic regulation regime be applied to the reformed three waters sector, with information disclosure as a minimum [CAB-20-MIN-0521.01 refers]. In June 2021, Cabinet noted that the full benefits of reform cannot be achieved by scale alone, and the ability of new water services entities to realise any efficiencies will depend on several other factors, including the establishment of an economic regulation regime and mechanisms for protecting consumers.

Cabinet proposals on pricing and charging and other implementation matters have been made by the Minister of Local Government to inform the drafting of the Amendment Bill. DIA has undertaken an options analysis for these implementation arrangements. To complement the pricing and charging proposals, the Minister of Commerce and Consumer Affairs proposes a new economic regulation and consumer protection regime. Options for the regulatory regime are the subject of this MBIE RIA.

Key features of the regulatory system already in place for water services

The Water Services Act 2021 sets out the functions of the new drinking water regulator, Taumata Arowai, including the ability to develop drinking water standards and compliance rules, and to promote best practice relating to all three waters. Taumata Arowai has oversight of the public health and safety aspects of drinking water, and environmental aspects of wastewater and stormwater.

The Ministry of Health and Ministry for the Environment have a role in overseeing public health and environmental regulation. Regional councils will continue their role in managing rivers, mitigating soil erosion and flood control, e.g. by developing regional policy statements and the issuing of consents.

The following legislation offers general protection for water consumers:

- Commerce Act 1986 – under Part 4, economic regulation may be imposed on goods or services in markets by Order in Council where there is no competition and no likelihood of a significant increase in competition (i.e. markets with natural monopoly characteristics). This requires the Commerce Commission to first undertake a formal inquiry into the state of the market. Part 2 also prohibits restrictive trade practices, including practices substantially lessening competition and taking advantage of market power.
- Consumer Guarantees Act 1993 – protects consumers by setting minimum guarantees for

goods and services, including requiring services to be provided with reasonable care and skill.

- Fair Trading Act 1986 – protects consumers against misleading and unfair trade practices, requires certain information be disclosed, and promotes product safety.

What would happen under the status quo if no action were taken?

Without economic regulation and consumer protection mechanisms, the generic competition and consumer law framework would apply. Therefore, under the status quo, the three waters system is likely to be characterised by the following issues that are typical of natural monopolies:

- consumers will have no alternative suppliers, and so the entities would be able to charge unjustifiably high prices or provide levels of service quality below consumer expectations
- the entities would face weak incentives to be efficient and innovative, as regards:
 - operating and maintaining assets cost efficiently
 - ensuring that networks are resilient, and services are reliable
 - investing in the assets needed to close the infrastructure gap.

The weakness of incentives may be particularly pronounced given the Boards of the entities will not face the usual equity market disciplines nor strong pressures from elected Councillors. The inherent power and resource imbalance between large utility providers and consumers may also lead to consumer harm in some instances.

Therefore, sector-specific economic regulation and consumer protection will complement Taumata Arowai's powers by overseeing the resilience of network assets and focussing more broadly on consumer harm. This includes the harms caused by network outages and faults, issues with flow or pressure rates, billing practices that lack transparency, insufficient communications or engagement with consumers, and inadequate treatment of consumers experiencing hardship.

1.2 What is the policy problem or opportunity?

Problem definition

The establishment of four financially and operationally independent water services entities is intended to address current problems related to poor water quality and customer service, insufficient infrastructure investment and inefficient pricing practices. Given that the new entities are natural monopolies delivering essential services in each of their areas, the Government has already agreed that a regulatory regime is required to realise efficiencies and protect consumers.

Without a fit-for-purpose economic regulation and consumer protection regime, the potential consumer outcomes (in terms of factors such as price, service quality, infrastructure resilience and network reliability) could be worse than under the current system. This would undermine the outcomes that the reforms are intended to achieve, particularly given the loss of existing accountability through elected territorial authorities.

Furthermore, as the entities will need to rectify past under-investment, but will be prohibited from paying dividends and will be unable to access equity capital, the entities will rely heavily on debt markets to finance their investment in infrastructure. In the absence of economic regulation, credit rating agencies and debt markets would lack certainty about the risk associated with these entities, which could affect the entities' ability to obtain finance.

Issues for design of an economic regulation and consumer protection

regime

Overarching issue

Issue 1: Protecting consumer interests in monopoly markets

Without economic regulation, the monopoly nature of the entities, combined with the lack of equity market and local government oversight, will likely be detrimental to consumer welfare. This is because entities will have the ability and incentive to charge higher prices and provide services that are lower quality and less efficient and innovative than what would be seen in a workably competitive market. There is also an inherent power imbalance between large, vertically integrated monopoly suppliers and the consumers they service, creating a risk that customers of the four new entities will suffer unsatisfactory outcomes.

Implementation design issues

If the overarching issue is addressed through a sector-specific economic regulation and consumer protection regime (as we recommend later in this RIS,) there are several detailed design issues that will need to be addressed. These issues are set out below.

Issue 2: Scope of purpose statement for regulation

In the absence of a clear and well-designed purpose statement, the regulator may not take relevant issues into consideration in its decision-making processes and courts may face difficulty in interpreting and applying the provisions of the Act.

Whilst all new legislation needs a purpose statement, the wording of this purpose statement is particularly important in economic regulation regimes because these regimes tend to devolve a lot of decision-making power to the regulator. A purpose statement will need to recognise:

- there are unique characteristics of the water sector compared to other regulated sectors
- the lack of financial incentives, with no requirement for a return to owners on capital.

The purpose statement may also have to recognise the broader objectives of the regime, such as climate change resilience and the unique importance of water to Māori.

Issue 3: Scope of economic regulation and consumer protection

Without clear scope for the regime, the regulator may target areas that were not intended to be addressed, leading to undue costs for consumers and compliance burden for suppliers.

Issue 4: Initial forms of economic regulation

Without clarity regarding the initial form of economic regulation, regulated suppliers will be unable to prepare effectively for regulation, and interested parties such as consumers, debt markets and credit rating agencies will be unable to predict the impact of regulation.

Issue 5: Provision of a minimum service level code

Without a service level code, suppliers would not have to meet minimum service levels in matters such as customer service, billing, and communication about network outages. International and domestic experience suggests that minimum service level requirements, if appropriately drafted and targeted, can improve aspects of service quality that can be otherwise difficult for consumers or the regulator to address.

Issue 6: Provision of expert advocacy body

Without mechanisms to strengthen the consumer voice, consumers will struggle to engage with large monopoly utility providers, communicate their expectations, and hold them to account.

Barriers to participation include:

- some of the issues that affect consumer welfare are highly technical and difficult for consumers to express clear views on
- consumers often lack the time and resources to get involved in decision-making processes.

Issue 7: Consumer dispute resolution

At present, water services are provided to most New Zealanders by their local council. If consumers encounter issues with their water supply, they can often escalate these to their elected representatives. These local democracy safeguards will fall away under the reformed three waters system. Without a consumer disputes mechanism, consumers will have no viable avenue for resolving complaints that cannot be resolved directly by their service provider.

Stakeholder views

On 27 October 2021, MBIE released a discussion paper for public consultation titled *Economic Regulation and Consumer Protection for Three Waters Services in New Zealand (the discussion paper)*. MBIE received 53 submissions from local government, industry bodies, dispute resolution schemes, iwi/Māori groups, and consumer advocates.

Overall, submitters agreed an economic regulation regime was needed to protect consumers from problems associated with natural monopoly suppliers. Submitters also agreed that additional consumer protections were warranted for the three waters sector, and that the regime should be aimed at ensuring high quality services and transparency. Submitters emphasised the importance of managing regulatory overlap, given the economic and consumer protection regime will interface with entities such as Taumata Arowai, the new drinking water safety regulator.

Several submitters requested to meet with us to discuss their submission in more depth, and so we scheduled meetings with those submitters. This included Hamilton City council, the Institute of Public Works Engineering Australasia (IPWEA), National Iwi Chairs Forum: Fresh Water Iwi Leaders Forum, Ngāi Tahu, Ngātiwai, Richard Taylor (Thomas Consultants), Tame Te Rangi (Chair of the Mana Whenua Kaitiaki Mangers Group), Utilities Disputes Ltd, Waikato-Tainui, Water NZ, and Wellington councils. We also consulted a panel of international experts on economic regulation.

Submitter views on the policy options discussed below can be summarised as follows:

- **Protecting consumers in monopoly markets** – In general, submitters supported our proposals, and largely agreed on the need for economic regulation and consumer protection in the three waters sector.
- **Scope of purpose statement for economic regulation** – Submitters agreed the statutory objectives of the economic regulation regime should be similar to the purpose statements underpinning energy, airports, and fibre regulation, but adapted to recognise the unique characteristics of the water sector. Several iwi/Māori groups, as well as other stakeholders, emphasised the importance of reflecting Te Tiriti in legislation, as well as recognising cultural, social, and environmental issues such as Te Mana o Te Wai and climate change.

- **Scope of economic regulation and consumer protection** – Submitters agreed economic regulation should be applied to all three waters. Some submitters noted there were additional complexities associated with regulating storm water networks. Most submitters agreed only the four entities should be economically regulated and the consumer protection regime should apply to all water service providers above a certain number of customers.
- **Initial form of economic regulation** – Submitters agreed information disclosure and price-quality regulation were necessary given the natural monopoly characteristics of the sector and the need for investment and transparency. However, several submitters, including the Commerce Commission (the Commission), questioned the appropriateness of applying price-quality regulation to entities given the lack of profit motive.
- **Provision of a minimum service level code** – Submitters agreed the regulator should be able to prescribe mandatory minimum service level codes to ensure consumers receive a satisfactory level of service from suppliers. Most submitters agreed minimum service level requirements should be able to vary across different types of consumers to recognise the needs of vulnerable consumers, and urban and rural communities.
- **Options to strengthen the consumer voice** – Submitters agreed there is a need to strengthen the consumer voice in the three waters sector. This includes the need to create an expert advocacy body that can advocate technical issues on behalf of consumers, as well as a dedicated three waters consumer disputes resolution scheme.

1.3 What objectives are sought in relation to the policy problem?

The overall objective for economic regulation and consumer protection of the water sector is to deliver long-term benefits for consumers of three waters services within New Zealand. To support this overall objective, a robust regulatory regime will aim to achieve the following outcomes:

- **Efficiency:** Provision of waters services at the lowest possible long-run cost, with entities incentivised to invest efficiently in three waters infrastructure, and pricing practices that reflect the costs of delivering three waters services. Efficiency is the most important outcome that the options in this RIA aim to achieve, as realising substantial efficiency gains is one of the key drivers of the reforms.
- **Quality:** Provision of water services that meet community expectations and consumer preferences. Quality is the second most important outcome that the options in this RIS aim to drive. The new water regulator Taumata Arowai will be the primary agency responsible for water quality from a public health and safety perspective. Economic regulation and consumer protection will complement water quality regulation to ensure networks are resilient and service delivery meets consumer expectations.
- **Transparency and accountability:** Entities engage effectively with the consumers and communities they service. Billing practices are transparent and easy to understand, and consumers have confidence that the prices they are paying are justified. Consumers understand the relative performance of their suppliers and can hold suppliers to account through their consumer engagement activities. Transparency and accountability are the third most important outcomes in this RIS.
- **Price stability:** Consumers do not experience significant or unexpected price shocks. This outcome is particularly important given:

- all New Zealanders need to be able to access water services but do not have choice of supplier
- the amount of investment that needs to be undertaken to address the current infrastructure deficit, and the risk of this resulting in large price increases.

While price stability is an important outcome for the overall reform, it is the least important outcome for the economic regulation and consumer protection regime. Other aspects of the three waters regulatory system will aim to support price stability and affordability for consumers (see the Minister of Local Government's Cabinet paper, *Pricing and Charging for Three Waters Services*). While economic regulation can smooth aggregate price shocks, it has little control over the prices faced by individual consumers, as suppliers are largely free to choose their pricing structures within the overall revenue cap set by the regulator.

At times there will be natural tensions between different outcomes. For example:

- between price stability and efficiency, since actions taken to stabilise prices can result in prices that do not reflect the efficient cost of production
- between price stability and quality, since efforts to keep prices at a certain level can limit regulated suppliers' ability to improve quality.

Because the primary objective sought by the economic regulation and consumer protection regime is efficiency improvements, this has taken precedence where conflicts occur in the options analysed below.

Section 2: Deciding upon an option to address the policy problem

2.1 What criteria will be used to evaluate against the status quo?

The following criteria will be used to assess the effectiveness of policy options in the context of the desired outcomes of the regime listed above:

- **Effectiveness:** The potential for each policy option to drive the outcomes.
- **Practicality:** The cost and simplicity of each policy option.
- **Certainty:** The potential for each policy option to allow stakeholders to predict how regulation will apply, so they can prepare for how that regulation might affect them.
- **Flexibility:** The extent to which each policy option allows the regime to adapt to changes in the sector. Flexibility is important given the complexities involved in establishing the entities, and the fact that economic regulation has not previously applied to the sector.
- **Regulatory coherence:** The extent to which each policy option enables the regime to provide appropriate levels of regulatory scrutiny and guidance while also ensuring that the overall three waters regulatory system is cohesive and delivers the reform objectives.

Given the importance of designing a regime that drives the outcomes listed in section 1.3, effectiveness will be weighted twice as heavily as other criteria, with the remaining criteria having equal weighting. There are trade-offs to be made in weighing up the options against criteria, e.g. natural tension between flexibility and certainty.

2.2 What scope will options be considered within?

The following sections analyse options to address issues at two levels:

- *Overarching issue (issue 1):* The options analysis discusses the benefits of having economic regulation and consumer protection in place versus the status quo approach of relying on existing competition and consumer law (i.e. it is not a comparison with having no regulation).
- *Implementation design issues (issues 2 to 7):* The options here cover a range of specific implementation aspects. These options were informed by current approaches used in other sectors in New Zealand, as well as approaches used in the water sector in other jurisdictions.

In our discussion paper, we set out a wide range of regulatory and non-regulatory options for designing the new regime. Because most submitters supported our preliminary positions, all of which focused on regulatory options, we have not undertaken further analysis of non-regulatory options. The options we did not consider are set out in Section 3.3.

There are also several options we did not favour in the discussion paper, but that we have now given further consideration due to convincing arguments made by submitters. For example:

- We did not include a detailed analysis of quality-only regulation in the discussion paper. However, following submissions on the risks of imposing price-quality regulation on not-for-profit firms, we have considered this option further.
- In the discussion paper, we favoured a simple approach to setting the objectives of the new

regime, based on Part 4 of the Commerce Act and Part 6 of the Telecommunications Act 2001 (which provides for the regulation of fibre fixed line access services), rather than including broader objectives regarding climate change, Te Tiriti and Te Mana o Te Wai. However, following submissions from and consultation with iwi/Māori and other stakeholders, we have considered this option further.

The options we analysed have also been informed through engagement with other agencies working on the Three Waters reforms, particularly DIA. As mentioned above, the Minister of Local Government is making several proposals regarding pricing and charging, protections for vulnerable consumers, and customer agreements, that will complement economic regulation and consumer protection. As such, we have not considered options that would duplicate proposals already put forward by the Minister of Local Government.

2.3 Description and analysis of options

Issue 1: Protecting consumers from harm in monopoly markets

- Option A: Rely on existing competition and consumer law (status quo).
- Option B: Implement a sector-specific economic regulation and consumer protection regime for three waters.

Description of options

Economic regulation refers to the use of regulation to protect consumers from the problems that can occur in markets with little or no competition, including where businesses have a large amount of market power. Consumer interests are protected because economic regulation mimics the role of competition, thereby changing the incentives faced by businesses, so that businesses behave in a manner similar to what might be seen in a more competitive market.

Consumer protection refers to rules that aim to safeguard the interests of consumers against market practices that are inconsistent with consumer welfare. Utilities retail businesses can struggle to provide the levels of customer service consumers expect. For example, there have been issues in the retail telecommunications sector with customer service, fault service levels, and billing. Sector-specific regulation in the form of Part 7 of the Telecommunications Act was brought in to remedy these issues.

Option A – Rely on existing competition and consumer law (status quo)

Existing competition law is set out in the Commerce Act. This could involve the Commission taking any action it deemed necessary against the entities for restrictive trade practices, as set out in Part 2 of the Act, such as practices substantially lessening competition (section 27) or taking advantage of market power (section 36). These sections apply to all businesses rather than specific industries. Alternatively, the Commission could undertake a Part 4 inquiry into the level of competition in the water sector (sections 52K-52H) which could result in the Minister recommending an Order in Council imposing economic regulation on three waters services (sections 52L-52O).

It would also involve relying on New Zealand's generic consumer protection law. The Consumer Guarantees Act protects consumers by allowing them to seek repairs, replacements, or refunds when goods are faulty, and setting minimum guarantees for all products and services. The Fair Trading Act exists to ensure the interests of consumers are protected, businesses compete effectively, and consumers and businesses participate in markets confidently.

Option B - Implement a sector-specific economic regulation and consumer protection regime for

three waters

This would involve implementing some combination of information disclosure that allows the performance of entities to be easily compared, and regulatory controls on the price and quality of services delivered to consumers. This is the approach used in other regulated monopoly sectors in New Zealand and other jurisdictions. It would also involve implementing sector-specific consumer protection mechanisms to ensure the vertically integrated nature of the entities does not lead to consumer harm. This could involve providing for a minimum service level code and measures to strengthen the consumer voice, as discussed below.

Analysis of options

Given the natural monopoly characteristics of the entities, relying on the restrictive trade practices provisions in Part 2 of the Commerce Act would not be effective in driving the objectives set out above. Part 2 deals with conduct that substantially lessens competition, and competition cannot be lessened where none exists to begin with. Generic consumer law also does not recognise the fact that water is not something people can do without. In addition, generic competition and consumer law does not provide stakeholders (including consumers) with the same level of certainty as sector-specific regime would, given it is reactive rather than proactive.

In terms of the inquiry mechanism under Part 4 of the Commerce Act, the Commission would have to expend significant resources analysing the level of competition in the three waters sector before making a recommendation to the Minister. This is a less practical option than imposing economic regulation from the outset.

The benefits of sector-specific economic regulation and consumer protection legislation are:

- It allows the legislation to be designed in a way that reflects the unique characteristics of the entities compared with other monopoly businesses regulated under Part 4 and generic consumer law, particularly that the entities will be publicly owned and unable to pay dividends. Certain regulatory approaches used under Part 4 may not be effective or practical when applied to the entities, given they will operate differently and face different incentives to other regulated businesses. For example, Part 4 and generic consumer law do not go far enough in reflecting cultural and environmental concerns, which are highly important in the water sector compared with other utilities sectors.
- It would better reflect the reform objectives, particularly regarding efficiency. For example, Part 4 does not allow for comparative benchmarking, which will be a key tool in driving efficiency of the entities. The new regime could also include tools such as performance requirements that are broader than the Part 4 approach of setting quality standards. The regime could also reflect the entities' inability to pay dividends by allowing the regulator to 'ring-fence' a portion of an entity's allowable return that would then be held in reserve in case of any unexpected investment requirements. This would ensure entities have the minimum required level of cash to finance their operations, and that they spend this cash efficiently.
- It would allow the regulator to consult with consumers about the issues that are most important to them, then set and enforce performance requirements, quality standards and minimum service levels for these issues.

Issue 1: How do the options compare to the status quo?

	Option A: Rely on existing competition law (status quo)	Option B: Implement a sector-specific economic regulation regime for three waters
Effectiveness (double weighting)	0 Existing competition and consumer law is unlikely to be effective in curbing the consumer harm associated with vertically integrated natural monopolies. Regulating water via Part 4 would not allow the regime to recognise the differences between the new water entities and other utility providers.	+ Moderately effective. Sector-specific economic regulation regimes have a proven track record in driving price stability, efficiency, quality, transparency and accountability. This option is more effective than the status quo as existing generic competition and consumer law, but is likely to be only slightly more effective than water regulation implemented via Part 4. Sector-specific consumer law would be more effective than the status quo option at targeting specific types of consumer harm, strengthening the consumer voice, and promoting quality, transparency, and accountability.
Practicality	0 While relying on existing competition and consumer law would not involve a complex implementation process, a Part 4 inquiry is a lengthy process.	+ Moderately difficult to implement given the need to enact new legislation, but more effective than the status quo option given it does not require a lengthy inquiry process as would be required under Part 4 of the Commerce Act.
Certainty	0 Relying on existing competition and consumer would not give stakeholders any certainty as it contains reactive measures. Conducting a Part 4 inquiry into the water sector would create uncertainty about when and how the sector would be regulated.	++ Will give stakeholders a significant amount of certainty on how regulation will apply since the regulator will be consulting on regulatory approaches under a bespoke regime, rather than first conducting a lengthy inquiry then attempting to apply Part 4 to the sector. Significantly more certainty provided than relying on the reactive provisions in existing competition and consumer law, since these would be used in an ad hoc fashion.
Flexibility	0 Relying on existing competition and consumer law measures does not promote flexibility as these are already enshrined in legislation and cannot easily be tailored to the water sector, since they were intended to apply to all sectors.	+ Moderately flexible compared with the status quo in that a broader range of regulatory tools than what is available under generic competition and consumer law, as well as Part 4, will be included in the regime to reflect the unique nature of the water industry. The regulator will have more scope to ensure it targets areas where the most consumer harm is likely to occur.
Regulatory coherence	0 Existing competition and consumer law does not reflect the wider reform objectives, including cultural and environmental objectives.	++ Could complement requirements in the wider system relating to Te Tiriti and Te Mana o te Wai. This option is much more likely to promote regulatory coherence than the status quo since the regime will be designed to reflect the unique characteristics of the water industry, and to complement existing governance and accountability mechanisms, as well as consumer protection mechanisms such as requirements for consumer consultation and customer agreements.
Overall assessment	0	7

Issue 2: Scope of purpose statement for economic regulation

- Option A: Purpose statement with no additional objectives
- Option B: Purpose statement with additional objectives relating to obligations in respect of Te Tiriti, Te Mana o te Wai and Treaty settlements.

For this issue, we have assumed economic regulation will be implemented. We have also treated option A as the status quo since all new legislation must have a purpose statement, and the purpose of new economic regulation legislation tends to be based on the purpose statement of Part 4 of the Commerce Act (e.g. the purpose of Part 6 of the Telecommunications Act).

Description of options

Having a clear purpose for economic regulation and consumer protection legislation guides regulatory decision-making and helps stakeholders understand the objectives of regulation. Existing economic regulation in New Zealand, including Part 4 of the Commerce Act and Part 6 of the Telecommunications Act, aim to promote the long-term benefit of consumers by driving outcomes that are consistent with outcomes produced in competitive markets. This includes incentivising suppliers to innovate and invest, improve efficiency, provide services of a quality that consumers demand, share the benefits of efficiency gains with consumers (including through lower prices), as well as ensuring suppliers are limited in their ability to extract excess profits.

Consumer protection regimes tend to focus on protecting the interests of consumers and promoting fair conduct. While the precise wording in other jurisdictions will vary, overseas jurisdictions invariably employ the same focus on consumer interests. Our view is that the purpose of the consumer protection regime for water should be improved service quality to reflect the demands of three waters consumers.

Our view is that the purpose statement for any economic regulation regime that applies to the water sector should be as close as possible to the purpose statements contained in Part 6 and Part 4 given their interpretation has been thoroughly tested through numerous judicial and merits review processes. These regulatory regimes are well understood by capital markets and ratings agencies, which could make it easier for entities to raise a financially sustainable level of debt capital to fund their investment in infrastructure.

However, there are unique characteristics of the water sector compared to other regulated sectors, in that water is not a commodity but rather an essential service. The purpose statement could recognise the lack of profit motive these entities will face, meaning 'profit' could be more accurately described as a return to cover the cost of debt. The purpose statement could also reflect the risk of any efficiency gains that are not shared with consumers through lower prices going back into the businesses, e.g. through higher salaries.

Given the clear benefits of including a purpose statement relating to the long-term benefit of consumers, the question then becomes whether additional objectives are required. Given the breadth of the Government's Three Waters Reform objectives, it may be necessary for the economic regulator to have regard to a broader range of objectives. For example, one of the reform objectives is to address the impacts of climate change and ensure the resilience of water services. This could be reflected by including a specific objective in the regime requiring the regulator to consider climate change mitigation and adaptation proposals by the entities.

While other economic regulation regimes, such as those applying to electricity and

telecommunications, have not included specific objectives, water is unique in its importance to Māori. Option B would require decision makers (such as the regulator and Ministers) to recognise and enable the entities' obligations with respect to Te Tiriti, Te Mana o te Wai, and Treaty settlements, as set out in legislation, Te Mana o te Wai statements, and other legislative instruments. Specifically:

- The courts have said that the principles of Te Tiriti include reciprocity, active protection, partnership, equity, and equal treatment.
- Te Mana o te Wai is a concept that refers to the fundamental importance of water and recognises that protecting the health of water protects the mauri of the wai and the health and wellbeing of the wider environment and communities.
- The entities will be taking on Treaty settlement obligations from territorial authorities.

Including this objective would require decision makers to assess costs and processes relating to these obligations, since these obligations may require the entities to spend more than would typically be deemed economically efficient by a regulator.

Analysis of options

The main benefit of Option A over Option B is its practicality, since a regulator that is focussed on the commercial and consumer aspects of infrastructure regulation may be best placed to focus solely on those aspects. It could also be argued that this option would favour regulatory coherence; given Taumata Arowai's focus on Te Mana o te Wai, it may be preferable that the economic and consumer protection regulator does not stray into making decisions related to this issue. In addition, it could be argued that ensuring entities are able to fulfil their obligations in respect of Te Tiriti, Te Mana o te Wai and Treaty settlements will fall within the overarching objective of promoting the long-term interests of consumers, thus dampening the benefits of Option B over Option A.

The main benefit of Option B over Option A is that it provides a clear mandate to the regulator as to how they must consider climate change, as well as obligations in respect of Te Tiriti, Te Mana o te Wai and Treaty settlements, which will help build Crown-Māori relations. Having this clear mandate also provides stakeholders, particularly the entities, with the certainty they need to plan for future expenditure. It could also be argued that Option B promotes regulatory coherence by ensuring the economic and consumer protection regulator has a common set of objectives with other players in the regulatory system, such as Taumata Arowai, in upholding Te Mana o te Wai and considering the environmental impacts of water services.

Issue 2: How do the options compare to the counterfactual?

	Option A: Purpose statement with no additional objectives (counterfactual)	Option B: Purpose statement with additional objectives relating to obligations in respect of climate change, Te Tiriti, Te Mana o te Wai and Treaty settlements
Effectiveness (double weighting)	0 Highly effective at enabling economic regulation to drive outcomes relating to price stability, efficiency, and quality; moderately effective at promoting transparency and accountability in relation to entities' wider obligations.	+ Highly effective at enabling economic regulation to drive outcomes relating to price stability, efficiency, quality. More effective at promoting transparency and accountability than option A due to additional obligations being explicitly included in the objectives of the regime.
Practicality	0 Very simple to implement as the Part 4 precedent has been thoroughly tested through the courts.	- Simple to implement the main purpose, but there may be some difficulty for the regulator in balancing this against the other considerations given there may be some natural conflicts between economic efficiency and other objectives.
Certainty	0 Would give stakeholders certainty as to how regulation will apply, in that it will be based on the Part 4 approach. The Part 4 purpose is well understood by stakeholders, including rating agencies.	+ Stakeholders will have certainty as to how the main purpose will apply since it is based on the Part 4 approach. Stakeholders, including the entities themselves, will also have visibility over how other important considerations will be dealt with.
Flexibility	0 Regulator must focus its regulatory decision-making on achieving the outcomes set out under the Part 4 purpose statement, is limited in its ability to consider other objectives.	+ Regulator has the flexibility to consider a wider set of objectives compared with option A.
Regulatory coherence	0 The role of the economic regulator is clear but there may be issues in ensuring its approach aligns with the wider three waters regulatory system, given obligations in other parts of the system relating to cultural and environmental factors.	+ Could complement accountability mechanisms in the wider three waters regulatory system by ensuring the regulator is required to recognise cultural and environmental obligations set out in the wider system.
Overall assessment	0	3

Issue 3: Scope of economic regulation and consumer protection

- Option A: Include only the entities in the economic regulation and consumer protection regime.
- Option B: Include only the entities in the economic regulation regime, but some smaller suppliers in the consumer protection regime.

For this issue, we have assumed sector-specific economic regulation and consumer protection will be applied to the three waters sector. We have treated option A as the counterfactual, since the status quo option of relying on existing competition and consumer law has already been analysed above and is not particularly relevant to the issue of scope.

Description of options

The four new entities will provide water services to approximately 4.3 million New Zealanders, or around 85 per cent of the population. Each of the entities will serve populations of between 800,000 to 1,700,000 consumers and have the natural monopoly characteristics that are present in the current service delivery arrangements. While the governance arrangements and consumer engagement requirements will ensure that consumer voices are heard by the entities, the scale of the entities and the absence of competition means there are still significant risks that the entities do not act in the long-term interests of consumers.

Given the clear benefits in subjecting the entities to economic regulation and consumer protection, the question then becomes whether the regime should also apply to smaller suppliers. 15 percent of the population will continue to be served by small community, private schemes or self-suppliers, the majority of which serve less than 5,000 consumers. Specifically:

- No private or community drinking water schemes that serve more than 10,000 consumers would fall outside the coverage of the new entities.
- Only two private/community drinking water schemes service between 5,001 and 10,000 consumers. These two schemes belong to Massey University and Christchurch International Airport and are perhaps better described as self-suppliers given that they are highly unlikely to provide drinking water to downstream consumers.
- There are only eight private/community drinking water schemes service between 501 and 5,000 consumers. Of these eight, five are New Zealand Defence Force bases, with the other three being in Opaki in the Wairarapa, Doubtless Bay in Northland, and Milford Sound in Fiordland.

Analysis of options

Given that the purpose of economic regulation and consumer protection is to promote the interests of consumers, small non-entities suppliers should only be economically regulated if the benefits of economic regulation exceed the costs. Coming to a view on whether economic regulation is likely to result in net benefits or net costs requires consideration of the following factors:

- The practicality of imposing the administrative and compliance costs involved in economic regulation and consumer protection. International and New Zealand experience suggests it is unlikely to be economically viable to regulate small entities, particularly entities that service fewer than 10,000 water consumers.
- Ability of consumers to influence the strategic direction, investment intentions, prices, and

quality of service of a supplier. If consumers have the power and resources to influence their suppliers, this can render economic regulation and consumer protection unnecessary.

- The potential effectiveness of the economic regulation and consumer protection regime. In general, regulation tends to be more effective the smaller the number of firms that are regulated. Most economic regulation regimes apply to fewer than 15 suppliers. However, general consumer protection tends to apply to the entire economy, and sector-specific consumer protection mechanisms tend to apply to many suppliers.

Our view, which was supported by submitters, is that it would be difficult to justify the heavy compliance burden of applying economic regulation to small private suppliers. These suppliers are unlikely to be capable of complying with economic regulatory obligations, and any benefits from applying economic regulation would likely be small given the owners and consumers are likely to be the same people. The costs and benefits of imposing consumer protection regulation on smaller suppliers are more finely balanced, given these requirements will likely be more light-handed than economic regulation, and the fact that even smaller suppliers often struggle to respond to consumer demands.

International approaches to the application of consumer protection frameworks in water (and other utilities) markets vary. In Australia, some states (e.g. Victoria) have limited the application of their minimum service standards to certain customers or water suppliers, while other states (e.g. Western Australia) apply the same consumer protection standards across all water suppliers, irrespective of their size or location.

In terms of practicality, there are concerns about the compliance burden of the consumer protection regime being heavy for small suppliers. It could be the case that these suppliers are not capable of complying with their consumer protection regulatory obligations, for example they may be too small to employ the necessary expertise or lack the financial resources to upgrade their systems.

In terms of the effectiveness or necessity of including small schemes in the consumer protection regime, it could be argued that there is often a significant degree of overlap between the owners and consumers of these suppliers. This results in consumers having a stronger voice than would be the case for larger suppliers, e.g. entities' customers.

Issue 3: How do the options compare to the counterfactual?

	Option A: Include only the entities in the economic regulation and consumer protection regime (counterfactual)	Option B: Include only the entities in the economic regulation regime, but some smaller suppliers in the consumer protection regime
Effectiveness (double weighting)	0 Highly effective at driving price stability, efficiency, quality, transparency, and accountability by only including those suppliers who are best equipped to achieve these outcomes.	- Moderately effective at driving price stability, efficiency, quality, transparency and accountability, some difficulties in driving these outcomes in smaller suppliers.
Practicality	0 Moderately practical to apply regulation to entities in that there is always some difficulty in ensuring regulated suppliers understand requirements, but these larger entities will have the resources to build this capability.	- Moderately practical to apply regulation to large entities, impractical to apply regulation to smaller suppliers since they lack the resources required to build capability in understanding and complying with complex requirements.
Certainty	0 Would give entities a great deal of certainty as to how regulation will apply, certainty for smaller suppliers that they will not initially be included in the regime, but some uncertainty as to if and when they might be brought in.	0 Would give entities a great deal of certainty about how regulation will apply, and uncertainty for smaller suppliers in coming up to speed with these extensive requirements without the resources required to build capability.
Flexibility	0 Regime allows for regulation to adapt and bring in smaller suppliers, if necessary, e.g. if it becomes clear it would be in the best interests of consumers.	- Some flexibility in that while smaller suppliers must be included in the regime initially, the regulator can recommend they be deregulated in future. The regulator could employ different regulatory approaches depending on the size and capability of entities.
Regulatory coherence	0 Would complement the wider three waters regulatory system by focusing economic regulation on large monopoly suppliers where the biggest scope for efficiency gains lies.	0 Would complement wider three waters regulatory system by ensuring a wider range of consumers are protected from harmful practices.
Overall assessment	0	- 3

Key:

++ much better than the counterfactual + better than the counterfactual 0 about the same as the counterfactual - worse than the counterfactual -- much worse than the status quo

Issue 4: Initial forms of economic regulation

- Option A: Implement information disclosure initially but allow for quality-only and price-quality regulation in future.
- Option B: Implement information disclosure and quality-only regulation initially but allow for price-quality regulation in the future.
- Option C: Implement information disclosure and price-quality regulation initially but allow for quality-only regulation in future.

Under all proposed options above, we consider the regulator should be able to conduct reviews and make recommendations to the Minister as to how regulation should apply in future periods. This ensures any future regulation is fit for purpose and the risks of unintended consequences are minimised. This is discussed further in section 4.2: Monitoring and Evaluation.

For this issue, we have treated option A as the counterfactual, since it is generally considered the bare minimum level of economic regulation, and the status quo option of relying on existing competition law has already been analysed above.

Description of options

As mentioned above, economic regulation regimes in New Zealand typically employ some form of:

- Information disclosure, which generally requires regulated suppliers to publicly disclose information to make them more accountable to customers and stakeholders. It promotes transparency by shining a light on the performance of regulated suppliers, which in turn can incentivise performance improvements by benchmarking regulated suppliers against each other. It can also provide valuable information to the owners/governors of businesses.
- Quality-only regulation involves the regulator setting quality standards without an accompanying price path. This can be a preferable option to price-quality regulation when regulated suppliers do not face strong incentives to charge excessive prices, as may be the case in the water sector given the entities' lack of profit motive.
- Price-quality regulation involves directly regulating the prices charged or revenue earned, as well as the quality of service provided, by regulated entities. In other utility sectors in New Zealand, price-quality regulation tends to take the form of a revenue cap, which is often achieved by summing costs to give a regulated maximum allowable revenue each year. Price-quality regulation can allow the regulator to drive efficient expenditure and smooth price shocks over time.

Application of information disclosure as a minimum

In the context of three waters, information disclosure will be crucial in addressing the lack of information about the current performance and investment activities of suppliers. As such, we have assumed information disclosure will apply at a minimum to the entities, consistent with Cabinet's in-principle decision. However, given that information disclosure alone may not be fully effective, we propose the regime should also allow for stronger forms of regulation such as price-quality or quality-only being brought in in the future. This would allow for flexibility in the regime, so that the regulator could adapt its approach to changes, for example, in the commercial or regulatory environment. The question then becomes what form, or combination, of economic regulation should apply from the outset of the regime.

Analysis of options

Several economically regulated suppliers are subject to information disclosure only, such as small community-owned electricity distribution businesses and international airports (Option 1). However, given the small scale of these suppliers (in the electricity sector) and potential for regional competition (in the airport sector) these likely have weaker natural monopoly characteristics than the water sector.

Given the strong focus of the Three Waters Reforms on ensuring water services meet customer demands, and that entities manage networks efficiently and deliver services that are reliable, some form of quality regulation is likely to be necessary (Option B or C).

The benefits of Option B (quality-only) can be summarised as follows:

- The Minister of Local Government proposes to regulate the rate of price increases to mitigate the risk of price shocks as the entities are established. These proposals are likely to be more effective at achieving short-term price stability than a revenue cap in the first few years of the reformed system.
- The lack of robust information in the sector means that, during the establishment phase, the entities will still be discovering their cost structures and the state of their assets. It is unlikely the regulator will know enough in the first period about the entities' costs and assets to mitigate inefficiencies via price-quality regulation, which would undermine the effectiveness of regulatory decisions.
- Given the poor state of information, a revenue cap presents risks of unintended consequences. If allowable revenues are set too low, the entities may be unable to undertake substantial upfront investment or to obtain debt on appropriate terms.
- The inability to pay dividends means there is a risk that price-quality regulation would not be as effective as it would be when applied to profit-maximising monopoly businesses. This is because, unlike entities with a profit motive, there is little incentive to reduce their costs. However, experience regulating water services suggests that price-quality regulation can be a highly effective tool even where water suppliers are publicly owned and/or unable to pay dividends, especially if the regulated entities also face reputational incentives.
- The new entities will be subject to a large range of governance and accountability requirements, as well as regulation enforced by Taumata Arowai. Imposing price-quality regulation on top of this may have practical implications for the entities in terms of navigating these regulatory responsibilities.

The benefits of Option C (price-quality) can be summarised as follows:

- Given the significant amount needed to address the current infrastructure deficit, price-quality regulation can help by capping revenue, and scrutinising expenditure, to ensure these are in the long-term interests of consumers.
- In terms of price stability, price-quality regulation could help ensure that revenue is smoothed out over the lifetime of the asset so that consumers do not face price shocks as the entities undertake the significant investment necessary to address the infrastructure deficit.
- In terms of efficiency, in the absence of price-quality regulation, the entities may not face

strong enough incentives to minimise the cost of production. They could therefore be tempted to spend inefficiently to satisfy the performance requirements set by the regulator.

- Price-quality regulation would allow the regulator to 'ring-fence' a portion of entities' allowable return that would then be held in reserve in case of any unexpected investment requirements. This is particularly important given the inability to pay dividends could result in significant free cash flows being available within the businesses.
- In terms of transparency, price-quality regulation gives consumers confidence that the prices they pay are justified, since it would involve the regulator scrutinising the entities' efficient costs and expenditure proposals.

Option B avoids potentially implementing a regulatory regime that is not fit for purpose and mitigates against the unintended consequences that could occur as a result. However, because all the options include a proposed review by the regulator to recommend the most appropriate regulatory regime, the risk of any regulatory regime not being fit for purpose is minimised.

Under Option B, it is our intention that there would be a presumption of a move to price-quality regulation from the second regulatory period. Therefore, the entities and all other stakeholders would know in advance the likely direction of travel. This will set expectations and drive the benefits of Option B, with the flexibility of the presumption (as opposed to a mandated move) providing a safety valve if price-quality is not fit for purpose.

Issue 4: How do the options compare to the counterfactual?

	Option A: Information disclosure only (counterfactual)	Option B: Information disclosure and quality-only regulation	Option C: Information disclosure and price-quality regulation
Effectiveness (double weighting)	0 Moderately effective at driving quality and efficiency; highly effective at driving transparency and accountability. Ineffective at driving price stability.	+	0 Highly effective at driving quality and efficiency, transparency, and accountability; moderately effective at driving price stability. Risk of incorrect regulatory settings, risk of undermining initial pricing measures.
Practicality	0 Simple to implement, risk of remedial work needed in future periods given the lack of oversight of efficiency and quality when entities are only subject to publication requirements.	-	- Complex and expensive to implement as it requires the regulator to undertake extensive stakeholder consultation. There is also risk of insufficient information being available initially about costs and assets in the sector to allow the regulator to determine the correct regulatory settings.
Certainty	0 Would give stakeholders some insight into how regulation will apply but would not give consumers much certainty that the prices they pay for water services are justified.	0 Entities could predict the effects of regulation, but consumers would not have much certainty that the prices they pay for water services are justified.	+
Flexibility	0 Regulatory tools would be limited to those available within information disclosure, the regulator would be limited in its ability to apply stricter regulatory settings in response to unsatisfactory outcomes.	+	+
Regulatory coherence	0 Limited in its ability to drive the outcomes stronger forms of economic regulation can drive so not as strong a complement to accountability mechanisms in the wider system as other options.	+	0 Could complement accountability mechanisms in the wider system, particularly Taumata Arowai's remit by targeting issues with network quality. Risk of accountability overload given the extensive requirements in the wider system, including initial measures to mitigate price shocks.
Overall assessment	0	2	1

Issue 5: Design of a minimum service level code

- Option A: Regulator sets a minimum service level code.
- Option B: Industry sets its own minimum service level code with regulatory backstop.

The status quo for this issue would be not having a minimum service code and relying on measures set out in existing consumer law. For example, the Consumer Guarantees Act provides for guarantees in respect of three waters services, and the Fair Trading Act prohibits misleading conduct in relation to billing practices and consumer rights.

Because the status quo has already been analysed above, and a minimum service level code would represent a large component of any sector-specific consumer protection regime introduced for the water sector, we have not replicated this analysis here. Instead, we have treated option A as the counterfactual.

Description of options

Option A would involve the regulator setting minimum service quality requirements that apply to entities. Option B, which is the approach used under Part 7 of the Telecommunications Act, would involve a code being developed by the industry. This provides the industry with the opportunity to use their detailed sectoral knowledge to self-regulate to improve customer service. The regulator can then step in and impose minimum service level requirements via a regulatory code if industry self-regulation is inadequate, or if satisfactory voluntary codes do not emerge. The credible threat of government intervention under this approach tends to drive greater improvements in the quality of service for consumers, relative to a purely voluntary approach.

Analysis of options

The main benefit of Option A is that the regulator can directly control the requisite quality service levels, therefore it could potentially be more effective than Option B. It also gives stakeholders, particularly consumers, certainty, and confidence in the appropriateness of service levels. However, in terms of practicality, mandatory codes can be costly to develop, monitor and enforce, and may also impose significant compliance burdens on industry. Some of these costs may be mitigated by allowing or requiring the code to be periodically reviewed, so that it focuses on areas of service quality that have the biggest net impacts on consumer welfare. Overseas, regulators appear to prefer mandatory codes.

Option B could be generally easier to update and adapt to reflect market and technological developments, given the code would be developed by industry. However, it may not provide a satisfactory level of protection to consumers over time (as has been the experience in other utilities markets in New Zealand) because of the perverse incentives on industry to degrade quality to cut their own costs. In addition, it is possible that only suppliers that already meet the standards provided in the code volunteer to sign up to the code. While there is the threat of a regulatory backstop, there is a risk that regulatory intervention occurs too late for some consumers.

Issue 5: How do the options compare to the counterfactual?

	Option A: Regulator sets a minimum service level code (counterfactual)	Option B: Industry sets its own minimum service level code with regulatory backstop
Effectiveness (double weighting)	0 Highly effective at driving quality, transparency, and accountability since requirements in the code are set by the regulator in consultation with stakeholders.	- Moderately effective at driving quality, ineffective at driving transparency and accountability due to lack of independent oversight by the regulator, meaning there is an incentive for industry to include easy requirements in the code.
Practicality	0 Simple to implement but can be costly to develop given the need for the regulator to spend time and resource engaging with the sector and consumers.	+ Simple and cheap to implement since it is developed by industry experts and may be able to borrow significantly from existing best practice requirements.
Certainty	0 Would give consumers certainty that the code is in their best interests, industry has certainty that a regulator-led code will apply from the outset.	- Industry would have certainty over how the code will apply to them, consumers will have little certainty that the code is in their best interests. Industry would have little certainty over if, and when, a regulatory backstop would be implemented.
Flexibility	0 Code could cover a wide range of service quality issues. Regulator has the ability and impetus to target the areas where consumer harm is most likely, or issues that consumers are most concerned about.	- Code would only cover those areas of service quality industry agrees are important, little incentive for industry to target areas where consumer harm is most likely.
Regulatory coherence	0 Could complement accountability mechanisms in the wider system better than option B in that the regulator is better equipped to ensure the requirements in the code complement existing mechanisms and set aspirational targets for service quality.	- Industry may be able to set code in a way that ensures requirements in the wider system are not duplicated but does not go above the bare minimum acceptable level of service quality. Regulatory backstop mechanism could ensure the code complements accountability mechanisms in the wider system but without the regulator being able to directly control the contents of a code in the first instance.
Overall assessment	0	- 3

Key:

++ much better than the counterfactual + better than the counterfactual 0 about the same as the counterfactual - worse than the counterfactual -- much worse than the counterfactual

Issue 6: Provision of an expert advocacy body

- Option A: Consumers advocate on their own behalf.
- Option B: Create a bespoke advocacy body made up of water sector experts.
- Option C: Extend the remit of an existing expert advocacy body.

For this issue, we have treated the status quo as a scenario in which there is no expert body to advocate on behalf of three waters consumers and consumers must advocate for themselves, relying on support from existing organisations such as Consumer NZ. We have summarised costs and benefits of this status quo option in the summary table below.

Description of options

Consumers tend to struggle to engage with issues in utilities sectors. Other sectors and jurisdictions face similar challenges with low levels of engagement and under-representation in regulatory processes because of barriers to participation, including the fact that:

- some of the issues that affect consumer welfare are highly technical and difficult for consumers to understand and express clear views on
- consumers tend to lack the considerable time and resources needed to get involved in decision-making processes.

An option to strengthen the consumer voice in the water sector would be to establish an expert body to advocate on behalf of consumers and engage with regulators and suppliers on technical issues. This could include issues that tend to be beyond the ability of the average consumer to engage on, such as weighted average cost of capital, or the different technical solutions for treating wastewater. Expert bodies that engage in in-depth research activities to inform their technical advocacy tend to enhance the strength and credibility of consumer voices. They also expand the range of issues on which consumer voices are heard.

Option B would involve creating a bespoke advocacy group to allow the body to build up specialised expertise and develop a reputation as an expert advocate in the water sector. Option C would involve extending the mandate of an existing advocacy body such as the Consumer Advocacy Council (the Council). When the Council was created, provision was made for it to broaden its remit over time to other sectors. Water was identified as one of the sectors that would have direct synergies with electricity given both sectors involve economically regulated utilities.

Analysis of options

While Option B may foster greater confidence among consumers and small businesses in its ability to represent and promote their water related interests, the downside is that establishing a new body is likely to take considerable time and require additional funding. Such a body may also struggle to attract staff as it would be fulfilling a very similar role to the Council.

Advantages of Option C are as follows:

- in terms of effectiveness, it is more likely to be recognised and supported by consumers as protecting their interests; it could also leverage off its experience in other sectors and learn from changes in the regulation of other utilities markets over time
- in terms of practicality, it is cost-effective, and it avoids two separate bodies competing for expert staff and advocates.

Issue 6: How do the options compare to the status quo?

	Option A: Consumers advocate on their own behalf (status quo)	Option B: Create a bespoke advocacy body made up of water sector experts	Option C: Extend the remit of an existing expert advocacy body
Effectiveness (double weighting)	0 This is unlikely to be effective given the ability and incentive of entities to ignore consumers in the absence of one coherent voice on behalf of consumers.	+	++
Practicality	0 This is unlikely to be practical given the barriers consumers face in engaging with monopoly suppliers.	0 Costly to implement given a new body needs to be set up, risk of two expert bodies competing for resource would make recruitment difficult.	+
Certainty	0 This would not give consumers certainty as to the process they need to follow in engaging with monopoly suppliers.	+	++
Flexibility	0 No flexibility implications – each option is equally as flexible as the status quo since no option would prohibit experts from advocating on behalf of consumers in an informal setting.	0 No flexibility implications – each option is equally as flexible as the status quo since no option would prohibit experts from advocating on behalf of consumers in an informal setting.	0 No flexibility implications– each option is equally as flexible as the status quo since no option would prohibit experts from advocating on behalf of consumers in an informal setting.
Regulatory coherence	0 Would not promote regulatory coherence as consumers would struggle to build their understanding of these complex reforms.	+	+
Overall assessment	0	3	6
Key:			
++ much better than the counterfactual + better than the counterfactual 0 about the same as the counterfactual - worse than the counterfactual -- much worse than the counterfactual			

Issue 7: Consumer disputes resolution

- Option A: Create a mandatory consumer disputes resolution scheme to complement the existing Taumata Arowai water-quality disputes resolution scheme.
- Option B: Create a voluntary disputes resolution scheme with a regulatory backstop.

Because this status quo has already been analysed above, we have treated option A as the counterfactual.

Description of options

Consumer dispute resolution schemes are an essential component of consumer protection regimes as they help consumers to resolve complaints when they cannot resolve them directly with their service provider. At present, most water consumers in New Zealand have limited recourse to dispute resolution with water providers. Consumers have some ability to raise service provision concerns with democratically elected councillors and with the Ombudsman.

The Water Services Bill creates a backstop consumer complaints framework designed to ensure that consumer concerns about drinking water are properly investigated by suppliers. Under that framework, if a consumer is not satisfied with the way a supplier has handled their complaint, they can escalate the complaint to Taumata Arowai, who can review and investigate the complaint and take the appropriate action. These powers are mostly focussed on drinking water and public health, rather than wastewater, stormwater, customer satisfaction or the resolution of consumer disputes. For these reasons, our view is that a dedicated consumer disputes resolution scheme is required for the three waters sector. This could cover issues related to billing and payment, customer service, water restrictions, access to property, and the actions of staff or contractors.

Option A would involve requiring the entities to belong to this dispute resolution scheme. This could be established as new statutory scheme by expanding the mandate of an existing schemes such as Utilities Disputes Ltd, or by requiring regulated suppliers to be a member of a suitable dispute resolution scheme approved by the Minister of Commerce and Consumer Affairs. Option B would involve allowing entities to set up their own scheme (like the Telecommunications Dispute Resolution scheme or the Water Complaints Scheme). The risks and benefits of these two approaches are like those outlined above in relation to minimum service level codes.

Analysis of options

In terms of Option B, industry-initiated or voluntary schemes can generally be established more quickly and involve lower set-up costs than mandatory schemes set out in legislation. However, there is evidence that consumers who come under the jurisdiction of non-mandatory schemes can struggle to get suppliers to engage in dispute resolution processes, thereby leaving consumers without adequate dispute resolution mechanisms. Arguably, voluntary schemes have lower incentives to improve consumer outcome over time and can be perceived by some consumers as lacking independence. In this way, Option A is more likely to be effective and provide consumers with certainty.

Requiring suppliers to belong to a scheme removes the issue of some consumers not having access to appropriate dispute resolution mechanisms. However, they tend to take longer and be more extensive to establish.

Issue 7: How do the options compare to the counterfactual?

	Option A: Create a mandatory consumer disputes resolution scheme, to complement the existing Taumata Arowai water-quality disputes resolution scheme	Option B: Create a voluntary disputes resolution scheme with a regulatory backstop
Effectiveness (double weighting)	0 Highly effective at driving quality, transparency, and accountability since entities would be required to belong to a scheme that drives these outcomes.	- Moderately effective at driving quality, transparency, and accountability since many suppliers may opt not to belong to a scheme that drives these outcomes.
Practicality	0 Simple to implement in that the regulator and scheme provider work to develop the scheme from the outset.	- Simple for the scheme provider to implement initially but may require rework if regulatory backstop is needed.
Certainty	0 Would give consumers certainty over which suppliers belong to a scheme and which body they should contact to escalate complaints.	- Industry would have certainty over how the scheme will apply to them since they can choose to opt out, consumers have little certainty that suppliers will continue to belong to a scheme.
Flexibility	0 Flexibility for regulator to periodically review scheme to ensure its fitness for purpose, less flexibility for suppliers than option B in that entities must belong to a scheme.	+ Flexibility in allowing suppliers to opt out with option of regulator making membership mandatory if it becomes evident that that would be in the best interests of consumers.
Regulatory coherence	0 Could complement accountability mechanisms in the wider regulatory system, particularly since the largest entities must belong to the scheme.	- Could complement accountability mechanisms in the wider system but only to the extent that suppliers join the scheme, so less flexible than option A.
Overall assessment	0	-3

Section 3: Preferred package of options

3.1 What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

Issue 1: Protecting consumer interests in monopoly markets

- Option A: Implement a sector-specific economic regulation and consumer protection regime for three waters.

Issue 2: Scope of the purpose statement for economic regulation

- Option B: Purpose statement based on promoting the long-term benefits of consumers, with additional objectives relating to obligations in respect of climate change, Te Tiriti, Te Mana o te Wai and Treaty settlements.

Issue 3: Scope of economic regulation and consumer protection

- Option A: Include only the entities in the economic regulation and consumer protection regime.

Issue 4: Initial forms of economic regulation

- Option B: Implement information disclosure and quality-only regulation initially but allow for price-quality regulation in future.

Issue 5: Provision of a minimum service level code

- Option A: Regulator sets a minimum service level code.

Issue 6: Provision of an expert advocacy body

- Option B: Extend the remit of an existing expert advocacy body.

Issue 7: Consumer disputes resolution:

- Option A: Create a mandatory consumer disputes resolution scheme.

3.2 What other options have been ruled out of scope, or not considered, and why?

Some options were not analysed because they are already being considered by the Minister of Local Government, or because they will be insufficient in driving beneficial outcomes, namely:

- **Initial pricing standard** – It may be beneficial to implement an initial pricing standard that will apply from the outset of the regulatory regime, or shortly afterwards, so the benefits of regulation are felt by consumers sooner rather than later. An example of this can be seen in the Retail Payment System Act, which limits interchange fees. We have ruled out a similar option for the three waters sector since the Minister of Local Government proposes to set limits, via regulation, on the rate of initial price increases for water services.
- **Supplier oversight of pricing practices** – Some submitters on the discussion paper were of the view that each entity should be able to determine its own pricing practices, following engagement with their governance group, communities, and consumers. Our view is that, given the potential for these large entities to not be responsive to stakeholders, as well as the importance of price stability and transparency, the economic regulator should have oversight of pricing principles and rules. This option is being considered by the Minister of Local Government, and so has not been discussed in this RIS.
- **Consumer contracts** – While the Fair Trading Act already prohibits unfair contract terms in standard form consumer contracts, there is an option have the core terms and conditions

on which a service is supplied to consumers be developed or approved by the consumer protection regulator. The Minister of Local Government is considering this option.

- **Consumer charters** – These involve the regulator setting policies that set out how suppliers will meet key consumer protection obligations. Consumer charters generally put the onus on suppliers to assume responsibility for their relationship with customers, and to consult with those customers to determine their key needs and how services can be refined to meet those needs. This does not appear to have clear advantages over minimum service level codes, but impose development costs on suppliers, who are unlikely to face strong incentives to promote consumer interests.
- **Supplier hardship or vulnerability policy** – These kinds of policies generally shift the onus onto the water supplier, rather than the regulator, to identify consumers’ needs and determine how to respond to, and protect, those interests. Our view is that suppliers are unlikely to face strong incentives to protect vulnerable consumers. In addition, the Minister of Local Government is considering options to protect consumers experiencing hardship or vulnerability.

3.3 What are the marginal costs and benefits of the preferred option?

Affected parties	Comment	Impact	Evidence Certainty
Additional costs of proposed approach, compared to taking no action			
Consumers served by the entities	<p>Small financial cost to households of implementing this regime expected, as the entities pass on cost of levy.</p> <p>The costs have been extrapolated from other levy-funded economic regulation and consumer protection regimes in New Zealand.</p>	<p>Developing input methodologies is likely to cost around \$10 million over two years, or \$10.80 per household.</p> <p>Depending on the nature of the economic regulation used in each period, costs will be roughly \$7 million - \$10 million per year, or between \$4.60-\$7.70 per household annually.</p> <p>The consumer protection regime is likely to cost around \$10 million per year, or \$5.28 per household annually.</p>	High
Regulated parties	Initial implementation costs incurred to set up systems and processes to collect the data required by the economic and consumer protection regulator.	Low-medium	Medium

	<p>Ongoing compliance costs incurred from information collection and disclosure, including high-quality engagement with communities, consumers, mana whenua and business customers.</p> <p>Compliance with quality and price standards, minimum service level codes and dispute resolution mechanisms.</p> <p>Creation of asset management plan for economic regulator's review.</p>		
Overall economy	Compared to taking no action, there should be no additional costs of the proposed approach on the overall economy, since economic regulation will help incentivise entities to minimise costs.	Low	Medium
Regulators	<p>Initial and ongoing establishment, implementation, and enforcement costs.</p> <p>As set out in the CRIS, costs incurred by the economic regulator are proposed to be levied on the entities and passed onto consumers in the costs they pay for water services. Thus, we have put these costs into the consumer category.</p>	Access to transitional funding of \$4 million over two years has been agreed by Cabinet.	High
Total monetised cost		Between \$17-\$20 million, depending on the nature of the economic regulation used in each period.	n/a
Total non-monetised cost		Low	Medium
Expected benefits of proposed approach, compared to taking no action			
Consumers	Efficient infrastructure investment decisions by the entities.	High	High.

	<p>Receive reliable and high-quality water services.</p> <p>Access to a dispute resolution scheme.</p> <p>High quality engagement from regulated parties on decision-making.</p> <p>Increased information about three waters asset management decisions.</p> <p>Protection from undue price shocks.</p> <p>The evidence certainty has been extrapolated from experience with other levy-funded regimes in New Zealand.</p>		
Overall economy	Greater public confidence in the supply of water services, following efficient investment in water infrastructure by the entities.	Low	Medium-high
Regulators	<p>Regulatory functions might be improved by data sharing between Taumata Arowai and the economic and consumer protection regulator.</p> <p>Regulators will have clear delineation of system roles and responsibilities.</p> <p>Evidence certainty has been drawn from the experience of the Commission's interaction with other regulators, such as the Electricity Authority, while acknowledging water is a different sector and Taumata Arowai is a new organisation.</p>	Low	Low-medium
Total monetised benefit	Not estimated	Not estimated	n/a
Total non-monetised benefits	It can be difficult to assess the benefits of the regime while decisions on other parts of the reform programme are happening in parallel. However, we have considered	High	Medium

	<p>qualitative analysis, including stakeholder feedback and analysis of similar regimes in New Zealand and overseas.</p> <p>Our assessment is that the benefits outweigh the costs. We consider that our preferred package of options provides sufficient flexibility to minimise costs and increase benefits where possible.</p>		
--	---	--	--

3.4 Further comments

Robustness of evidence supporting this assessment

These issues have been identified based on:

- submissions received on the MBIE discussion document
- consultation with internal and external stakeholders
- close collaboration with DIA (leading the Three Waters Reform Programme)
- MBIE and the Commission’s experience from implementing other economic regulation regimes in New Zealand, and
- overseas experience of implementing regulation of water services.

The figures used for the major cost components for implementing economic regulation and consumer protection in the Three Waters Reform Programme were estimates provided by the Commission in 2021. These figures are based on its experience with economic regulation and consumer protection activities for other sectors in New Zealand. These figures may need to be updated in the future if new information becomes available and in line with inflation.

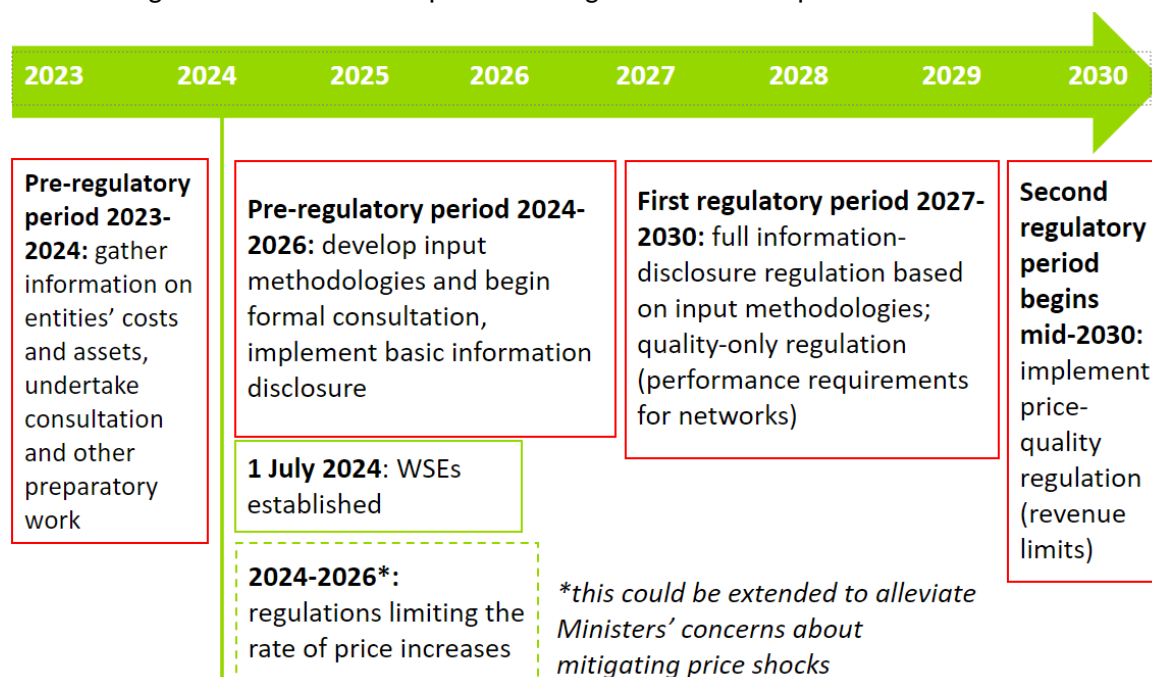
We discuss the robustness of evidence of the problem and quality of data available in section 1 (Key Limits or Constraints on Analysis).

Section 4: Implementation and operation

4.1 Implementation of the proposals

How will the new arrangements be implemented?

A new standalone piece of legislation, the Water Regulation Bill, will establish the economic regulation and consumer protection regime. We expect the Water Regulation Bill and the Water Services Entities Amendment Bill to be introduced in late 2022 and passed in mid-2023. Assuming these Bills pass on time, DIA has set the 'go live' for the entities as 1 July 2024, meaning the economic regulation and consumer protection regime would be implemented as follows:



Ministers have indicated their preference for price-quality regulation to be implemented at the second regulatory period. Therefore, we consider this should be the default option, subject to a recommendation by the economic regulator and decision by the Minister of Commerce and Consumer Affairs. The criteria to make this decision will be developed during drafting but will include whether implementing price-quality regulation would be in the best interests of consumers. Refer to the monitoring and evaluation section for more information.

Who will be responsible for implementation?

We considered three options for who the economic and consumer protection regulator could be:

	Benefits	Risks
Option A: Commerce Commission	The Commission is experienced at regulating other natural monopoly sectors (energy, telecommunications, airports) as well as implementing consumer protection legislation (Fair Trading Act, Credit Contracts and Consumer	It does not have experience with water. It received funding in 2019 to support its development in Māori-Crown capability as part of its "Fit for the Future" strategy). ²

² You can read more at https://comcom.govt.nz/data/assets/pdf_file/0033/277476/Commerce-Commission-Annual-Report-2021.pdf.

	<p>Finance Act).</p> <p>It could realise synergies from its extensive legal and economic resource and promote policy coherence across regulated sectors. It is an Independent Crown Entity, so operates at arm's length from the Crown.</p>	
<p>Option B: Taumata Arowai</p>	<p>Taumata Arowai is the new regulator for drinking water quality. It has water sector expertise and connections across the sector.</p>	<p>Taumata Arowai does not have economic regulation or consumer protection experience. It is a Crown Agent, so does not have the degree of independence from Government to allow it to effectively implement economic regulation. In other countries, the economic regulator tends to be separate from the water safety regulator.</p>
<p>Option C: Create a new agency</p>	<p>This would allow a new entity to build specific expertise in economic regulation of three waters. This option could allow for greater focus on economic regulation of three waters, as opposed to other economically regulated sectors.</p>	<p>Creating a new agency would be costly. It would take time to build specific expertise on economic regulation and commence operations.</p> <p>It would also see New Zealand's scarce economic regulation and consumer protection expertise spread across multiple agencies in a way that prevents synergies being realised, with impacts for other regulated sectors.</p>

Submitters on the discussion document agreed the Commission was the most appropriate body to act as the economic and consumer protection regulator but emphasised the need for it to have appropriately skilled staff given the complexities of the water sector.

If the Commission is appointed, MBIE's advice is that a Water Commissioner be established

If the Commission is appointed as the economic and consumer protection regulator, MBIE considers a position of Water Commissioner should be established as part of the Commission's board. This could be similar to the existing Telecommunications Commissioner position, though the Commission does not have a dedicated Commissioner for any of the other sectors it regulates.

This would mean appointing a water industry expert to provide industry with a figurehead to look to as it navigates this significant reform. However, it could also add unnecessary complexity to Commission's governance structure, as water experts could be hired as part of the Commission's staff regardless of whether there is a dedicated 'Water Commissioner'.

On balance, and given the unique elements of the water sector, we consider it desirable to establish a position of Water Commissioner, or similar position(s), within the Commission's board.

How will stakeholders or other agencies with a substantive interest in the relevant regulatory system be involved in its implementation and

ongoing operation?

MBIE is working closely with DIA, Taumata Arowai and the Commission on the regime's design and implementation. Submitters will have another chance to provide their feedback on the proposals during the select committee process, and through ad hoc engagement with agencies. DIA is also leading work on communication and education campaigns for the broader Three Waters Reform Programme. MBIE will work with DIA to ensure any communications are joined-up and appropriate for the audience.

The economic and consumer protection regulator will work with the National Transition Unit for any consultation activities, including on levies, prior to 1 July 2024. After that, the regulated entities will be established, and the economic regulator can discuss matters with their boards and the Regional Representative Groups.

Implementation risks and mitigations

Transition uncertainty

The Three Waters Reform represents a significant transition for the water sector in New Zealand and submitters have remarked on the significant uncertainty facing stakeholders during this period.³ Therefore, we have designed the economic regulation regime flexibly to allow for different forms of economic regulation to apply in a staged approach. This will ensure that regulatory settings can be adjusted over time as the entities become operational and as more information becomes available.

Over time, it may become evident that the scope or form of economic regulation is not in the best interests of water consumers. We therefore consider that the economic regulator be able to recommend to the responsible Minister that certain services or entities be regulated, de-regulated or subjected to a different form of regulation, but only after it had carried out a review, including an assessment of whether this would be in the best interests of consumers.

Sequencing issues

MBIE assumes the Water Services Entities Amendment Bill and the Water Regulation Bill will receive Royal Assent in mid-2023. This is just before the New Zealand election, which is expected to occur mid-late 2023. If progress on either Bill is delayed, the implementation of the Three Waters Reforms may be delayed, or the economic regulation and consumer protection regime may not be enacted in time for the regulator to undertake the necessary preparatory work before the entities 'go live' on 1 July 2024.

We are mitigating this risk by working closely with DIA and Ministers' offices on timing of the Bills. We are also mitigating the risk of delays by ensuring our proposals are informed by high-quality public consultation and targeted stakeholder consultation. This has helped to ensure we have stakeholder buy-in to minimise the risk of needing to rework proposals later in the process and has helped build stakeholder understanding of how the proposed regime will work.

Capacity of the Commission to pick up another function

In the past two years, the Commission has added several new functions.⁴ MBIE has considered

³ See for example the submission from the Canterbury Mayoral Forum: [Submission on economic regulation and consumer protection for three waters services in New Zealand \(mbie.govt.nz\)](#) the Christchurch City Council: [Submission on economic regulation and consumer protection for three waters services in New Zealand \(mbie.govt.nz\)](#), and the Commerce Commission: [Submission on economic regulation and consumer protection for three waters services in New Zealand \(mbie.govt.nz\)](#).

⁴ This includes a monitoring and enforcement role under the Fuel Industry Act 2020, and it is proposed to be the

whether the Commission has the capability to add another new function. The Commission received funding in 2019 after a “Fit for the Future” review, which saw changes to its operating model and structural changes. The Commission has paid greater attention to distinct regulatory regimes, increased stakeholder engagement, strengthened leadership, improved accountability and governance. It is also investing in the capability and capacity of its staff, including around te ao Māori.

Economic regulation of three waters infrastructure fits with the Commission’s regulation of other infrastructure sectors. We will put a specific requirement for the Commission to be required to develop and maintain systems and processes to ensure it has the capability to uphold Te Tiriti o Waitangi, and to engage with and to understand perspectives of Māori. This aligns with a similar provision in Taumata Arowai’s legislation.⁵

On this basis, MBIE is confident the Commission has the capacity to take on this new function if it is funded appropriately. Funding is set out below in Section 5: Cost Recovery Impact Statement 1.

How will the existing stewardship arrangements of the regulatory system support the implementation of this proposal and help to manage implementation risks?

There are several agencies and entities with policy, regulatory, or implementation/service delivery responsibilities, as set out below:

AGENCIES WITH POLICY OR STEWARDSHIP RESPONSIBILITIES	AGENCIES WITH REGULATORY RESPONSIBILITIES	ENTITIES WITH IMPLEMENTATION OR SERVICE DELIVERY RESPONSIBILITIES
<ul style="list-style-type: none"> Ministry of Health (public health regulation) Ministry for the Environment (environmental regulation) Ministry of Business, Innovation and Employment (economic and consumer protection regulation) Department of Internal Affairs (lead agency for Water Services Bill and Water Services Entities Bill) 	<ul style="list-style-type: none"> Taumata Arowai Regional councils Economic regulator Consumer protection regulator Consumer dispute resolution schemes 	<ul style="list-style-type: none"> National Transition Unit Four Water Services Entities Community/private schemes Self-suppliers

In this context, we think effective system governance will require:

- clear outcomes: system outcomes need to be comprehensive and clear to system players
- role clarity: system players need to understand their respective roles
- strategy and delivery: the arrangements to deliver outcomes need to be clear and effective
- performance and risk management: system performance needs to be effectively monitored so any underperformance can be identified and addressed quickly.

A range of approaches can promote effective system governance, including memorandums of

regulator of retail payment systems under the Retail Payment System Act.

⁵ Taumata Arowai Act, section 19.

understanding or regulatory charters that set out the system objectives, roles of key players, and how the system objectives will be delivered and monitored.

In other regulatory regimes, strategy, delivery, and performance /risk management functions are often advanced by a “council of regulators” or similar coordination arrangements that involve key policy and regulatory bodies meeting regularly to share information about system performance and discuss system issues that require coordination across agencies. Both the option for a regulatory charter or memorandum of understanding, and a council of regulators, will be important for system stewardship in the three waters system.

4.2 Monitoring, Evaluation and Review

The success of the economic regulation regime achieving its objectives hinges upon the timely monitoring of actions against those objectives and evaluation of whether those actions have been effective.

Importance of information disclosure to provide on-going monitoring of economic regulation regime

The design of the economic regulation framework supports good regulatory stewardship, as it provides the ability to monitor, review, and adapt the regulatory framework in response to changes in the sector or as new information becomes available through information disclosure.

Information disclosure:

- provides timely information about the entities’ performance enabling the economic regulator to track changes over time and across entities (e.g. benchmarking)
- allows the regulator to act based on that information including resolving poor performance
- facilitates external scrutiny of whether those actions would support the achievement of the regime’s high-level objectives.

The information disclosure regime is effectively a timely monitoring mechanism which measures the performance of the entities as well as the success of the regulator to drive performance to ensure overall objectives are being achieved. The economic regulator, as an independent Crown entity, will set measures that form part of the information disclosure requirements under the statute to design performance measures, which form the basis of the information disclosure regime.⁶ These would be based on the purpose statement in the Water Regulation Bill and be informed by the indicators used in other utilities which face economic regulation, such as electricity. The indicators used in the information disclosure regime would also be informed by the baseline review conducted by DIA on the state of water assets in New Zealand.⁷

The legislation will require the economic regulator to consult with interested parties in making those decisions. We expect the economic regulator to liaise with Taumata Arowai on the information disclosure requirements it is intending to set, especially those which are likely to relate to the same performance dimensions as the information disclosure requirements set by Taumata Arowai.

Examples of performance measures that could form the basis for ID could include:⁸

⁶ As discussed in issue 3, MBIE’s preferred option is for the purpose statement to be for the long-term benefit of consumers, with additional objectives relating to obligations in respect of Te Tiriti, Te Mana o te Wai and Treaty settlements. The purpose statement will be developed through drafting.

⁷ See: <https://www.dia.govt.nz/three-waters-reform-programme-national-evidence-base>.

⁸ These measures have been informed by conversations with MBIE’s monitor for the Commission, and the Commission,

- operational indicators e.g. servicing costs
- service quality indicators e.g. number of unplanned disruptions, number of planned disruptions, volume of water delivered
- capital expenditure e.g. asset replacement, consumer connection
- estimated state of the treatment assets e.g. water treatment plants at good/medium/poor quality
- estimated state of pipeline assets e.g. average age of urban pipelines, amount of regulatory asset base.⁹

Existing regulatory stewardship mechanisms to support monitoring

In addition to the information disclosure regime, the economic regulation of Three Waters will become part of the competition system's regulatory charter, so will benefit from oversight from the MBIE Competition and Consumer Policy team.¹⁰ This will include stakeholder engagement and complaints data, environmental scanning and MBIE's wider research agenda and programme.

Baseline measures

The pre-regulatory period starts on 1 July 2024. A voluntary form of information disclosure during this period will allow the economic regulator to establish baseline of the state of the three waters assets, and the entities' performance. Once Cabinet decides who the economic regulator is, it will establish the measures that will form this baseline, liaising with the National Transition Unit and Taumata Arowai. We expect this baseline to include similar measures to the above list.

Formal review points in the Water Regulation Bill

As the lead policy agency for the competition and consumer protection regulatory systems, MBIE will monitor, evaluate, and review the regulatory framework in line with the Government's expectations for regulatory stewardship. MBIE is the monitor for the Commission, including its activities under Part 4 of the Commerce Act.¹¹

Monitoring, review, and evaluation of the new regime will be ongoing, with national-level monitoring and reporting powers in the Water Regulation Bill. For example, we consider provisions similar to the following will be part of the Bill:

- s 53B of the Commerce Act - to enable the Commission to monitor compliance with information disclosure regulation
- s 53N of the Commerce Act - to enable the Commission to monitor compliance with price-quality paths.

These are major, complex reforms, and it will be important to ensure the new system is fit for purpose. As discussed above, the Water Regulation Bill will provide for the following reviews:

- 2029: There will be a presumption in the Bill that price quality regulation is implemented in the second regulatory period, beginning 2030, unless the Minister receives advice from the economic regulator that it is (among other criteria to be developed) not in the best interests of consumers.
- By 2034: A more comprehensive review of the economic regulation and consumer protection framework will take place within 10 years of the commencement of that

as the current economic regulator and consumer protection regulator.

⁹ These have been adapted from that used for electricity lines companies.

¹⁰ <https://www.mbie.govt.nz/dmsdocument/4796-regulatory-charter-competition-system>.

¹¹ More information about MBIE's monitoring role can be found at: <https://www.mbie.govt.nz/business-and-employment/business/competition-regulation-and-policy/monitoring-the-commerce-commission/>

system.

This aligns with the approach DIA is taking in its RIA for a comprehensive review of the wider Three Waters system and will support and inform central government's ongoing system oversight, stewardship, and monitoring work. A 10-year timeframe for review gives sufficient time for the regime to embed and ensures the review is suitably resourced. It also provides the regulator and affected parties' certainty of when such a review will take place so that evidence is gathered to support it.

Informal review points in the Water Regulation Bill

At any time, the economic and consumer protection regulator can conduct reviews and make recommendations to the Minister. The economic and consumer protection regulatory will create the indicators that will guide these reviews, but the types of things that we expect would be included are below:

Economic regulation

- Whether the entities should be subject to a different form of economic regulation.
- Whether any of the three waters services should be subject to a different form of economic regulation.
- Whether other three water suppliers (other than the entities) should be included in the scope of the economic regulation regime if they exhibit natural monopoly characteristics.

Indicators could include:

- the number and nature of investigations and enforcement action by the economic regulator
- the quality of the relationship between the Commission and Taumata Arowai (i.e. timely and effective information sharing, memorandum of understanding in place).

Consumer protection

- Whether other three waters suppliers should be included in the scope of the code (for example, if a community scheme grows larger).
- Whether other three waters suppliers should be required to be part of the consumer disputes resolution scheme.

These reviews can be either at the regulator's initiative or following the Minister's direction and could align with the approach taken in other economic regulation regimes, such as electricity lines.

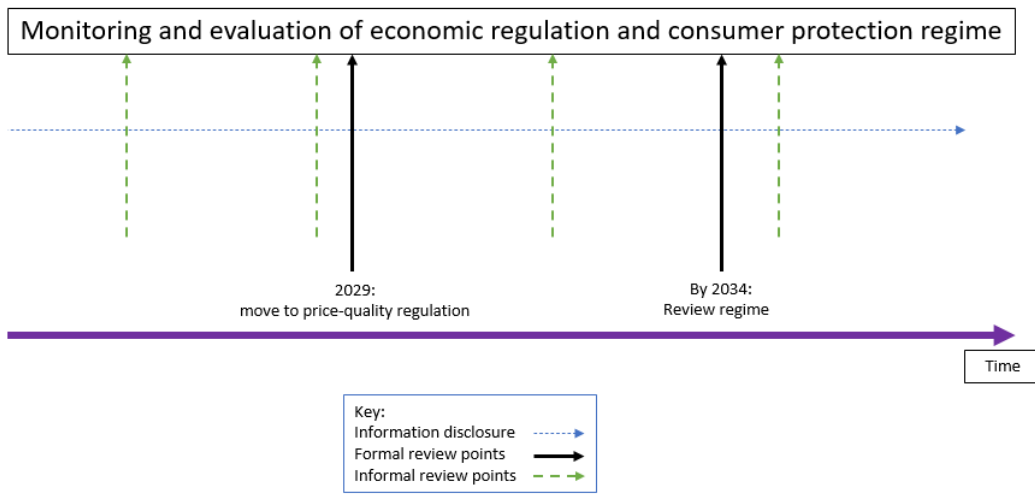
Indicators could include:

- number and nature of complaints to the consumer protection regulator, broken down by each entity
- number and nature of complaints upheld by the consumer protection regulator, broken down by each entity
- number and nature of breaches of the minimum service code, broken down by each entity
- number and nature of complaints to the consumer disputes resolution scheme, broken down by each entity
- number and nature of complaints upheld by the consumer disputes resolution scheme, broken down by each entity
- nature of consumer experience going through the complaints process, and satisfaction

with result.

Diagram

The below diagram outlines how the different parts of this framework would work together.



Section 5 – Cost Recovery Impact Statement (CRIS 1)

Who should pay for the costs of the economic regulation and consumer protection regime?

5.1 Status quo

The Commerce Commission receives an annual departmental appropriation from the Crown and its economic regulation activities are funded by third-party industry levies. Part 4 of the Commerce Act gives the power to set levies for economically regulated entities under that Act. Section 53ZE allows the responsible Minister to charge a levy to any service provider, or class of service providers, specified in regulations.¹² The Minister sets the total amount of levy funding by determining the regulator’s appropriation(s) in the Main Estimates of Appropriations for the levy year.¹³ Local government currently charges for water services through rates on property owners.

5.2 Policy Rationale: Why a user charge? And what type is most appropriate?

Fees and levies are often suited to situations where there are significant private benefits to individuals or groups rather than society at large. MBIE proposes to use levies to fund the three waters economic regulation regime, because it is possible to identify parties that directly benefit from economic regulation, namely the consumers who will receive three water services from the entities (around 85 percent of the population). We want to avoid charging the 15 percent of people who will not be served by the entities. The costs of implementing economic regulation are typically levied on the supplier of regulated services, and then passed through to consumers in the prices they pay for regulated services.

5.3 High level cost recovery model

Economic Regulation

Based on the policy positions outlined earlier in the RIS, there are likely to be four major cost components to implementing economic regulation on the proposed four new entities.

Transition costs

Transition costs are estimated to be \$4m over two years, comprising \$1.5 million in the 2022/23 financial year, and \$2.5 million in the 2023/24 financial year. This involves working with the sector to improve their understanding of economic regulation and preliminary work to improve the quality of data in the sector; for example, gathering and preparing supporting information, researching, and obtaining legal advice related to the proposed economic regulation model.

We are not proposing to recover costs incurred by the economic regulator from the transition to the new regime. The Government has decided this will be covered by the Crown [CAB-21-MIN-0219] as there are public benefits of setting up the regime to economically regulate the entities.¹⁴

Development of input methodologies

¹² See also: Telecommunications Act 2001 s 11 and the Electricity Industry Act 2010 s 128.

¹³ The Minister may elect to refer to the decision to Cabinet if the Minister considers the decision meets the thresholds set out in the Cabinet Manual.

¹⁴ This funding will be provided from the *Transforming Three Waters Service Delivery for New Zealanders: Transition and Implementation* tagged contingency.

This involves developing the rules, requirements and processes underpinning the application of economic regulation. Developing input methodologies is likely to cost around \$10m and take approximately two years. This equates to an average annual household cost of \$5.40, or \$10.80 for the period over which input methodologies would be developed.

Development of information disclosure, quality regulation and price-quality regulation

Implementing information disclosure regulation involves collecting, analysing, summarising the data disclosed by regulated suppliers, and undertaking compliance and enforcement activities. This will cost approximately \$5 million per annum on average. This equates to an average annual household cost of \$2.64.

Implementing quality regulation involves the setting of quality paths, approval of major capital expenditure projects, undertaking compliance, and enforcement activities. This will cost approximately \$2 million per annum. This equates to an average annual household cost of \$1.08.

Implementing of price-quality regulation involves the setting of price-quality paths, approval of major capital expenditure projects, undertaking compliance, and enforcement activities. This will cost approximately \$3 million per annum. This equates to an average household cost of \$1.56.¹⁵

The preliminary proposal in the discussion paper is full cost recovery of the cost of these via levies on each entity as a proxy for the consumers that ultimately benefit. This approach is preferred to a general taxation model, as over time, there may be different costs involved in the economic regulation of the entities. Therefore, this approach retains flexibility to charge different levies to entities, costs of which can be passed onto consumers.

Summary: monetised costs for economic regulation for households and in total

Economic regulation activity	Average cost per household, annual	Total cost, annual
Developing input methodologies	\$5.40	\$5 million
Information disclosure	\$2.64	\$5 million
Quality regulation	\$1.08	\$2 million
Price quality regulation	\$1.56	\$3 million

Summary: costs of economic regulation of Three Waters set out by year, presuming there is a move to price- quality regulation in the second regulatory period

	Per household, annual	Total cost, annual
Pre-regulatory period	mid 2024 – mid 2026: \$7.64 per year	\$10 million
	mid 2026 – mid 2027: \$4.20 per year	\$7 million
First regulatory period	Mid 2027 – mid 2030: \$3.72 per year	\$7 million
Second regulatory period	From mid 2030: \$4.20 per year	\$8 million

We consider the benefits of economic regulation outweigh the costs on consumers. Refer to section 3.3 on the marginal costs and benefits of the proposed option for a summary of this.

¹⁵ Based on Statistics NZ March 2021 estimate of households. <https://www.stats.govt.nz/information-releases/dwelling-and-household-estimates-march-2021-quarter>

Consumer protection regulator

If the Government were to pass legislation that enabled the consumer protection regime to be levy funded, it is likely that a separate consultation process would be required to determine the quantum of levy funding provided. However, approximate costings are included below.

Minimum service code

This would cover development and maintenance of the code together with the work required to undertake compliance monitoring and enforcement work. This work is likely to cost around \$2m in the first year and \$1.5 million to \$2 million in subsequent years. An ongoing cost of \$2 million equates to an average annual household cost of \$1.08.

Operation of consumer dispute resolution scheme(s)

The costs of developing a new scheme or requiring regulated suppliers to be a member of an approved scheme are likely to be met by regulated suppliers separately through the levies process. Comparable schemes in other sectors cost around \$2 million to \$3 million annually to operate. We expect the costs to be passed to consumers in the price they pay for three waters services. An ongoing cost of \$3 million equates to an average annual household cost of \$1.56.

We consider the benefits of economic regulation outweigh the costs on consumers. Refer to section 3.3 on the marginal costs and benefits of the proposed option for a summary of this.

Consumer protection activity	Average cost per household, annual	Total cost, annual
Minimum service code	\$1.08	\$2 million
Operation of consumer disputes resolution scheme	\$1.56	\$3 million
Total cost of consumer protection	\$2.64	\$5 million

Expert advocacy body

Officials have not yet undertaken analysis of the likely cost of funding an expert advocacy body, but will commence this following Cabinet decisions. If the remit of the Consumer Advocacy Council is extended to cover the water sector, we will consider whether this should be funded by the Crown or via levies on regulated water suppliers on behalf of consumers.

5.4 Design of funding regime – options

The discussion document consulted on two options for a levy regime for the economic regulation regime and the consumer protection regime.

Option 1: A regulator led levy regime like that used by the Electricity Authority under the Electricity Industry Act¹⁶

This option would require the regulator to consult on and collect levy funding within the total amount determined by the Minister. Requiring the regulator to consult on its work programme and funding needs could promote efficiency in the regulator's activities and provide a useful accountability mechanism to consumers, regulated suppliers and other stakeholders. On the other hand, there can be a perception of a conflict-of-interest risk of the regulator consulting regulated

¹⁶ See s 128 of the Electricity Industry Act 2010.

parties on its funding requirements, even if the final decision rests with the Minister.

Option 2: A minister levy regime like that administered by the Ministry of Business, Innovation and Employment under Part 4 of the Commerce Act¹⁷

This option would require the Ministry to consult on the levy (on behalf of the Minister) and collect levy funding within the total amount determined by the Minister. A Ministerial led regime creates a degree of separation between the regulator and regulated parties. However, the inherent accountabilities of a regulator led regime are lost and there is potential for regulator funding requirements to be subject to a higher degree of political decision making.

Table: levy regime options

	OPTION A - REGULATOR LED LEVY REGIME	OPTION B - MINISTER LED LEVY REGIME
WHAT PROCESS IS USED TO SET THE LEVY?	The regulator publicly consults on its work programme and required funding.	The Ministry consults on funding required (on behalf of the Minister) in close consultation with the regulator.
WHO SETS THE FINAL AMOUNT OF THE LEVY?	The Minister sets the total amount of levy funding by determining the regulator's appropriation(s) in the Main Estimates of Appropriations for the levy year. ¹⁸ The levy rates applying to industry participants are calculated in accordance with the allocation mechanism specified in the levy regulations and are published in the Gazette.	The Minister sets the total amount of levy funding by determining the regulator's appropriation(s) in the Main Estimates of Appropriations for the levy year. ¹⁹ The levy rates applying to industry participants are calculated in accordance with the allocation mechanism specified in the levy regulations. Levy payers are notified of their levy liability.
WHO COLLECTS THE LEVY?	The regulator.	The Ministry, on behalf of the Minister.

5.5 Assessment criteria

In developing our criteria and carrying out our assessment, we have considered the Office of the Auditor General's good practice guide: *Charging fees for public sector goods and services* and the Treasury's *Guidelines for Setting Charges in the Public Sector*.

Our overarching principle in assessing how the economic regulator and consumer protection regulator should be sourced is proportionality. In addition, we considered:

- sustainability – the levy funding is sustainable and viable in the long-term, and consumer activity is not unduly negatively impacted because of the levy on entities
- efficiency – the charges are collected in an economically efficient manner.

¹⁷ See, in particular, s 53ZE of the Commerce Act 1986.

¹⁸ The Minister may elect to refer to the decision to Cabinet if the Minister considers the decision meets the thresholds set out in the Cabinet Manual.

¹⁹ The Minister may elect to refer to the decision to Cabinet if the Minister considers the decision meets the thresholds set out in the Cabinet Manual.

5.6 Consultation and stakeholder feedback

Public consultation on funding options occurred through the discussion document. A summary of the options consulted on, and submitter feedback is set out below.

Funding for economic regulation regime

Most submitters agreed the costs of implementing the economic regulation regime should be funded via levies on regulated suppliers, although several submitters were of the view the costs of establishing and implementing the regime should be funded by central government.

Funding for consumer protection regime

Most submitters agreed the costs of implementing a consumer protection regime for the three waters sector should be funded via levies on regulated suppliers. Others argued that levies should not be imposed on small schemes, or that there needs to be mechanisms to waive the pass-through cost of levies for consumers who cannot afford to pay. Some submitters suggested the amount of the levy should be based on the number of complaints upheld against each entity. We will investigate the practicality of implementing this.

A regulator-led or Minister-led levy regime

Most submitters were of the view this should be regulator-led. Some submitters made the point that the levy process needs to be transparent and predictable. In contrast, the Commission preferred a Minister-led levy model, as that is consistent with their approach to other regulated entities. Others argued that councils should be involved in the process. Our view is that councils could be consulted as interested parties, but this should not be a requirement.

Further consultation to occur

If the Government were to pass legislation that enabled the economic regulation regime to be levy funded, it is likely a separate consultation process would be required to determine the quantum of levy funding provided. However, approximate costings are set out above.

5.7 Assessment

To determine who should pay for the increased funding, we have assessed the private and public benefits of the two regulators against the principle of proportionality. This allocation of benefit is then weighed against sustainability and efficiency to make our assessment. However, this assessment is limited by the fact that the private and public benefits of the two regulators cannot readily be translated into quantitative benefit. Accordingly, we cannot establish percentages or proportions for the level of private and public benefit. Instead, our allocations and assessment of benefit are constrained to the more general explanations below.

Proportionality

Regulator	Benefits	Benefit predominantly private or public
Economic regulator	There are general public benefits to drive the entities to invest efficiently in water infrastructure. However, like other utilities, the economic regulation of three waters services is specifically designed to directly benefit the long-term interests of consumers of the services (private benefits).	Predominantly private benefit to consumers served by the entities.

Consumer protection regulator	The consumer protection elements of three waters services are specifically designed to directly benefit the long-term interests of consumers of the services. The consumer protection regulator's activities will result in increased consumer trust in the quality of the water services they receive and reduced consumer harm.	Predominantly private benefits.
--------------------------------------	---	---------------------------------

Sustainability and efficiency

Water charges should not unduly impact future generations, given the economic regulation and consumer protection regime is operating for the long-term benefit of consumers. Therefore, levies, which are compulsory, can ensure the economic regulation and consumer protection regime is appropriately funded despite individual consumer ability to pay.

The cost of the economic and consumer protection regime will be passed onto consumers through the price they pay for water services. We see this as broadly justified as consumers served by each entity are the ultimate beneficiaries of the economic regulation and consumer protection regime. Consumers will already receive a bill from the regulated entities for the cost of the services that is received and it is efficient that this is paid all at once.

However, some consumers will have different abilities to pay. Equity issues are broadly considered in the DIA pricing and charging work. However, for the purposes of this CRIS, levy funding on the entities will ensure the economic regulation and consumer protection regime will continue to be funded by the levies charged on the entities despite any one consumer's ability to pay.

5.8 Conclusion

Consistent with the funding approach used in other economic regulated entities, and the preferred approach in the discussion paper, we propose a levy-based model. We will put a power to cost recover in the Water Regulation Bill, along the lines of equivalent provisions in the Commerce Act and Telecommunications Act.

The type of levy model preferred is Option B: Minister-led levy model. While most submitters preferred a regulator-led model, a Minister-led model is consistent with the approach taken by the Commission (the preferred economic and consumer protection regulator) in regulating other utilities. Therefore, it would be efficient to use this model as there are established relationships between the Commission, the monitoring agency MBIE, and the Minister of Commerce and Consumer Affairs. Furthermore, a Minister-led model means the Ministry can consider broader considerations, such as te ao Māori and Te Tiriti o Waitangi.