

Item 2: Local Water Done Well Update

SESSION TYPE: Workshop

PURPOSE/DESIRED OUTCOME:

This workshop will cover three topics:

1. Briefing from the Commerce Commission on the proposed future regulatory regime for water services, based on the recently released discussion papers (attached)
2. Briefing from legal advisors Simpson Grierson on key legal elements of current and proposed future legislation including, but not limited to, the differences between a CCO established under the Local Government Act versus Local Government (Water Services) Bill and consultation requirements.
3. Discussion of, and feedback on, short list of future water service delivery model options, including high-level design elements of these options.

DATE/TIME:

Tuesday, 1 April 2025 at 11.05am

TIME BREAKDOWN:

Commerce Commission briefing: 30 minutes (briefing + questions)

Simpson Grierson briefing: 30 minutes (briefing + questions)

Short list option high-level design: 30 minutes (briefing + feedback)

Prepared by:



Name: Pennie Pearce
Title: Strategy & Reform Manager
19 March 2025

Reviewed and Authorised by:



Name: Tony Avery
Title: GM Property & Infrastructure
19 March 2025

ATTACHMENTS:

A	Economic Regulation of Water Services - Information Disclosure (Discussion Paper)
B	Economic Regulation of Water Services - Information Disclosure (Technical Discussion Paper)
C	Short List Options High-Level Design (to follow)

12 FEBRUARY 2025

Economic Regulation of Water Services - Information Disclosure

Discussion Paper



Glossary

Kupu taka

Term	Definition
Capex	Capital expenditure
CCO	Council-controlled organisation
Consumer	A person who consumes, uses, or is provided with water services
Determination	A document the Commerce Commission publishes as secondary legislation which (among other things) sets out the information that water service providers must disclose to the public and the Commission under the WSPA Act and proposed LGWS Bill
DIA	Department of Internal Affairs
Economic regulation	A way of influencing the behaviour of suppliers in sectors which are important to people's lives and where there are issues with market power (eg, monopolies), including the price and quality of products and services supplied
Enduring ID	Longer term form of information disclosure (ID) proposed under the LGWS Bill which may apply to all water service providers
Foundational ID	An early form of information disclosure (ID) under the WSPA Act which can apply to specified water service providers except Watercare
ID	Information disclosure – a type of economic regulation that requires suppliers to publicly report certain information about their performance
ID requirements	The type of information that water service providers would need to disclose under an information disclosure determination
ISAE (NZ) 3000 (Revised)	The International Standard on Assurance Engagement that covers New Zealand-based assurance engagements other than audits or reviews of historical financial information
LGWS Bill	Local Government (Water Services) Bill introduced to Parliament on 10 December 2024 and currently before the Select Committee
Opex	Operational expenditure
Supplier	Regulated party from any regulated sector, such as an electricity distributor
Water services	Services provided to consumers by water service providers including drinking water, stormwater and wastewater services as defined under the WSPA Act and as proposed under the LGWS Bill
Water Service Delivery Plans	The Water Service Delivery Plans required to be prepared by territorial authorities (councils) under Section 8 of WSPA Act and are a way for councils to demonstrate their commitment to deliver water services that meet regulatory requirements, support growth and urban development, and that are financially sustainable
Water service providers	An entity to which foundational ID could apply under section 39 of the WSPA Act or an entity to which enduring ID may apply under Schedule 6, cl 57B of the LGWS Bill
WSPA Act	Local Government (Water Services Preliminary Arrangements) Act 2024

Foreword

Wāhinga kōrero

Tēnā koutou, tēnā hoki tātou katoa.

Tukua te reo mihi kia rere atu ki a tōpito e whā o te motu. Kia mihi anō ki ngā maunga whakahī, ki ngā wai nui me ngā wai roa e rere ana, tae atu hoki ki ngā tāngata katoa. huri noa, huri noa. Haere atu i runga i te wairua o te kōrero, he pūkenga wai, he nohonga tāngata, he nohonga tāngata, he putanga kōrero.

Tēnei mātou e whakatakoto ake nei i tēnei tuhinga e pā ana ki te whakarite i tētahi pūnaha whākinga mōhihio (ID) mō te whakahaere i te wai hei painga anō mō te tangata. Ko te tino pūtake o te tuhinga hei whakawhitiwhiti kōrero, he matapakinga anō mō koutou, mō tātou anō hoki. Tirohia, matapakingia, tukua mai ō whakaaro.

On behalf of the Commerce Commission, I am pleased to present this discussion paper as one of our first steps in engaging on the information disclosure (ID) regime that will underpin economic regulation of the water sector.

We need to work together to ensure that water infrastructure is developed, maintained and operated for the long-term benefit of consumers. That is why we need your feedback. This collaborative effort will help ensure that economic regulation is flexible, workable and effective, so it can support providers to deliver quality water services to their communities across New Zealand for decades to come.

We acknowledge the water sector faces a unique set of challenges, including renewing aging networks, meeting modern quality standards and finding efficient ways of providing for growth. Like electricity, but even more so, water is also an essential service for all consumers and is of fundamental importance to the future of our country and the planet. Economic regulation has an important role to play here, ensuring benefits to customers and wider society, via improvements to services and better value for money.

As a regulator, we have our own challenges. These include accommodating the diverse circumstances of local providers, learning from international best practice, being dependent on the quality of information from providers, and staying joined-up with other regulators.

We will also need to move swiftly to meet the expected timeline of setting initial ID requirements within six months after the commencement of the legislation (likely by early 2026). That is why we are establishing relationships and starting to work with you as early as possible.

This is only the start of an ongoing conversation. We welcome your feedback on this paper and look forward to hearing from you. Thank you in advance for your time and effort.

John Small,
Chair

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1. Introducing information disclosure

Mō te whākinga mōhiohio

Purpose of this discussion paper

Te pūtake o tēnei tuhinga matapakinga

- 1.1 This paper is our first step in engaging with water sector stakeholders to get your views on how we could develop a new performance reporting regime (known as ‘information disclosure’ or ‘ID’) for water service providers.
- 1.2 **Chapter 1** provides background information on the Government’s Local Water Done Well policy, economic regulation and the Commerce Commission’s role. It outlines what ID is, its purpose and benefits.
- 1.3 **Chapter 2** outlines our initial views on what we think stakeholders might want to understand about the performance of water service providers. Based on this, it also discusses the types of information stakeholders might want to see and the information water service providers may need to disclose. We want to understand more about which areas are most important to you.
- 1.4 **Chapter 3** outlines how we could develop cost-effective ID requirements, including how these may evolve over time. It also seeks feedback on our approach to some other key features of the regime such as timing and assurance processes.

Local Water Done Well introduces information disclosure

Te Whakahaere Wai Kia Tika, Kia Pai hei whākinga mōhiohio

- 1.5 Local Water Done Well is the Government’s plan to address New Zealand’s long-standing water infrastructure challenges, covering drinking water, wastewater and stormwater services.
- 1.6 It recognises the importance of local decision-making and provides flexibility for communities and councils to determine how their water services will be delivered in the future. It has a strong emphasis on meeting economic, environmental and water quality regulatory requirements.

1.7 Local Water Done Well is being implemented in three stages, each with its own piece of legislation:¹

- **Stage 1: Repeal of previous water service legislation**—In February 2024 the Government introduced and passed legislation to repeal all previous legislation relating to water services entities.
- **Stage 2: Establish framework and preliminary arrangements for the new water services system**—The Local Government (Water Services Preliminary Arrangements) Act 2024 (**WSPA Act**) was enacted on 2 September 2024. The WSPA Act establishes the Local Water Done Well framework and the preliminary arrangements for the new water services system. It introduces a transitional form of economic regulation with foundational ID (that can apply to specified water service providers), and separate provisions for Watercare. It also includes a requirement for councils to develop Water Service Delivery Plans by September 2025.
- **Stage 3: Establish enduring settings**—The Local Government (Water Services) Bill (**LGWS Bill**) was introduced to Parliament on 10 December 2024 and will establish the enduring settings for the new water services system. It includes a new economic regulation and consumer protection regime for local government water service providers (including Watercare), to be implemented by the Commerce Commission.² The proposed economic regulation regime includes enduring ID as well as other regulatory tools.³

What is the Commerce Commission's role?

He aha te wāhi ki te Komihana?

1.8 The Commerce Commission is responsible for economic regulation. This is a way of influencing the price and quality of products and services of suppliers with substantial market power such as natural monopolies like water services.⁴ Consumers in these sectors have limited choices, and it is important that their interests are protected.

¹ Department of Internal Affairs "[Local Water Done Well legislation](#)" webpage.

² Department of Internal Affairs "[LWDW Factsheet: Economic regulation and consumer protection](#)" (December 2024).

³ References to the LGWS Bill in this paper are to the LGWS Bill as introduced to Parliament. The LGWS Bill is subject to change through the legislative process, and we would need to develop any enduring ID requirements consistent with legislation passed by Parliament.

⁴ A 'natural monopoly' is a market where a single supplier can provide a product or service at a lower cost than multiple suppliers.

- 1.9 We are already the economic regulator for several important infrastructure sectors, including international airports, gas pipelines, electricity lines companies and fibre networks.⁵ The LGWS Bill would provide us with a range of tools to ensure that, over time, water service providers deliver a quality that communities expect at an appropriate price.
- 1.10 To ensure services are delivered at that quality, an important focus on economic regulation is the suppliers' stewardship of the assets. This stewardship includes sufficient maintenance and investment, driven by robust asset management and strategic planning.
- 1.11 You can find more information about economic regulation of water on our [website](#) and also on the Department of Internal Affairs (DIA) [website](#).

How does this fit with other regulators?

He pēhea nei te hāngai ki ētahi atu ritenga waeture?

- 1.12 We know that the regulatory landscape for water service providers is complex, with different agencies imposing requirements. Multiple agencies have different roles in relation to the quality of water services, such as the impacts on public health and the environment. The DIA has set out the future regulatory landscape for water services [here](#).
- 1.13 Meeting other regulatory requirements, including those that relate to drinking water and wastewater quality, will have an impact on the cost of providing water services that are ultimately paid for by consumers. We are interested in these price impacts of meeting regulatory requirements as well as being interested in some regulatory requirements as a measure of the quality that consumers are receiving. These could include customer service and the performance of the infrastructure that is involved in collecting, treating, transmitting, and storing water and wastewater.
- 1.14 Paragraphs 3.11 to 3.14 outlines our plan for working with other regulators to ensure our ID regime is cost-effective.

⁵ Further information about the Commerce Commission and other infrastructure sectors that are subject to economic regulation can be found on our "[Our role in regulated industries](#)" webpage.

What is information disclosure?

He aha ia te whākinga mōhiohio?

1.15 Information and transparency are at the heart of economic regulation of water. The information published and our subsequent analysis of it will highlight comparative performance and the areas where most improvement is needed. ID is a common type of economic regulation that requires suppliers to publicly report certain information about their performance.⁶ We set out the ID requirements in a ‘determination’. This is a legal document that covers things such as:

- which supplier(s) the determination applies to
- the information a supplier must publish (including performance measures and definitions)
- any methodologies that the supplier must apply in preparing or compiling the information
- how the supplier must publish the information (eg, on its website)
- when a supplier must publish certain information (eg, annually), and
- any auditing or certification requirements the supplier must follow when preparing the information.

1.16 ID regulation typically requires information from regulated suppliers on a range of topics that affect prices and service quality. Suppliers must publish this information themselves and provide it to us. Key areas of information include:

- quality of service
- asset management
- general financial information, and
- pricing and contracts.

⁶ We already use ID in other industries including electricity, fibre, international airports, and gas. For example, see our [“Information disclosure requirements for electricity distributors”](#) webpage, which outlines the ID requirements we set for the electricity distribution sector.

1.17 We monitor and analyse the disclosed information we receive and publish what we have found (including a summary of the information) on our website. This helps to promote a greater understanding of the suppliers' performance, how they perform compared to each other, and how their performance changes over time. For example, we have published a range of analysis on [our website](#) about the performance of electricity distributors.

Who and what does information disclosure apply to?

Hāngai ana te whākinga mōhiohio ki a wai mā, ki te aha?

1.18 **Table 1.1** outlines which providers and which water services foundational ID and enduring ID could apply to.

Table 1.1 Providers and water services ID could apply to

	Foundational ID (WSPA Act)	Enduring ID (LGWS Bill)
Water service providers	<p>Any local government water service provider (if specified) including:⁷</p> <ul style="list-style-type: none"> a territorial authority that delivers water services the Wellington Regional Council a council-controlled organisation (CCO) that delivers water services, and a subsidiary of a CCO that delivers water services. <p><i>Excludes Watercare¹⁰</i></p>	<p>Any 'decision-making local government water services supplier' including:⁸</p> <ul style="list-style-type: none"> a local authority (including territorial authorities and regional councils), and a water organisation. <p>Other water service providers could be brought in later.⁹</p> <p><i>Includes Watercare¹¹</i></p>
Water services¹²	Drinking water, wastewater, stormwater (if specified). ¹³	Drinking water and wastewater (stormwater could be brought in later). ¹⁴

1.19 The water service providers that ID applies to are likely to change over time, moving from foundational ID to enduring ID under the LGWS Bill.

⁷ Local Government (Water Services Preliminary Arrangements) Act 2024, s 39(1).

⁸ Local Government (Water Services) Bill, Schedule 6, cl 57B.

⁹ Local Government (Water Services) Bill, Schedule 6 - new Schedule 7 of Commerce Act, cl 57J.

¹⁰ Local Government (Water Services Preliminary Arrangements) Act 2024, s 39(2). Watercare cannot be subject to foundational ID but is subject to an interim economic regulation regime that is administered by a Crown monitor, see Local Government (Water Services Preliminary Arrangements) Act 2024, Part 4.

¹¹ Local Government (Water Services) Bill, Schedule 1, cl 8.

¹² Note that the definitions of the regulated services differ between the WSPA Act and the LGWS Bill.

¹³ Local Government (Water Services Preliminary Arrangements) Act 2024, ss 39(4)(b) and 44(1)(b).

¹⁴ Local Government (Water Services) Bill, Schedule 6 – new Schedule 7 of Commerce Act, cl 57J.

- 1.20 Under the LGWS Bill, a water service provider (including Watercare) could be subject to ID if they make decisions on expenditure or the level of charges or revenue recovery for the service. This means that there could be two water service providers subject to ID for the same service. For example, both a ‘parent’ asset-owning council (that makes decisions on revenue) and its council-controlled water organisation (that makes decisions on expenditure) could be required to disclose information.

What is the purpose of information disclosure?

He aha kē te pūtaka o te whākinga mōhiohio?

- 1.21 Broadly, the purpose of ID is to make suppliers share information about their performance, which stakeholders and the Commission can then scrutinise, providing an incentive for suppliers to improve their performance.
- 1.22 For water, the legislated purpose of foundational ID is set out under the WSPA Act.¹⁵ This purpose statement is broadly similar for other industries we regulate under Part 4 of the Commerce Act and Part 6 of the Telecommunications Act.¹⁶ The LGWS Bill currently leverages the purpose statement from Part 4 of the Commerce Act.

The purpose of foundational ID under the WSPA Act is to promote the long-term benefit of consumers of water services and to ensure that sufficient information is readily available to interested persons to assess whether the promotion of the long-term benefit of consumers is occurring.

The long-term benefit of consumers is promoted by ensuring outcomes that are consistent with outcomes produced in competitive markets such that suppliers:

- ❖ have incentives to—
 - innovate and to invest in water services, including in replacement, upgraded, and new assets
 - improve efficiency in providing water services
 - provide water services at a quality that reflects consumer demands
- ❖ share with consumers the benefits of efficiency gains in supplying water services, including through lower prices, and
- ❖ are limited in their ability to extract excessive profits.

¹⁵ Local Government (Water Services Preliminary Arrangements) Act 2024, s 38.

¹⁶ Commerce Act 1986, s 53A and Telecommunications Act 2001, s 186.

- 1.23 The purpose of foundational ID is to promote the long-term benefit of consumers of water services and to ensure that sufficient information is readily available to assess that is occurring. This means that we are seeking outcomes in the water services sector that are consistent with the outcomes of competitive markets, like pressure on providers to improve their efficiency.
- 1.24 For water, ‘consumers’ include anyone that uses or is provided with a water service.¹⁷ For example, it includes residents that are connected to the local wastewater network or the local drinking water network, commercial drinking water customers, landowners who pay for a stormwater service, and commercial customers that discharge trade waste into a wastewater network.

What are the benefits of information disclosure?

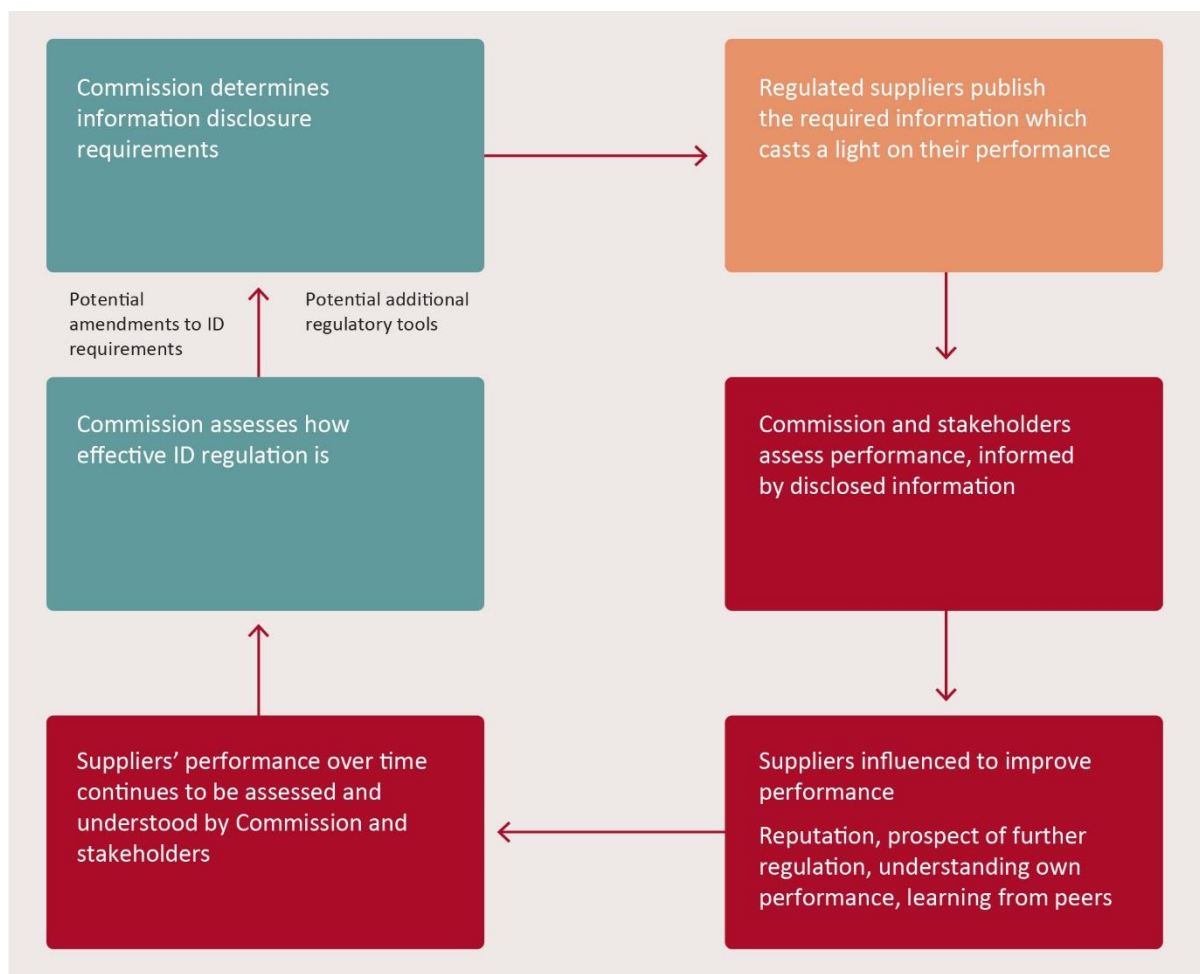
He aha ngā hua o te whākinga mōhiohio?

- 1.25 The key benefits of ID are:
- **Transparency for stakeholders**—gaining a better understanding of how suppliers are performing now, how this compares to past performance and to other suppliers, and what is expected to change in the future.
 - **Providing reputational incentives**—influencing suppliers to improve performance by shining a light on poor performance and practices.
 - **Supplier’s understanding of their own performance**—better and consistent information collection improves suppliers’ understanding of themselves.
 - **Learning from peers**—understanding the performance of their peers, as well as good or best industry practice, can help suppliers identify ways to improve their own performance.
 - **Informing policy and regulation**—the improved understanding of the suppliers’ performance improves regulation and policy-setting, including evaluating the effectiveness of current regulatory provisions, and knowing whether additional regulatory measures are required.
 - **Prospect of further regulation**—the need for further regulation resulting from poor performance being revealed can influence suppliers to improve their performance to avoid further regulation.

¹⁷ See Local Government (Water Services Preliminary Arrangements) Act 2024, s 5 for the interpretation of ‘consumer’.

1.26 **Figure 1.1** summarises how ID is intended to work.

Figure 1.1 Life-cycle for development of ID requirements



1.27 **Table 1.2** shows the many groups of stakeholders that we think could be interested in aspects of the information disclosed.

Table 1.2 Potential stakeholders interested in ID for water services

Potential stakeholders		
❖ Consumers, consumer groups and local communities	❖ Regulated water service providers, representative groups and their council owners	❖ Lenders and their advisers
❖ Tangata whenua	❖ Other regulatory agencies (such as the Water Services Authority – Taumata Arowai)	❖ Businesses that supply products and services to water service providers
❖ Developers	❖ Commerce Commission	❖ Central and local government
❖ Industry bodies and associations		

We are seeking your views

Kei te rapu mātou i ōu nā whakairo

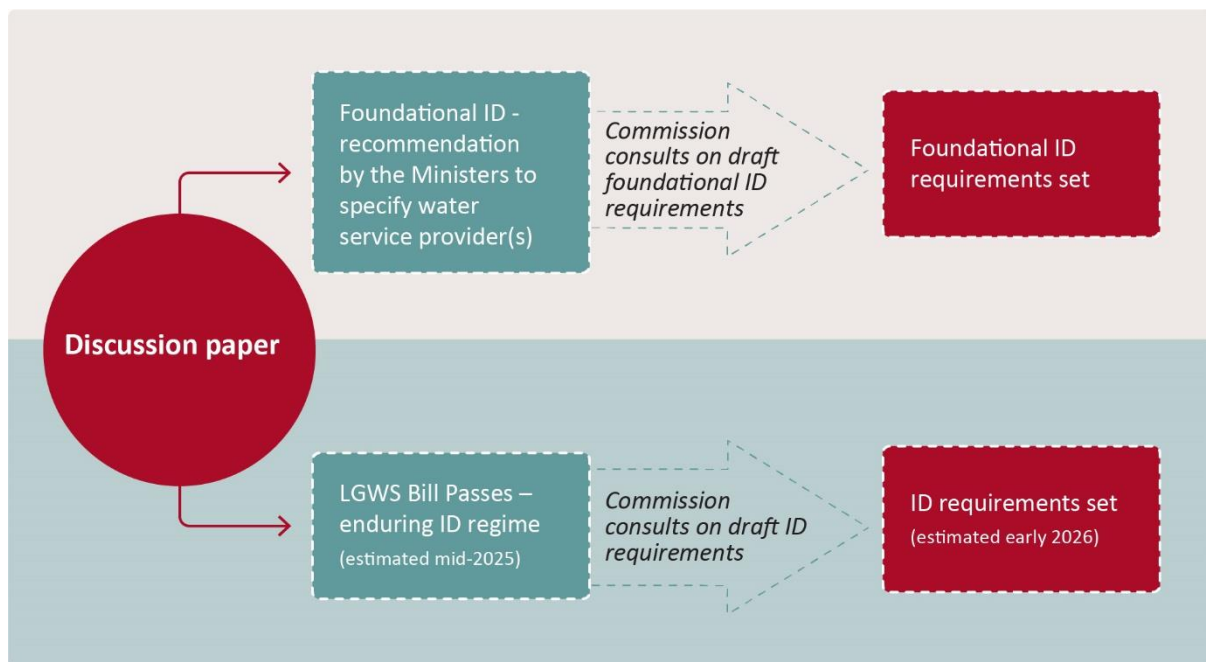
- 1.28 We are seeking stakeholder views on this discussion paper. Your views will support the development of economic regulation in the short-term (foundational ID under the WSPA Act), with a view to the longer term (enduring ID after the LGWS Bill is in force). We have provided feedback prompts throughout this discussion paper, outlining some of the areas we are particularly interested in your views on. The *Feedback Prompt Template* outlines how to provide your views, which are due by 26 March 2025. You can find this on our website [here](#).
- 1.29 We will keep stakeholders up to date on our process for developing an ID regime. You can sign up to our mailing list by emailing us at wai@comcom.govt.nz.

We will engage several more times before making a decision

He wā anō ka whakawhitiwhiti kōrero mātou me koutou i mua i te whakaoti whakatau

- 1.30 Based on the stages above, **Figure 1.2** shows the possible next steps for our development of ID. These steps are dependent on a recommendation by the Minister for Local Government and Minister for Commerce and Consumer Affairs (to specify a water service provider to be subject to foundational ID).¹⁸ They are also dependent on Parliament passing the LGWS Bill, which, as proposed, requires us to set ID requirements within six months of the legislation commencing.

Figure 1.2 An outline of the possible next steps



¹⁸ Local Government (Water Services Preliminary Arrangements) Act 2024, s 39.

1.31 There are two more key ways we intend to get stakeholder feedback to support any ID requirements:¹⁹

- **Consult on a draft of any ID determination**—we must seek submissions from stakeholders on a draft of any material ID determination(s). This will give stakeholders the opportunity to provide their views.
- **Run targeted workshops**—if needed, we may run targeted workshops to get more detailed technical input when developing any draft foundational ID determination or when finalising the determination.

¹⁹ This is based on foundational ID under the WSPA Act. We are likely to use the same methods for enduring ID under the LGWS Bill (if enacted as drafted).

2. Areas of interest and the types of information

Ngā wāhi ka āta tirohia me ngā momo mōhiohio

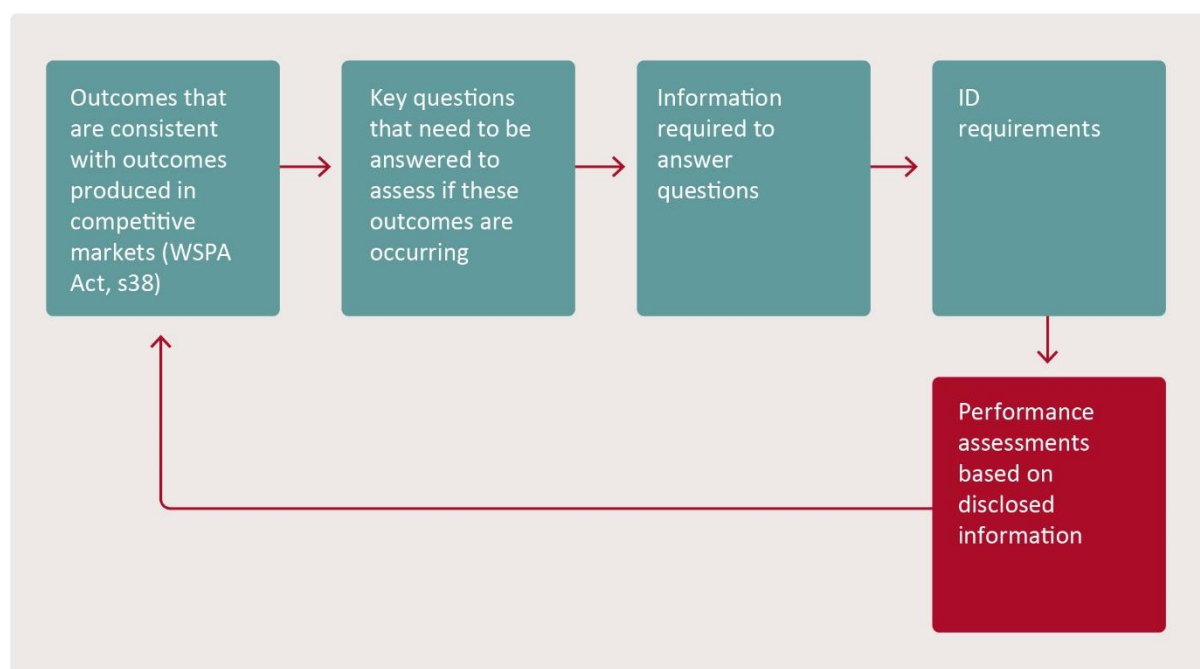
- 2.1 We want to understand what areas are most important to you, so we can take these into account when developing any foundational ID requirements. This chapter outlines our initial views on what we think stakeholders might want to understand about the performance of water service providers, and based on this, the information that those providers may need to disclose.

We set information requirements to answer important questions

Ka whakarite herenga mōhiohio hei whakautu pātai hirahira

- 2.2 **Figure 2.1** shows our high-level approach to developing any foundational ID requirements. We would base our ID requirements on the questions stakeholders have about the performance of water service providers in relation to the outcomes that are consistent with competitive markets. The sections below provide more detail on the outcomes, key questions, and information required to answer those questions.

Figure 2.1 Process for developing ID requirements



- 2.3 In determining what key questions and information we need to ask for and collect, we are also mindful of the cost to water service providers, which is ultimately paid for by consumers. Chapter 3 outlines how we intend to develop ID requirements in a cost-effective manner. This includes evolving ID requirements over time, considering existing practices and capabilities, and other regulatory requirements.

The WSPA Act outlines the service outcomes that we should test

Ka whakarārangi mai te WSPA Act i ngā otinga ratonga me mātua whakamātau

2.4 It can be complex to determine whether a water service provider is acting in the long-term interest of consumers—the underlying purpose of foundational ID. Stakeholders should be able to have confidence in a water service provider’s performance when the following outcomes are achieved over time:²⁰

- **Quality**—service is provided at a quality that reflects what consumers might reasonably expect.
- **Pricing**—prices represent value for money and encourage efficient use of water resources and infrastructure.
- **Investment**—investment occurs on the right things in the right place at the right time.
- **Efficiency**—spend is minimised while still meeting investment and regulatory requirements.
- **Sharing efficiency gains**—benefits of efficiency gains are shared with consumers, including through lower prices.
- **Innovation**—appropriate innovation occurs.
- **Limiting excessive profits**—an appropriate economic return over time is earned.

2.5 Enduring ID under the LGWS Bill is likely to cover similar outcome areas to those above, given the broadly similar purpose. It may also include an additional outcome relating to ring-fencing, that is, that revenue received from the provision of water services must be spent on those services.²¹ The LGWS Bill would also allow us to include ID requirements relating to consumer protection.²²

²⁰ This is in alignment with the purpose of foundational ID in the Local Government (Water Services Preliminary Arrangements) Act 2024, s 38.

²¹ Local Government (Water Services) Bill, Schedule 6 – new Schedule 7 of Commerce Act, cl 3. Ring-fencing is also a financial principle that water service providers must act in accordance with under the Local Government (Water Services) Bill, cl 16.

²² Local Government (Water Services) Bill, cl 226 – new cl 57X of the Commerce Act.

We have proposed a list of high-level questions about performance

Kua whakarite mātou i te rārangi pātai e pā ana ki te whakamahinga

- 2.6 Stakeholders may have different views on a water service provider's performance based on their area of interest. Therefore, ID needs sufficient scope to cover the full operational model of the water service provider's business. We consider that water service providers should already understand their own performance across these areas if they are operating in the long-term interest of consumers. They should also understand whether and how they might need to improve their performance.
- 2.7 **In Table 2.1** we have outlined high-level questions we think stakeholders may continue to have an interest in over the longer term, grouped by the areas of a typical operational model. We are not proposing to set ID requirements that answer all these questions straight away. As outlined in paragraphs 3.15 to 3.18 (including **Table 3.2**), we intend to evolve any ID requirements over time in a way that takes account of the cost to water service providers of complying with the requirements as well as which areas of performance stakeholders are most interested in.
- 2.8 We think that stakeholders will also be interested in the processes and assumptions the water service provider uses in answering the questions. For example, we think it would be helpful to know how the water service providers assess the condition of their assets in addition to knowing what condition the assets are in.

Table 2.1 Possible questions that stakeholders may be interested in asking

Relevant area	Questions that stakeholders may be interested in asking
Purpose and outcomes	<p>How does the water service provider measure its performance against its purpose and outcomes as set out in its strategic planning documents?</p> <p>How has the water service provider engaged with its consumers and stakeholders, including tangata whenua?</p> <p>What has the water service provider found from its engagement with consumers and stakeholders, including tangata whenua?</p> <p>What are the processes and assumptions used by the water service provider to establish the information that it is disclosing under ID requirements?</p>
Customer service	<p>Processes</p> <p>What processes does the water service provider have in place to address complaints? Are these working effectively?</p> <p>Do consumers have to a third party to assist with dispute resolution and arbitration?</p> <p>Responses</p> <p>How efficiently are customer complaints responded to and resolved?</p> <p>How did the water service provider respond to the physical faults and constraints?</p>
Levels of service	<p>To what extent are customers satisfied with the service provided by the water service provider?</p> <p>How has the water service provider ensured the drinking water is safe to drink and aesthetically pleasing?</p> <p>How is the water service provider meeting public health and environmental obligations?</p> <p>How is the water service provider ensuring that services are available when and where they are needed?</p> <p>What was the level of physical faults and constraints and how did they impact the service?</p> <p>How are new connections being provided for appropriately?</p>
Performance, condition, confidence analysis, and reporting	<p>Asset condition and criticality</p> <p>How does the supplier measure the condition of its assets and what is the condition of the water service provider's assets?</p> <p>How does the water service provider determine what assets are critical, and what are these assets?</p> <p>Data confidence</p> <p>How does the water service provider measure data confidence, and how reliable is the data?</p>

Looking after existing assets

What is the water service provider's standard for determining asset health and what credible plan does it have to ensure that it maintains or moves towards a reasonable state of assets?

If necessary, how is the water service provider moving towards a reasonable state of assets at a reasonable pace?

Maintaining and improving levels of service

What levels of resilience (eg, flood, drought, and earthquake) are being planned for and how does the water service provider know that the level is appropriate?

How might a demand-supply imbalance now or in the future adversely affect levels of service and/or new connections?

What investment is needed to maintain or achieve applicable levels of service, compliance, quality, and environmental regulations?

What investment is needed to maintain or minimise the water service provider's environmental impact in providing services?

Investment needs**Planning**

How is the water service provider integrating the findings of its engagement into its planning, expenditure, and operations?

What is the water service provider's asset management planning process?

How robust and mature is the water service provider's asset management planning process and what are its plans to improve it?

Growth

What planning has the water service provider done towards allowing for future growth?

Are those wanting to connect to the network able to do so without restraint, or are there constraints impacting on new connections?

Innovation

What is the historical, current, and planned expenditure on research and development activities?

What processes does the water service provider have to maximise the opportunities from innovations (both internally and externally developed) and solutions from the past? What innovations have recently been implemented and what lessons have been learnt from development and implementation of the innovation?

Expenditure

How does the water service provider's recent and forecast expenditure compare to its historical trends?

How does expenditure compare between different water service providers?

What does the water service provider do to ensure efficiency of spend?

How does the expenditure of water service providers compare to providers overseas?

What are the reasons and intended outcomes for planned expenditure?

Efficiencies

Are higher than expected returns a result of efficiency gains, and if so, how?

Are efficiency gains resulting in lower prices for consumers, and if so, how?

Financial management**Financial management**

Does the water service provider have ring-fencing provisions in place, and if so, what are they?

What are the financial systems that the water service provider has in place to enable the separate financial reporting of regulated water activities?

What dividend has the water service provider provided to its owner?

Has the owner provided any financial injections into the water service provider?

What plans does the water service provider have to make changes to its approach to ring-fencing and financial management?

To what extent does the water service provider engage in related party transactions?

What is the water service provider's approach to managing debt, interest costs and liquidity and how does this affect its investment and efficiency?

Revenue

What return has the water service provider been earning?

What return is the water service provider targeting in the future?

Pricing

What is the structure of charges or rates component?

Revenue and pricing

What rationale is the water service provider using in setting the structure of charges?

To what extent do customers understand the structure of charges and their bills?

Is the water service provider aiming for its charges to be as cost-reflective as is practicable? How does it plan to achieve this?

How do charges compare against efficient pricing principles?

To what extent does the water service provider charge development contributions for growth and what proportion of the total cost of growth are these contributions?

A range of information would be required to answer the performance questions

Inā te whānau o te mōhiohio e hiahiatia hei whakautu i ngā pātai whakamahinga

- 2.9 We consider that requiring water service providers to publicly disclose a range of non-financial and financial information would allow stakeholders to answer questions about the performance of those providers. This would help stakeholders assess whether the long-term interests of consumers are being promoted. **Table 2.2** sets out examples of information that we could seek through ID.

Table 2.2 Possible types of performance information that may be needed to understand performance

Quality of service information	<p>Customer satisfaction: Complaints handling, customer satisfaction scores, response and resolution times</p> <p>Availability of the service: Planned/unplanned interruptions, water restrictions, new connections</p> <p>Engagement methods</p>
Asset management information	<p>Asset information, condition, data confidence, consents, number of users by type</p> <p>Performance: Water loss, mains bursts, pressure, consumption, wastewater blockages, dry/wet water wastewater spills (internal/external), inflow/infiltration, compliance with drinking water standards and rules, resource consents, firefighting water supplies code of practice</p> <p>Asset Management Systems: Asset management policy, strategic asset management plan, asset management plan, asset information systems, asset management maturity</p> <p>Forecasts: 10-year, 30-year forecasts, annual programmes, delivery performance</p> <p>Capacity, utilisation, demand (including forecasts)</p> <p>Sustainability, resilience, and risk: energy use, response to climate change, natural hazards, risk management approach</p>
General financial information	<p>Historical financial information: Capex and opex by category, tax, revenue</p> <p>Projected financial information: Forecast capex and opex by category</p> <p>Explanations of variances between actual and forecast expenditure</p> <p>Asset values: Starting values, depreciation, revaluations, asset sales/disposals</p> <p>Financial performance: profits, dividends</p> <p>Cost allocation: Allocation of costs between the regulated water service provider and other purposes (eg, splitting cost of an office or vehicle that is used for the water service provider as well as other council activities)</p> <p>Financing: Cashflow, debt position, liquidity, financing costs of water service provider and its owner(s) and how they intend to manage future financing</p> <p>Supporting information</p> <p><i>Note: Regulatory accounts may differ to councils' statutory accounts in some respects, which is explored further in a separate technical working paper.²³</i></p>
Pricing and contractual information	<p>Prices</p> <p>Terms and conditions related to prices</p> <p>Pricing methodologies</p> <p>Development contribution methodologies</p> <p>Customer contracts/agreements for customers that have agreements that differ to the standard prices</p> <p>Related party transactions</p>

²³ Commerce Commission <https://comcom.govt.nz/regulated-industries/water-wai/economic-regulation-of-water-services-information-disclosure> webpage.

Feedback prompts – Understanding performance and information requirements

1. What are the top two or three things you want to understand about water service providers' performance in the short-term (in the context of the purpose of ID outlined in Chapter 1)?
2. Are there any additional performance questions (**Table 2.1**) that you believe should be added and why?
3. Are we missing any types of information (**Table 2.2**) that you think are needed to answer the performance questions we have posed and why?
4. Are there any areas that you think are the most important to ensure comparable information between providers?

3. How we could develop ID requirements

Ētahi huarahi mō te whakarite herenga ID

3.1 This chapter outlines how we could develop cost-effective ID requirements, including how these may evolve over time. It also seeks feedback on our approach to some other key features of the regime such as timing and assurance processes. The approaches outlined below would be relevant to developing any foundational ID requirements and are also likely to be relevant to an enduring ID regime under the LGWS Bill.

We intend to develop cost-effective information disclosure requirements

Ko te whakarite mātou i ngā herenga whākinga mōhiohio utu tika

3.2 We acknowledge that ID comes at a cost to water service providers, which is ultimately paid for by consumers. So, we intend to develop a cost-effective regime if we set ID requirements.

3.3 We would seek to balance the benefits from greater transparency that more comprehensive and detailed ID requirements would provide against the costs of complying with the requirements. In particular, we propose to:

- take account of water service providers' existing practices and capability
- tailor requirements based on water service providers' different needs and situations
- seek technical input from water sector stakeholders
- focus on information that will have the biggest benefit for understanding and influencing performance
- consider relevant obligations imposed on providers by other agencies, and
- evolve the requirements over time.

3.4 The sections below outline how we may apply each of these factors when developing any foundational ID requirements.

We propose to take account of water service providers' existing practices and capability

3.5 We acknowledge that water service providers may have significant differences in their current practices and capability when it comes to performance reporting. Water service providers may also be restructuring or merging as part of implementing their Water Service Delivery Plans. This may mean that some water service providers are limited in what information they can provide in the short-term.

- 3.6 We want to better understand water service providers' current practices and capability, so we can take this into account when setting any foundational ID requirements. As outlined in paragraphs 1.28 to 1.31, in addition to getting feedback on this discussion paper, we also intend to get stakeholders' views through consulting on any draft determination and through running targeted workshops (if needed). These would give stakeholders (including water service providers) an opportunity to share information on their ability to meet any proposed ID requirements, and on their current practices and capability.
- 3.7 We are also able to issue exemptions to water service providers for certain foundational ID requirements.²⁴ For example, we could issue limited exemptions for water service providers that are unable to meet the requirements at first (perhaps if more time is needed to develop the relevant systems and practices). The LGWS Bill also proposes exemption provisions.²⁵

We propose to tailor requirements based on water service providers' different needs and situations

- 3.8 When developing foundational ID requirements, we intend to have regard to the scale, complexity and risk profile of the water service providers.²⁶ We could then set different requirements to reflect relevant differences between water service providers or groups of water service providers. The LGWS Bill also proposes similar tailoring provisions.²⁷

We propose to seek technical input from the water sector stakeholders

- 3.9 We understand that it's important to get the technical details right in any ID requirements—for example, the definitions of certain measures and methodologies for preparing the information. As outlined in paragraphs 1.28 to 1.31, in addition to getting feedback on this discussion paper, we also intend to get stakeholders' views through consulting on any draft determination and through running targeted workshops (if needed). These would give stakeholders an opportunity to provide technical input on the way the information requirements are described (such as definitions and methodologies).

²⁴ Local Government (Water Services Preliminary Arrangements) Act 2024, s 44(5)(d).

²⁵ Commerce Act, s 53C(3)(d) (which will apply to ID regulation under cl 57B of the Local Government (Water Services) Bill).

²⁶ Local Government (Water Services Preliminary Arrangements) Act 2024, s 44(2).

²⁷ Local Government (Water Services) Bill, Schedule 6 – new Schedule 7 of Commerce Act, cl 4(2).

We propose to focus on information that will have the biggest benefit

- 3.10 We intend to focus our ID requirements on information that will provide the biggest benefit for understanding and influencing performance. We will focus on information that answers the questions on performance that stakeholders are most interested in and that we think currently present the most risk.

We propose to consider relevant obligations imposed on water service providers by other agencies

- 3.11 We understand that water service providers sit within a complex regulatory environment and are subject to many reporting and regulatory requirements.
- 3.12 To minimise the regulatory burden on water service providers, we intend to engage with other regulators to:
- identify where there could be areas of overlap or duplication
 - ensure alignment in any potential areas of overlap to avoid poor outcomes
 - coordinate timing if possible/relevant
 - consider the use of any relevant information sharing provisions in legislation to make use of information that the water service providers are already disclosing, and
 - maximise opportunities for complementary activities.
- 3.13 We will also build on information provided under Water Service Delivery Plans and will align, where possible, with similar information contained in the documents in the new planning and reporting framework for water services.²⁸
- 3.14 We have a memorandum of understanding with the Water Services Authority – Taumata Arowai, which sets out how we will work together.²⁹ We are already working closely together to minimise regulatory burden.

We propose to evolve the requirements over time

- 3.15 We propose to evolve any ID requirements over time and continue to make improvements. We intend to start with requirements that are realistically achievable for water service providers and ensure the basic information is being collected well.

²⁸ Department of Internal Affairs “[LWDW Factsheet: Planning and accountability for local government water services](#)” (December 2024).

²⁹ The memorandum of understanding is available on our “[Working with other agencies](#)” webpage. We intend to update this memorandum of understanding to reflect the LGWS Bill after it is enacted.

- 3.16 In some cases, this might mean starting by requiring disclosure of information that we know the water service providers already collect. We can then work towards getting the most benefit from ID in the longer term. This approach would also allow us to use the information disclosed by water service providers in the first years of any foundational ID regime to inform improvements to requirements in future years.
- 3.17 **Table 3.1** outlines our initial thinking on the main characteristics of information that best support stakeholders' understanding of the performance of water service providers. We consider that these characteristics are consistent with the statutory purpose of ID. We propose to make improvements to ID over time to move towards these characteristics as well as improving our understanding of what characteristics are important. However, we recognise that we may need to make trade-offs between the characteristics.

Table 3.1 Illustrative information characteristics for an enduring ID regime

Information characteristic	Reasoning
Relevant	To answer the performance questions that stakeholders are most interested in.
Cost-effective	To provide benefits that exceed the costs of collecting, managing, and assessing the information.
Comparable	To be comparable between water service providers across Aotearoa New Zealand, and internationally where practicable.
In scope	To line up with the scope of the service that we regulate as defined in legislation.
Consistent	To be consistent over time, so that performance trends can be appropriately assessed.
Accurate	To be accurate, supported by robust information management processes that are improving over time if required.

- 3.18 **Table 3.2** gives some examples of how our ID requirements could evolve over time to better meet the purpose.

Table 3.2 Potential evolution of ID requirements

Area of information	Potential types of ID requirements	
	Short-term	Longer term
Financial information <i>A separate technical working paper provides an explanation of different approaches to accounting (affecting depreciation, asset values, and profits) and how this could change over time.³⁰</i>	Financial accounts generally aligned to water service providers' current financial records (eg, based on Generally Accepted Accounting Practice).	<p>Higher prescription definitions.</p> <p>Regulatory accounts for ID separate to the water service providers' standard accounts.</p> <p>Potential for different measures of asset valuation, revenue, and expenses.</p> <p>Full and clear separation from non-water activities and between drinking water, wastewater, and stormwater.</p>
Asset management and capability	Asset management plans utilising councils' current format.	Asset management plans with a prescribed format and information requirements.
Pricing and contracts	Current pricing and an explanation of how it is set.	<p>Explanation of pricing approach and how well it aligns with standard principles of cost-reflective pricing.</p> <p>Information on contracts with customers that have non-standard prices or terms.</p>
Quality	<p>Measures similar to water service providers' existing practices eg, the current DIA non-financial performance measures and targets.</p> <p>Requirements for water service providers to collect information for publication in whatever way they choose, along with an explanation of how they collect the information.</p>	International best practice performance measures and benchmarking.

³⁰ Commerce Commission <https://comcom.govt.nz/regulated-industries/water-wai/economic-regulation-of-water-services-information-disclosure> webpage.

Feedback prompts - How to make the ID regime cost effective

5. Is there anything else we should be doing to help keep down the costs of the ID regime?
6. What do you think are the key differences between providers and how could providers be grouped based on these differences?
7. Are there any other ways you think we should engage with the water sector to get technical input?
8. Is there anything else we should do to minimise the impact on providers of working in a complex regulatory environment?
9. What do you think are the most important obligations from other agencies for us to consider when developing an ID regime?
10. What are the characteristics of information that you think are most important to the success of an ID regime?

We will set other key features of an ID regime

Ka mātua whakaritea ētahi tino āhuatanga o te pūnaha ID

3.19 When developing an ID regime, there are several things to consider in addition to the information required. These include:

- timing for ID requirements
- assurance requirements
- form of publication, and
- management of confidential information.

3.20 The following sections seek stakeholders' views on how we could implement these features in a foundational ID regime. This is also likely to be relevant for an enduring ID regime under the LGWS Bill.

We generally have three reporting timelines for different types of information

3.21 In other sectors we regulate, we have three different reporting deadlines and we will consider whether we apply these to the water sector. These three potential reporting deadlines for the water sector are shown in **Table 3.3**.

Table 3.3 Potential reporting cycle for ID requirements

Timing	Type of information
Start of the financial year <i>(1 July for water sector)</i>	Forward-looking information (such as asset management planning and financial forecasting): Water service providers would report by start of the financial year, with preparation likely to begin a significant time before then. Pricing information (such as schedule of prices for the upcoming year): Water service providers would publish before the start of financial year.
Soon after the end of the financial year <i>(perhaps November for water sector)</i>	Backward-looking information (such as historical expenditure by category): Water service providers would start collecting at the start of the financial year and report annually sometime after the end of the financial year.
Ongoing when relevant	Ongoing requirements (eg, publication of information relating to mid-year price changes or new contracts): Could be published when relevant, such as a certain time after entering into a new contract of a prescribed type.

3.22 We recognise that there will be significant but differing lead-in times for preparing and reporting this information, and that these might be greater in the first year. We anticipate that the lead-in time will be less for information that is already collected. We may need to scale back the requirements for the first year depending on how close to the start of the financial year we set any ID requirements.

3.23 Our timing for introducing new requirements will also depend on other processes the water service providers are going through. For example, requirements we set for asset management planning information may relate to the water services strategies and water services annual reports (under the LGWS Bill).

We propose to consider assurance requirements

3.24 In other sectors we regulate, we require suppliers to obtain assurance (such as audits) on the information they provide through ID. This is to ensure that the published information is an accurate reflection of the performance of the suppliers.

3.25 For each piece of information we require from water service providers, we propose to choose between three key types of assurance:

- **Audits**—water service providers would be required to procure an independent audit of the disclosed information. We are considering requiring water service providers to audit historical quantitative data and to report whether proper records have been kept to enable the complete and accurate compilation of the information to help ensure that those providers have the processes in place to develop robust datasets.
- **Non-audit assurance**—this includes reviews of information and compliance engagements under ISAE (NZ) 3000 (Revised). These are likely to be considered in respect of qualitative or forecast information.
- **Certification only**—water service providers would be required to provide a statutory declaration verifying the disclosed information (or information from which disclosed information is derived). We are considering requiring certification only for information that is not subject to an audit or non-audit assurance. This could be a requirement for a nominated director or councillor of the water service provider to certify that the information is compliant and based on reasonable processes and assumptions.

3.26 These three types of assurance are allowed for under the WSPA Act and the proposals in the LGWS Bill.

We propose to develop simple Excel templates for data

3.27 For other sectors that we regulate we typically provide templates in Excel for suppliers to complete and publish for quantitative data. Suppliers publish qualitative data like asset management plans in their own format as a pdf.³¹

3.28 We are considering using a similar approach for the water sector. “Flat” Excel files are simple for suppliers to input data to and simple for us or other stakeholders to extract data from.³² It is also flexible for the future as these can be easily updated to match changes in the requirements and allow for a wide variety of data extraction and processing technologies.

³¹ For example, see our “[Current information disclosure requirements for electricity distributors](#)” webpage to access Excel templates; and Vector 2024 AMP to see an example of an asset management plan.

³² “Flat” Excel files are files with the data recorded in a single simple table, without additional structure and formatting.

The WSPA Act allows us to exempt public disclosure of commercially sensitive information

- 3.29 The purpose of ID regimes is to allow interested stakeholders to assess performance, which requires any interested parties to be able to access the information. So, our starting point is that water service providers' information should be publicly accessible.
- 3.30 However, we recognise that a small number of pieces of desired information might be considered confidential or commercially sensitive. For example, it could be risky for water service providers to publish data on their cybersecurity performance because malicious parties could use the acknowledgement of weaknesses to their advantage. We are considering whether any information should be treated as confidential for the water sector.
- 3.31 The WSPA Act enables us to exempt public disclosure of commercially sensitive information so water service providers would only need to provide confidential information to us.³³ We may publish analysis based on that information or publish aggregated information.

Feedback prompts - Proposed key features of the ID regime

11. Do you see any issues with our proposed timing or is there anything else we should align with?
12. Do you have any views on assurance requirements and what type of assurance should apply to the different types of information?
13. Are there approaches other than Excel templates that you think would better support the publication of ID data?
14. What types of information do you think might be useful for the ID regime but best kept confidential?

³³ Local Government (Water Services Preliminary Arrangements) Act 2024, s 46.

12 FEBRUARY 2025

Economic Regulation of Water Services - Information Disclosure

Technical Working Paper on the Accounting Basis for Regulatory Reporting



Purpose

1. This technical working paper outlines some key areas of accounting that we could require for information disclosure that differ from current practices in local councils and in other regulated sectors. This paper should help staff in water service providers (councils and council-controlled organisations) who work on accounting and reporting, and others who provide services to them, as it provides a view of what may be required in the future.
2. There is a significant connection between the approach to economic regulation and the basis on which accounts are prepared for regulatory tools like information disclosure. This is because accounting standards often underpin the financial aspects of economic regulation. For example, different accounting approaches can significantly affect the value of an organisation's assets, which in economic regulation is often used as a significant input into the calculation of returns.
3. In setting economic regulation, including information disclosure requirements, we have broad discretion in specifying accounting approaches, so long as the regulation is in line with the statutory purpose of the regulation.¹ The scope of what is accounted for will generally be set by legislation and different to the scope of what local councils' accounts currently cover.
4. This paper should be read in conjunction with the *Economic Regulation of Water Services - Information Disclosure - Discussion Paper - February 2025*, which can be found on our [website](#).

Scope and purpose of financial reporting

5. We expect that water service providers will currently be preparing and reporting general purpose accounts under various statutes as well as tax and management accounts. However, future regulatory accounts may differ in purpose and scope from existing accounts because of the boundaries of the service to be covered by economic regulation. The areas covered by economic regulation will often (but not necessarily) be a subset of the areas covered by the other accounts. These potential differences are shown in **Table 1.1** below.

¹ Regulation is currently legislated for under the [Local Government \(Water Services Preliminary Arrangements\) Act 2024](#), and further regulation is proposed to be legislated for through the [Local Government \(Water Services\) Bill](#).

Table 1.1 Purpose and scope of different accounts

Type of accounts	Purpose	Scope
Management	To meet internal requirements to support governance and operational decision-making	To be determined by the organisation
Statutory accounts: Companies Act and Income Tax Act	Legal requirement to report overall financial performance and position and assessable income for tax purposes	Full scope of organisation or group, defined by ownership
Statutory accounts: Local Government reporting	Provide transparency of the council's financial position and performance	Full scope of the council (which may be a subset of the statutory accounts), following generally accepted accounting practice (GAAP)
Statutory accounts: Local Government (Water Services) Bill (proposed)	Provide transparency of water service provider's performance	Water services, prepared on a GAAP basis
Regulatory accounts	To enable stakeholders to understand various dimensions of performance and whether the water service providers are meeting proposed legislated financial principles (like ring-fencing) As input into regulatory tools beyond information disclosure, such as price-quality paths	Regulated water services as determined by legislation, excludes non-water services, may be split between drinking water, wastewater, and stormwater – a subset of the local government reporting accounts Can include consolidated accounts, eg, to assess compliance

6. Statutory accounts based on generally accepted accounting practice (GAAP) include standard reports like Statements of Financial Performance and Position. We will need to consider the extent to which these existing types of accounting reports help meet the intended purpose of information disclosure to decide whether we should require them.
7. We may require additional or different information for regulatory accounts that better allow stakeholders to understand the broader performance of the water service provider. For example, this includes understanding changes in the providers' efficiency over time, which may be difficult to assess from the information in statutory accounts. Management accounts might include similar information but may not be consistent between providers and might cover a different scope of services.

8. Our preference is to rely on GAAP for the rules that apply to information disclosure where it is appropriate for our regulatory purpose, and doing so may help minimise compliance costs.² However, we might determine the use of specific approaches when there is a choice under GAAP, or where we consider that deviating from GAAP is required to support regulatory objectives. It is likely that there will be some differences between the regulatory accounts we require and the existing accounts that the water service providers compile, at least in the longer term.

Accounting basis – capital maintenance

9. One important choice to determine for reporting under the regulatory accounts relates to the underlying capital maintenance concept. Under GAAP, there are two broad approaches to capital maintenance, which are outlined in **Table 1.2**.³

Table 1.2 Relevant differences between accounting approaches

Financial capital maintenance (FCM)

- Focus on maintaining the value of starting capital before recognising a profit
- Recognises capital gains and losses associated with holding the assets as a contribution to income
- In a regulatory context, we have applied FCM alongside historical cost asset valuation for existing and new assets used to supply the regulated service⁴
- If assets are revalued – eg, inflation-indexed – revaluations are recorded as income

Operating capability maintenance (OCM)

- Focus on maintaining the physical productive capacity (or operating capability) of the entity before recognising a profit
- Capital gains (and losses) do not contribute to the operating capability and so do not constitute a profit
- Assets are valued using current cost accounting methods (such as depreciated replacement cost)

10. Our understanding is that water service providers' current approach is to use current cost accounting, consistent with OCM, to report their accounts under GAAP.⁵ However, FCM provides the basis for the preparation of the regulatory accounts under Part 4 of the Commerce Act and Part 6 of the Telecommunications Act.

² The term generally accepted accounting practice is defined in the Financial Reporting Act 2013.

³ See External Reporting Board "[New Zealand Equivalent to the IASB Conceptual Framework for Financial Reporting 2010](#)" (February 2011).

⁴ This is referred to as regulatory asset base (RAB), which is typically established with a deemed historic cost, after which actual expenditure is used to update the RAB along with depreciation and (often) inflation indexation. In other sectors, the initial deemed historic cost has often been based on some form of current cost accounting.

⁵ Our understanding is that councils revalue their assets under a current cost approach and these revaluations are included in comprehensive revenue and expenses and accumulated in an asset revaluation reserve. These asset revaluations are not recognised as profit.

11. FCM is a key accounting approach and economic principle we use to regulate monopoly suppliers in the electricity and telecommunications sectors to create a consistent incentive to invest. FCM provides investors in regulated suppliers with an expectation of a return on capital, and a return of capital based on a regulatory depreciation allowance.⁶ FCM is applied in a way that preserves the value of the invested capital while also compensating for some risks that come from investing capital. We consider that this can support both the investment, and the borrowing required for investment, with an expectation of the investment being recovered over time.
12. The difference between an FCM-based regime and an OCM-based regime can best be illustrated by the differences in the way assets are valued and the purpose of providing a depreciation allowance:
 - 12.1 Under a regulatory regime based on FCM, assets are valued at historical cost. The purpose of the depreciation approach is to provide for the recovery of capital costs already incurred. Any expenditure on replacing assets is treated as new investment which will, in turn, be depreciated on a historical cost basis and suppliers will generally expect to earn a reasonable return on that investment. Revaluations of the assets are treated as income.
 - 12.2 Under a regulatory regime based on OCM, assets are valued with reference to current market values or replacement cost. The purpose of the depreciation is to provide the supplier with the means of maintaining the operating capability of the business at a defined level. This means that regulatory depreciation is viewed as providing the funds for the renewal expenditure. In most OCM applications, depreciation allowances are likely to reflect the cost of replacing the existing asset with an optimised asset (ie, a modern equivalent replacement) rather than the historical cost of the actual asset. Revaluations of the assets are not treated as income.
13. We consider that there are advantages and disadvantages in using FCM or OCM as the basis for reporting the regulatory accounts for water and to set regulatory charges under an enduring regulatory regime. **Table 1.3** highlights the key features of each approach.

⁶ The FCM principle can be implemented using the net present value equals zero (NPV=0) principle. In the context of an investment, the NPV=0 principle ensures that the present value of the cash flow payments to capital (i.e., the free cash flow) equals the initial investment when the weighted average cost of capital is used as the discount rate. This effectively implies that the cash flow payments to capital provide investors with a normal return on capital, and a return of the initial capital invested.

Table 1.3 Comparison of financial capital maintenance and operating capability maintenance

Financial capital maintenance (FCM)	Operating capability maintenance (OCM)
Advantages	
<p>Consistent with incentivising investment, an important requirement for the water sector.</p> <p>A key problem in parts of the water sector has been underinvestment and low returns, not an excess return problem. We consider that the FCM principle can be useful because it provides more certainty for providers of capital, with the expectation of investment by the water service providers being recovered over time.</p> <p>Valuation of new assets when they enter the supplier's total asset value is relatively simple by recording actual costs.</p> <p>Calculation of profitability under FCM also provides appropriate investment signals under increasing or decreasing asset values because revaluations are treated as income.</p>	<p>Strong focus on maintaining the capability of the network at a pre-defined level of capability to produce.</p> <p>Useful for managerial decision-making.</p> <p>Consistent with current cost accounting practices, which councils are already using.</p>
Disadvantages	
<p>We understand that water service providers' current accounting practices are based on an OCM approach (including valuing assets by applying optimised depreciated replacement cost) rather than an FCM approach. If FCM is more appropriate, we would need to consider the practicalities of transitioning to a system of reporting regulatory accounts based on FCM.</p> <p>Any economic regulation approach based on an FCM principle will need to ensure that sufficient revenues are generated to pay for the infrastructure investment needs over time, while providing a path to financial sustainability. Under an FCM approach, the ability to achieve this objective is likely to depend (among other relevant factors) on the initial value assigned to water assets.</p> <p>Initially setting a total value of assets for an organisation can be challenging.</p>	<p>An OCM-based approach can expose regulated suppliers to the risk associated with unpredictable changes in capital costs relative to prices over time, meaning that they do not recover past investment in real terms, even where such investment is prudent and efficient.</p> <p>An OCM approach can equally result in windfall profits—in other words, profits that are not earned because of superior performance, but as a result of circumstances outside the regulated supplier's control.</p> <p>Deriving replacement cost values can often be a difficult exercise subject to significant judgement.</p> <p>Investment signals when asset values are increasing or decreasing may be inappropriate because revaluations are not treated as income (eg, lower depreciation on declining asset values will result in increased profitability, encouraging new investment, even though this investment may not be sustainable).</p>

14. One of the most significant decisions involved in establishing a new regulatory regime is whether, and if so how, to determine an initial total value of assets. Even if we choose to base the regime on the FCM principle, which values new assets at historical cost, we may choose an alternative approach to setting the initial value of existing assets. Once the initial total value of assets is established, it typically becomes a 'deemed' historical value at that point representing the financial capital already used by the supplier to provide regulated services, irrespective of the methodology used to determine it.
15. Overall, we will need to consider which capital maintenance approach is appropriate to apply to water service providers. One option we will consider is for water service providers to continue with their existing approaches to financial reporting to begin with. We would then consider whether to transition to FCM at some point in the future if it is in the long-term benefit of consumers of regulated water services.