

WHAT FUTURE ECONOMIC REGULATION MIGHT LOOK LIKE – LESSONS FROM ELECTRICITY, GAS AND AIRPORTS

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ABSTRACT

This paper considers how economic regulation is currently applied to New Zealand electricity, gas and airport businesses, and attempts to draw conclusions from these experiences as to how any potential future economic regulation of New Zealand water and wastewater providers could operate.

While New Zealand's regulatory framework is similar to those in the UK and Australia, the way in which it is implemented differs in some important respects. In general, it is lower-cost and less intrusive than the corresponding frameworks in those countries. While some sectors are subject to price and quality regulation, others are subject to less intrusive monitoring frameworks. In each case, the regulatory framework is designed to have low-cost default settings, with more complex regulations applied in certain circumstances. The regulatory framework is also designed to be scalable and to apply across a large number of suppliers.

While key objectives of economic regulation are to restrict monopoly pricing power and protect consumers' quality of service, these are far from the only objectives. Economic regulation can ensure fair prices and returns, and provide incentives for long-term investment and for efficiency and innovation. It can also provide certainty around future returns, which helps with investment and pricing decisions.

KEYWORDS

Economic regulation, natural monopoly, Commerce Commission, Commerce Act, pricing

1 INTRODUCTION

There was considerable discussion at the 2014 Water New Zealand conference about the possibility of future economic regulation of water and wastewater provision in New Zealand, in-keeping with the 'Implementing Reform' conference theme.

The papers that considered what future regulation of water and wastewater might look like largely focused on lessons from international jurisdictions, typically the UK and Australia. These are the most relevant international jurisdictions to consider, and their lessons are important. But there are other New Zealand industries which have experience with economic regulation. In our view, any consideration of what water and wastewater regulation might look like should consider those experiences, in addition to overseas regulation.

The New Zealand Commerce Commission (the Commission) implements economic regulation under Part 4 of the Commerce Act 1986 (Part 4). Currently, this involves the regulation of Transpower, electricity distribution businesses (EDBs), gas pipeline businesses (GPBs), and the three major international airports. Part 4 has provisions for adding new businesses and industries to the list of entities subject to economic regulation. We can draw on the experiences of the existing Part 4 regulation to consider potential future water and wastewater regulation.

While the overall Part 4 regulatory framework applies to each of the regulated sectors, the specific type of economic regulation applied, and the way in which it is implemented, differs between each sector.

This paper considers the Part 4 framework, and how it is currently applied to electricity, gas and airport businesses, and attempts to draw conclusions about what any future regulation of water and wastewater in New Zealand might look like. In particular, it considers how the water and wastewater providers compare to other regulated New Zealand businesses, and what this might imply for how water and wastewater could be regulated under similar overall objectives and principles to those used in Part 4.

In addition to considering the types of regulation that could be applied to water and wastewater businesses, this paper also considers the possible effects of economic regulation, in terms of both high-level outcomes and day-to-day processes for the providers.

Lastly, we note that this paper does not provide any opinion as to the merits, or otherwise, of implementing economic regulation in the New Zealand water and wastewater sector. It also does not consider whether, or to what extent, any legislative change would be needed in order to implement economic regulation.

2 THE PURPOSE OF ECONOMIC REGULATION

Competitive markets, with multiple businesses each competing to serve customers, are typically considered to achieve the most efficient outcomes – in terms of allocation of resources, and delivering what consumers want as cheaply as possible.

But in some industries, one individual firm can supply the whole market at a lower cost than a number of smaller firms supplying customers separately – these industries are known as ‘natural monopolies’. The most efficient market structure in these industries is for one firm to supply the entire market. Classic examples of natural monopolies are utilities and other large infrastructure-based sectors.

Monopoly firms have considerably more market power than firms in competitive markets. Monopolies can raise prices, or reduce service levels, without the threat of customers switching to other suppliers – the only response customers can make is to consume less (or not at all).

The primary purpose of economic regulation is to restrict this market power, while at the same time allowing the most efficient market structure to be used in a natural monopoly industry. It tries to mimic the outcomes produced in competitive markets, but under a monopoly structure.

The purpose of economic regulation under Part 4 is as follows:

“The purpose of [Part 4] is to promote the long-term benefit of consumers in markets [where there is little or no competition and little or no likelihood of a substantial increase in competition] by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services-

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
- (d) are limited in their ability to extract excessive profits.” (Commerce Act 1986, s 52A)*

This articulation of the regulatory purpose clearly sets out the intent to replicate the outcomes from competitive markets in markets which naturally lend themselves to monopolies. It also shows that while key objectives are to restrict monopoly pricing power and protect consumers’ quality of service, these are far from the only objectives. Regulation can also ensure fair prices and returns – providing incentives for cost reduction, while still allowing businesses to recover their costs from customers. In addition, regulation can provide certainty around future returns, helping investment and pricing decisions.

This Part 4 purpose also specifies the provision of incentives for efficiency and innovation. Regulation does not simply focus on short-term cost minimisation. It encourages investment in a way that best meets consumers' needs over the long term.

Regulation can sometimes be seen as harmful to monopoly infrastructure businesses. It is often considered that it restricts the options and flexibility, particularly in terms of pricing and expenditure decisions, that these businesses would otherwise have. But regulation typically still allows a large degree of flexibility regarding individual prices and the specific means of delivering desired outcomes. For water and wastewater providers, it is not necessarily the case that regulation will be more restrictive than existing council oversight. Furthermore, the regulatory focus on incentivising efficient investments for the long-term benefit of consumers is likely to help providers ensure that supply is maintained and that customer needs are met.

3 OVERALL APPROACH TO REGULATION

New Zealand differs from other regulatory jurisdictions, such as the UK and Australia, in some important respects which influence the regulatory approach used in this country.

- Regulated businesses in New Zealand are relatively small compared to their international counterparts. Even Transpower, the electricity transmission business for the whole country, is substantially smaller than the regulated electricity transmission businesses in the UK and Australia.
- New Zealand's electricity distribution sector has a relatively large number of businesses (29, whereas the UK has six). These EDBs cover a considerable range of sizes.
- New Zealand has a relatively small population over which to spread the administrative and compliance costs of regulation.

The regulatory framework is designed to provide a relatively low-cost form of economic regulation. In general, New Zealand's regulatory framework is lower-cost and less intrusive than corresponding frameworks in other countries. The Commission has noted that “[a] less burdensome method to achieve the regulatory purpose is always preferable to a more onerous one, all other things being equal” (Commerce Commission, 2008, para 197), and as such the regulatory methods are only as intrusive as is absolutely necessary.

While the regulatory framework is relatively low-cost in general, it also utilises more intrusive methods where it is deemed appropriate. It is also designed to accommodate a large number of suppliers, and be scaleable from small suppliers to large ones.

This balance between low-cost methods and effective regulatory oversight is primarily achieved in the following ways:

- Different businesses are subject to different types of economic regulation. Some types of businesses are only subjected to relatively light-touch regulation, while others are subject to more intrusive regulation. In addition, more intrusive regulation for certain sectors has only been applied after a period of light-touch regulation.
- Some businesses in otherwise regulated sectors are not regulated at all. Most notably, New Zealand has a number of airports, but only the three largest are subject to regulation.
- Price-quality regulation for some businesses involves two ‘forms’. A low-cost ‘default’ form applies to all businesses subject to this form of regulation, but individual businesses (expected to typically be the larger ones) can seek a more precise (but higher-cost and more intrusive) alternative to the default regulation if that might better align with their individual circumstances.

4 THE DIFFERENT TYPES OF REGULATION

There are two different types of economic regulation currently used by the Commission – ‘information disclosure regulation’, and ‘price-quality regulation’. All of the currently regulated sectors are subject to information disclosure regulation. Some sectors are also subject to price-quality regulation. Table 1 shows the types of regulation currently applied to each business.

Table 1: Type of regulation each sector is subject to

	Information disclosure regulation	Price-quality regulation
Transpower (electricity transmission business)	✓	✓
Non-consumer owned electricity distribution businesses	✓	✓
Consumer owned electricity distribution businesses	✓	
Open-access gas pipeline businesses	✓	✓
Auckland, Wellington & Christchurch airports	✓	

Part 4 also allows for ‘negotiate/arbitrate regulation’, but that is not currently used by the Commission.

4.1 INFORMATION DISCLOSURE REGULATION

Information disclosure regulation is the lowest-cost form of regulation currently used by the Commission. All regulated businesses are subject to it, and for some businesses it is the only type of economic regulation they are subject to.

This type of regulation involves each business making public a variety of information at regular (typically annual) intervals. The required information is specified by the Commission, and while the details differ by sector, it broadly includes:

- financial information, including expenditure, profitability and returns
- asset management plans and expenditure forecasts
- pricing information, including pricing methodologies and other contractual information
- asset information
- consumption information
- quality of service information.

Information disclosure is seen as a key part of the regulatory framework. Its purpose is to ensure that sufficient information is available to interested persons to assess whether the overall purpose of regulation (achieving outcomes consistent with those of competitive markets) is being met. This is particularly important for the businesses which are not also subject to price-quality regulation.

4.2 PRICE-QUALITY REGULATION

Price-quality regulation involves explicit regulation of prices (or revenues) and service quality levels. It is the ‘traditional’ method for regulating monopoly infrastructure businesses in the UK and Australia (among other countries).

4.2.1 OVERVIEW OF THE APPROACH USED

For a given regulated business, the Commission sets maximum prices (or revenues) in advance for a given time period – typically five years. The business is allowed to set its prices at or below that level. This does not involve regulation of individual prices – rather, it involves regulation of the total revenue earned, typically through setting a maximum weighted-average price. Businesses still have flexibility over how they spread the recovery of revenue across their customer base.¹

The maximum prices are set such that the business can recover from the customers the full cost of providing the service. The Commission determines a forecast of the business’ operating and capital expenditures, and asset values, over the period, and then uses this to determine a forecast of annual costs using the ‘building block’ approach. Put simply, the ‘building blocks’ are: operating costs plus depreciation plus a return on capital plus tax. Maximum prices are set equal to the sum of the building block costs.

The Commission also sets standards for business-wide average service levels, for the same time period, that must be complied with. To date, the Commission has set standards which are based on historical quality levels – as part of an approach designed to achieve ‘no material deterioration’ of service levels. (see, for example, Commerce Commission, 2009).

This approach incentivises businesses to reduce their costs during the period. If a business can deliver its service, and comply with the specified quality standards, at a lower cost than was forecast by the Commission, then it can make a profit in excess of the allowed return on capital.

4.2.2 WHICH BUSINESSES THIS IS APPLIED TO

In New Zealand, only Transpower, non-consumer owned EDBs and GPBs are subject to this form of regulation. Consumer owned EDBs and the airports are not. Price-quality regulation is applied to businesses with a significant degree of market power, and the incentive to use it, where information disclosure is not considered sufficient for restricting market power and achieving outcomes consistent with those in competitive markets.

All EDBs have monopoly market power, but the consumer-owned EDBs are considered to have less of an incentive to use that power than non-consumer owned ones. Through their ownership, consumers have more of an influence over pricing and quality decisions than for non-consumer owned EDBs. Furthermore, any profits earned by exercising market power are ultimately returned to the customers.

The airports, on the other hand, are considered to have lower market power than EDBs and GPBs, because they have a smaller number of customers (the airlines) who have some degree of market power themselves. Through their market power, the customers can influence pricing and quality decisions.

4.2.3 DIFFERENT METHODS OF IMPLEMENTATION FOR DIFFERENT BUSINESSES

NON-CONSUMER OWNED ELECTRICITY DISTRIBUTION BUSINESSES AND GAS PIPELINE BUSINESSES

The non-consumer owned EDBs and the GPBs are subject to two forms of price-quality regulation. A low-cost ‘default’ form applies to all these businesses – known as default price-quality paths (DPPs). Individual businesses can then seek an alternative to the default regulation if that might better align with their individual circumstances – known as a customised price-quality path (CPP).

Under the default method, forecast costs are determined in a relatively low-cost way. For example, some expenditure forecasts are developed by extrapolating historical values rather than using detailed bottom-up forecasts, in some areas industry-average values are applied to all businesses, and simplifying assumptions are made. This default form of price-quality regulation is lower-cost and less intrusive than corresponding price-quality methods in the UK and Australia, and reflects the large number, and relatively small scale, of regulated businesses in New Zealand.

¹ Regulation of specific prices is achieved through other means. For example, pricing methodologies are commonly required as part of information disclosure requirements, while the Electricity Authority has pricing principles which EDBs are expected to comply with.

Individual businesses can apply for a CPP if that might better align with their circumstances. Customised prices are determined using a much more intrusive approach than default prices. This includes much more detailed consideration of the business' expenditure forecasts, demand, service outcomes, engagement with customers, and justifications for investments. But they enable prices, and quality standards, for an individual business to better reflect business-specific information and customer needs.

TRANSPOWER

Transpower does not have two forms of price-quality regulation. Its prices and quality standards are set in a way which is similar to a CPP in terms of level of detail and intrusion, and it also has specific rules about capital expenditure which EDBs are not subject to. It is not able to seek an alternative to its price-quality path – its initial determination is intended to already reflect its unique circumstances.

Transpower is larger than all the EDBs, and much larger than many. It is better able to interact with a regulator and to absorb the costs (both financial and non-financial) involved with regulation. This reduces the benefits of using a low-cost regulatory method. Furthermore, one of the elements of the default approach for other businesses is that industry-average values are applied to all businesses – this distinction between a DPP and CPP is removed when there is only one supplier.

4.3 NEGOTIATE/ARBITRATE REGULATION

Negotiate/arbitrate regulation involves the business and its customers collectively agreeing on a combination of prices, investments, service quality levels, and any other important elements. The regulator typically only intervenes if the parties cannot reach an agreement.

This type of regulation is less costly and intrusive than price-quality regulation, and can be useful in sectors where there are a relatively small number of customers which have some market power themselves. It is used in some overseas jurisdictions, most notably in telecommunications and airport sectors. While included as an option in Part 4, this type of regulation is not currently used in New Zealand.

4.4 TRANSITIONAL ARRANGEMENTS

The regulatory methods used today have developed over time. The level of regulatory oversight applied to businesses has gradually increased to today's levels. This has allowed light-touch regulation to be considered first, with more intrusive regulation only considered if light-touch methods are not achieving outcomes consistent with those in competitive markets. It has also allowed the businesses time to understand each tranche of rules, and time to adapt their businesses to be able to comply with the regulations.

Price-quality regulation was not the first step for those businesses currently subject to it. For example, non-consumer owned EDBs and GPBs were subject to various forms of information disclosure regulation before price-quality regulation was first imposed in 2003, with subsequent refinements enacted in 2008.

Between 2012 and 2014, the Commission investigated the effectiveness of information disclosure regulation for each of the three airports. While the conclusions were mixed, no additional regulation has been implemented (or formally proposed).

5 HOW THESE REGULATORY PRINCIPLES COULD APPLY TO WATER BUSINESSES

In this section, we consider the similarities and differences between New Zealand water and wastewater providers and currently regulated New Zealand businesses. We use this comparison to consider how the regulatory principles and approaches used for in New Zealand to date could be applied to water and wastewater providers.

5.1 COMPARISON OF WATER AND WASTEWATER PROVIDERS WITH OTHER REGULATED BUSINESSES

5.1.1 NUMBER AND SIZE OF BUSINESSES

There are 67 different monopoly providers of water and wastewater services to residents and businesses in New Zealand. This is considerably more than the number of firms in other regulated sectors. There are 29 EDBs (10 non-consumer owned and 19 consumer owned), five GPBs, three regulated airports, and only one electricity transmission business.

63 of these water and wastewater providers are vertically integrated businesses. The exception is the four urban Wellington councils, which do not provide upstream water services – Greater Wellington Regional Council undertakes that activity. These five Wellington councils also contract out much of the operation and management activities to the jointly-council owned Wellington Water, but still retain ownership of the assets and set charging and other policies themselves.

The providers for the main cities are relatively large. Watercare has a similar scale to the largest New Zealand EDBs (Vector and Powerco). However, the majority of the district council providers are very small – even relative to the smallest EDBs.

5.1.2 CUSTOMERS

Water and wastewater is provided to a large number of individual households and businesses, similar to the electricity and gas sectors. This differs from the regulated airports, which have a very small number of customers with some degree of market power themselves.

5.1.3 OWNERSHIP AND GOVERNANCE

Water and wastewater provision in New Zealand is undertaken by local councils. The overwhelming majority of councils provide water and wastewater directly (along with the other council services). In Auckland, provision is by Watercare, an arms-length company 100% owned by Auckland Council. And as noted above, the urban Wellington councils contract out much of the operation and management to Wellington Water, a company jointly owned by those councils.

In terms of governance and ownership, there is no entity amongst the currently regulated businesses which is directly comparable to the council-based structure of the majority of the water and wastewater providers. However, in terms of the influence that customers have over decision-making, council-based provision is not too dissimilar from the majority of EDBs which are owned by customer trusts. The influence that customers have over these EDBs (and the fact that any profits are returned to those customers) is the reason that they are exempt from price-quality regulation. Local councils face a not dissimilar level of influence from their local residents and businesses.

The arms-length structure of Watercare is similar to three EDBs – Orion New Zealand, Aurora Energy and Electricity Invercargill – which are owned by local councils. While this arms-length arrangement is designed to reduce the level of political influence on the business, these businesses may still be subject to considerable influence from local residents and businesses, as a result of their council ownership.

The council ownership of water and wastewater differs considerably from those EDBs, GPBs and airports which are privately owned, where consumers have minimal ability to restrict the market power of the business.

5.1.4 FINANCING BASIS

All the currently regulated New Zealand businesses are self-financing. They charge their customers for specific services provided, to a sufficient level to fund their activities. In addition, the revenue they collect for their regulated activities is separate from any revenue they collect for unregulated activities.

In contrast, only a small number of New Zealand water and wastewater providers currently charge their customers specifically for these services. Examples include Watercare, Tauranga City Council and Kapiti Coast District Council. The majority of New Zealand councils fund the provision of water and wastewater through rates.

Where water and wastewater is completely funded through a targeted rate, the amount collected for these activities is explicit. However, this is not the case for councils which (either completely or partially) fund water and wastewater through general rates.

5.2 POSSIBLE APPLICATION TO WATER AND WASTEWATER

5.2.1 SIZE-BASED EXEMPTIONS FROM REGULATION

The smallest water and wastewater providers are smaller than the smallest EDBs – which are currently the smallest regulated entities in New Zealand. It may be appropriate, at least initially, for the smallest providers to be exempt from all economic regulation on account of their size.

Such an exemption would be consistent with the general approach of economic regulation only being applied to businesses where the benefits are likely to outweigh the costs. It would also be consistent with the treatment of airports, where currently only the largest three airports are regulated. We note however that there is currently a minimum size for EDBs for inclusion in regulation, and under a similar threshold no water and wastewater providers would be exempt from regulation.²

5.2.2 INFORMATION DISCLOSURE AS A FIRST STEP

If water and wastewater providers were to be regulated, information disclosure should be a key part of that regulation. The Commission currently subjects all regulated businesses to information disclosure regulation, and (apart from the issue of size discussed above) we see no reason for water and wastewater businesses to be treated differently.

It would also be appropriate for information disclosure to be applied as a first regulatory step. Then only if information disclosure was found to not be achieving the regulatory purpose, of outcomes similar to those in competitive markets, should price-quality regulation be considered. This approach would be consistent with that used in the past for Transpower, non-consumer owned EDBs and GPBs.

5.2.3 NEGOTIATE/ARBITRATE IS NOT USEFUL

It is not appropriate to apply negotiate/arbitrate regulation to water and wastewater businesses. This type of regulation is only useful in industries with a small number of relatively large customers – which is not the case for water and wastewater.

5.2.4 POSSIBLE EXEMPTIONS FROM PRICE-QUALITY REGULATION

As discussed above, council-based provision of water and wastewater is not too dissimilar from customer ownership of the majority of EDBs. In both cases, the customers have considerable ability to influence the decision-making of the business and restrict any market power.

As a result, price-quality regulation may be unnecessary for water and wastewater providers. This approach would be consistent with the exemption given to consumer owned EDBs.

It may still be appropriate for price-quality regulation to be applied to providers operating at arms-length from their council owners, such as Watercare. This would be consistent with the regulation applied to the EDBs owned by local councils. However, it would still be appropriate to apply information disclosure first, and see what effect that type of regulation had. This would allow the extent of customer influence over the business to be tested – only if information disclosure was considered insufficient should price-quality regulation be implemented.

5.2.5 RING-FENCING FOR PRICE-QUALITY REGULATION

As noted above, some New Zealand water and wastewater providers fund these activities, either fully or partially, through general rates.

² The EDB threshold is: 500 consumers, a network length of 25km, and total electricity supplied of 20 gWh per year. Only one need apply to be exempt. The smallest council has a water and wastewater service well in excess of the first two elements of this threshold.

Funding the provision of water and wastewater through general rates introduces some practical difficulties into the implementation of price-quality regulation. In particular, it makes it difficult to determine the amount of revenue collected for the water and wastewater activities, because that revenue is not separated from the revenue collected for other activities.

Without this distinction, a regulator would need to consider a breakdown of forecast costs. But this is not always a useful indicator – total forecast revenue does not always equal total forecast costs in a given year, and the regulator would have little oversight over the development of the costs for other council activities.

In order for price-quality regulation to work well in practice, the revenue collected for water and wastewater would need to be explicitly specified, as distinct from revenue collected for all other activities. This does not mean that delivery of the services, and their costs, would need to be separated from other council services. Shared costs can be easily allocated between regulated and unregulated services (which is currently done by many of the regulated businesses), but the revenue needs to be separate.

5.2.6 THE ‘TWO-FORM’ APPROACH TO PRICE-QUALITY REGULATION

If price-quality regulation was to be imposed to water and wastewater (at least for some providers), the ‘two-form’ method applied to non-consumer owned EDBs and GPBs is appropriate, rather than the single-form method applied to Transpower.

The large number of water and wastewater suppliers, many of whom are very small, lends itself to using the low-cost default method in the first instance. In fact, given that there are considerably more water and wastewater suppliers than non-consumer owned EDBs and GPBs, the two-form approach is even more useful for water and wastewater than it is for those currently regulated businesses.

This would mean that the form of price-quality regulation imposed on water and wastewater providers, if it was imposed at all, would be lower-cost and less intrusive than price and quality regulations in the UK and Australia.

6 WHAT THIS MIGHT MEAN FOR SUPPLIERS

In this section, we consider the potential day-to-day effects of economic regulation on water and wastewater providers.

6.1 INFORMATION DISCLOSURE REGULATION

The impact that any information disclosure regulation would have on water and wastewater providers will obviously depend on the specifics of the information required to be disclosed. However, the experience of other regulated businesses can help us assess the extent of possible impacts.

Water and wastewater providers already publish a considerable amount of information about their business, for example in Annual Reports, Asset Management Plans and Long-Term Plans. The requirements of a regulatory information disclosure regime may not be too different from existing business practices.

What a regulatory will try to do through an information disclosure regime is to make that information consistent between suppliers and over time, and to ensure that the information being made public is sufficient to enable consideration of whether the outcomes are consistent with those of competitive markets. This could mean that providers are required to make public some information which they do not currently make public, or to collect or disclose information in a different format to that currently used.³

Consistent with the experience of other businesses, a transitional approach would likely be applied to implementing information disclosure. Relatively easy to produce information would be required initially, with additional or different information required over time. A regulator would expect that the quality of businesses’

³ We note that there is already a good degree of consistency between New Zealand providers, in terms of many measures, as a result of the Water New Zealand benchmarking initiative (which currently includes 31 providers).

data would improve over time, and the transitional arrangements would give businesses the chance to ensure their information was robust before requiring them to publish it.

If information disclosure requirements become materially different from the information collected and produced in a normal course of business, it is our experience that complying with the requirements will likely take a not-insubstantial amount of time and cost – firstly to understand the regulations, and then to comply with them. The existing information disclosure requirements involve considerable costs for regulated businesses – particularly the relatively small ones.

The overall purpose of information disclosure is for this information to be made available to interested persons, to help them assess whether the outcomes are consistent with those in competitive markets. This public provision of information has the ability to change the way that businesses make decisions, and could change the outcomes for customers, but the extent to which this might be the case for water and wastewater providers is unclear.

Lastly, it is possible that a regulator may attempt to push water and wastewater businesses to make improvements over time. A particular example is asset management planning, where the Commission has increasingly put the onus on EDBs and GPBs to provide more robust justifications for their expenditure decisions.

6.2 PRICE-QUALITY REGULATION

The experiences of economic regulation in New Zealand is that price-quality regulation will only be implemented after information disclosure regulation had already been in place for a number of years, and where information disclosure has been considered to be insufficient in order to achieve outcomes consistent with those of competitive markets. Water and wastewater should not be any different.

This type of regulation will limit the amount of revenue that each provider can collect from consumers in any given year. However, providers will still have flexibility over individual charges, and how that total revenue is spread over its customer base and types of charges. It is also unclear whether price-regulation would lead to more or less revenue being collected by providers for water and wastewater – it is not necessarily the case that it should be one way or the other.

Business-wide quality of service standards will be imposed under this type of regulation. These will be based on common measures of service quality for water and wastewater – measures which providers will typically already collect information for. If standards are based on historical service levels, as they have been for the currently regulated businesses, then this is unlikely to cause significant changes in service quality in practice.

While expenditure is not explicitly regulated, a practical effect of regulating prices is to restrict the amount of expenditure that a supplier can incur. Suppliers can undertake additional spending, and make additional investments, but if these were not assumed by the regulator when prices were set, then the regulated prices will not be sufficient to allow these costs to be recovered from customers.

As discussed above, it is appropriate for price-quality regulation to be implemented using the ‘two-form’ model, as currently applied to non-consumer owned EDBs and GPBs. The default method is relatively low-cost and unintrusive – ensuring that the price and quality restrictions are complied with is the key day-to-day impact.

However, if a business wishes to apply for a CPP, this is considerably more onerous and intrusive – akin to the type of price-quality regulation found in the UK and Australia.

Lastly, before any price-quality regulation could be implemented, the water and wastewater activities of each provider would need to be ring-fenced so that any revenue collected by the business was not shared between water/wastewater and other activities. This will not be an issue for those councils which charge directly for these activities, or through a targeted rate. But funding for water and wastewater will no longer be able to be collected through general rates. We also note that new cost allocation requirements of an information disclosure regime could potentially lead to a reallocation of overheads from that current made by councils, and this could lead to a rebalancing of council funding between water/wastewater funding and general rates.

7 SUMMARY AND CONCLUSIONS

NZ's regulatory framework is similar to that used in the UK and Australia. However the way in which it is implemented differs in some very important respects. NZ is a small country, with a relatively large number of monopoly infrastructure businesses, many of which are relatively small. The NZ framework is designed to be low-cost, and scaleable.

Not all regulated New Zealand businesses are subject to price-quality regulation; some are only subject to information disclosure regulation. Price-quality regulation is only applied to businesses where consumers do not have sufficient influence to be able to restrict any market power, where information disclosure is not considered sufficient for achieving outcomes consistent with those in competitive markets.

If water and wastewater businesses were to be regulated in the future, applying information disclosure regulation would be an appropriate first step. Once this had been in place for a period of time, an assessment could be made as to whether this level of regulation was sufficient, or whether the more intrusive price-quality regulation should be considered.

Information disclosure is a relatively light-touch form of regulation. It involves each business making public a variety of specified information at regular (typically annual) intervals. To begin with, the requirements may not differ greatly from the information already collected and published by providers. But if the requirements become more detailed over time, complying with the regime could involve a not-insubstantial amount of time and cost for providers. The experience of EDBs is that information disclosure regulation can be particularly onerous for small businesses.

Council-based provision of water and wastewater is not too dissimilar from customer ownership of the majority of EDBs. In both cases, the customers have considerable ability to influence the decision-making of the business and restrict any market power. As a result, price-quality regulation may be unnecessary for water and wastewater providers. This approach would be consistent with the exemption given to consumer owned EDBs. However, it may be more appropriate for price-quality regulation to be applied to providers operating at arms-length from their council owners, such as Watercare – implementing information disclosure first would allow the extent of customer influence over the business to be tested before this form of regulation was adopted.

If price-quality regulation was imposed, we would expect that the framework would be lower-cost and less intrusive than the corresponding frameworks in Australia and the UK. This is consistent with the approach taken to applying price-quality regulation to non-consumer owned EDBs and GPBs.

Key objectives of economic regulation are to restrict monopoly pricing power and protect consumers' quality of service, but these are far from the only objectives. Regulation can also ensure fair prices, and provide certainty around future returns. The regulatory focus on incentivising efficient investments for the long-term benefit of consumers is also likely to help providers ensure that supply is maintained and that customer needs are met.

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