

June 2021

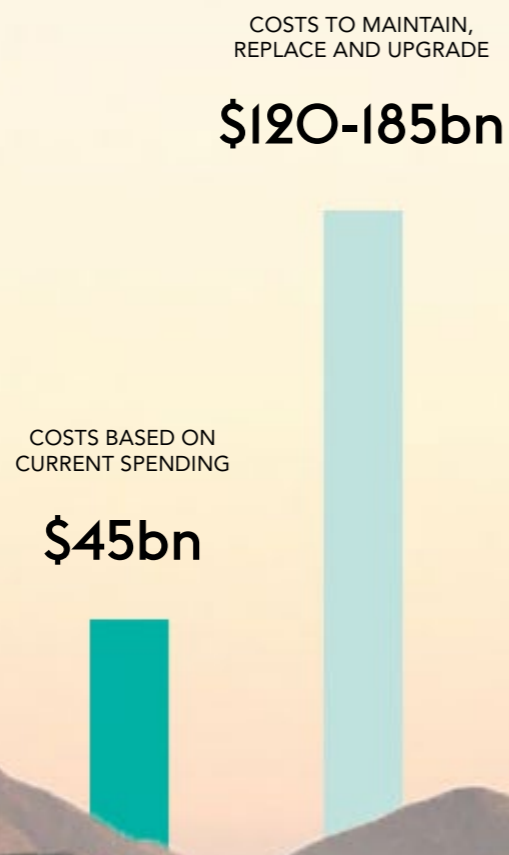
Three Waters

What's in the pipeline?

Under the leadership of Hon Nanaia Mahuta, the Government has been working hard on its proposed full-scale regulatory and structural reform of water service delivery. Key Cabinet decisions are due by the middle of this year. While we await those decisions, here is a summary of what we currently know, and the gaps we expect the Cabinet decisions will plug.

Russell
McAugh





Where things stand

The Three Waters reform programme proposes structural and regulatory reform rarely seen on this scale in Aotearoa New Zealand. There are urgent problems we face and economic benefits to be unlocked by tackling them. Reform provides an opportunity to achieve lasting benefits for the local government sector, our communities, and the environment.

The Government considers that the scale of investment to ensure acceptable water quality across New Zealand cannot be borne by local authorities and their communities. The required investment to maintain, replace and upgrade water infrastructure is estimated to be \$120 to \$185 billion over the next 30 years.¹ Current aggregate council spend is around \$1.5 billion annually (or \$45 billion over the next 30 years).

The reform programme is estimated to deliver a \$14 - \$23 billion new increase in GDP over 30 years and will support the creation of 5900 to 9300 additional new jobs countrywide between 2022 and 2051.²

The Government's preference is for three to five publicly owned statutory water services entities to replace the existing 70 odd public drinking water suppliers. The entities will be completely structurally separate from local authorities.

The reform process includes:

- establishment of a new water regulator (Taumata Arowai) – the board was recently appointed.

- a new drinking water regulatory framework, to be administered by Taumata Arowai. The Water Services Bill is currently at select committee stage.
- legislation to facilitate council decision-making on participation in the new service delivery system, and to establish the new water services entities.
- economic regulation of the new water service entities.

The Government expects the following features to be included/retained in the reformed water services structure:

- the new entities must be publicly owned, statutory entities.
- the design of the entities will protect against privatisation in future. For example, Cabinet will need to decide whether the entities can pay dividends to shareholders.
- the new entities must be able to borrow independently of local authorities.

The basic underlying thinking of the structural reform is that larger entities will lead to increased efficiencies, and combined with their greater debt capacity will enable the costs of investment to be shared over a greater number of connections over longer timeframes – leading to materially lower costs per household.

¹ Press Release: Reports prove case for urgent water infrastructure reform, Hon Nanaia Mahuta, 2 June 2021: <https://www.beehive.govt.nz/release/reports-prove-case-urgent-water-infrastructure-reform>

² Ibid.

Gaps to plug

Will the voluntary approach last?

Public comments by Hon Nanaia Mahuta have reinforced that “working with the sector” in a reform of this scale and complexity is the preferred approach. The Government does not want to “go in with a sledgehammer”.

However, the Minister is alive to the risk that some local authorities may choose not to participate, and that the proposal requires some degree of critical mass to achieve the efficiencies that the structural reform is intended to deliver.

Provision of capital funding by the Government has been successful in incentivising participation to date, but there are no strings attached. Other factors that may encourage local authorities to go with the flow include:

- the costs necessary to meet the new regulatory burdens under the Water Services Bill; and
- the requirement to justify to local communities any decision to retain the risk and costs of water service provision.

It remains difficult to predict whether local authorities may choose to opt out (for example if they believe their water infrastructure is already at a high standard) and whether the Government may need to move from the carrot to the stick in that case.

What is meant by equitable access?

There is plenty of evidence that historical under-investment in water infrastructure is a systemic issue, affecting all regions. It is not the case that the extent of the problem is the same in each region. Some local authorities are concerned about subsidising infrastructure in neighbouring regions (which may be a reason to “opt out” of the reforms).

The Government’s approach to ensure equitable access to waters services has two dimensions:

- equity of pricing, including whether to “smooth” prices over time; “harmonise” prices across different customer groups; and balancing harmonisation and the achievement of efficient price signals; and
- equity of access to services, and service quality, including whether to tolerate differences in service coverage and quality; and whether the new entities would be required to provide services to households that do not currently receive water services.

These considerations are important to reform decisions – because they influence the number of new entities, their geographic coverage, and funding and pricing arrangements.

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What regions will the new water entities cover?

There is a balancing act when determining the geographical reach of each entity. As discussed above, a key driver is to achieve efficiencies via scale, which suggests each entity must include at least one major urban centre. Other considerations include:

- local authority and regional authority boundaries
- rohe, takiwā, whakapapa, waka and other considerations
- population, size and distance
- asset location, condition and future investment requirements
- number of councils that opt out
- financial viability and pricing variability

The December 2020 Cabinet Paper indicated that the decision about the number and boundaries of any entities will need to balance the benefits offered by scale, against relevant community interest considerations.

It was agreed that it would be a centrally-led process, in which:

- a short list of options is identified.
- there is engagement on the shortlist with the local government sector and iwi/Māori
- proposals for the final number and boundaries of entities, and which entity each council would be part of, are considered by Cabinet

What will governance involve?

The governance model will be unique, but will have similarities to the crown entity and council controlled organisation statutory models, including:

- legislation will include specific objectives for the entities, and may include the ability for a government policy statement to guide objectives and priorities
- stakeholders can issue letters of expectations, which will inform a statement of intent against which the entities publicly and formally report back
- requirements to compile and/or adhere to various strategic plans

The uniqueness of the proposed model is that local authorities and mana whenua will jointly exercise ownership rights. Key features are that:

- local authorities and mana whenua will jointly (50/5) appoint a Governor Representative Group (GRG)
- the GRG will appoint an Independent Selection Panel, which appoints Board members
- the GRG otherwise exercises the rights of ownership under the above framework

How will Te Tiriti be recognised?

As drafted, the Water Services Bill requires drinking water suppliers, and other participants in the sector, to give effect to Te Mana o Te Wai, in executing any other duties under the Bill. It is not yet clear how iwi partnership and Māori kaitiakitanga will be protected in the new entities.

Recent updates from the Minister propose the following options:

- statutory recognition of both the Te Tiriti and Te Mana o Te Wai in legislation
- recognition that water services sits within a wider Te Ao Māori framework
- creation of new mechanisms to enable iwi/Māori to directly influence outcomes for Māori (ie through governance, board competencies, and direct mechanisms for mana whenua in the form of Te Mana o Te Wai statements)
- opportunities to improve wider outcomes for Māori (including the need for an improved service for marae and papakāinga)

“ The number of boundaries of any entities will need to balance the benefit offered by scale, against relevant community interests. ”

Who will own the new water entities?

For ownership, Cabinet agrees that the new entities need to have financial and operational autonomy, including independent and competency-based governance arrangements. Balance sheet separation from councils is needed to provide entities with the financial capacity to meet the infrastructure deficit and future investment needs.

Broadly speaking, Cabinet is deciding between:

- a collective (non-share based) ownership model – where assets are owned by the entities on behalf of the relevant local authorities (e.g. local authorities would not own shares, but would exercise ownership rights through governance and accountability arrangements as above); and
- a share-based ownership model, where assets are owned by the entities and relevant local authorities hold shares in the entities. Shareholding would reflect relative governance rights, rather than asset values.

How will the assets be transferred?

It is expected that water assets will be transferred to the new water services entities, and some form of compensation will be provided to local authorities. It is not clear how that compensation will be calculated or what form it will take. The Minister has recently suggested that it will be more complicated than “assets less liabilities” and will take into account catchment profiles, climate resilience, and the issue of variable historical investment across regions.

What will funding look like?

One of the objectives of the reforms is to create a better platform for funding the large amounts of investment that are required to improve water infrastructure and cater for population growth. Whilst no decisions have been made about the ownership of the water entities or their capital structures, it is expected that the new entities will borrow independently to fund infrastructure investments and that they will have more capacity to borrow than exists under the current arrangements. This debt capacity should help to create certainty around the long-term capital expenditure programme and allow the water entities to bring forward investment which is funded by water charges over the coming decades. The reforms provide an opportunity to create innovative funding models and to learn from best practice for funding and delivering long-term infrastructure.

How will water services be priced?

The apparent implication of the reform is that water would be metered and charged to consumers. However, this has not been expressly addressed in Cabinet Papers to date. The Minister has observed that the Government is eager to ensure that there is little change in how consumers are billed for water, and is exploring the option of a service agreement between local authorities and the relevant water services entity. This implies there would not be direct interaction between the water services entity and the consumer. This area of reform is particularly murky.

What type of economic regulation will apply?

Final decisions are yet to be taken. The most recent indications are that the regime is likely to involve:

- individualised price quality paths plus information disclosure for the proposed new water service entities
- a form of information disclosure for Councils that opt out of the proposed Water Service Entities. It is also possible that opt out councils will be subject to minimum service quality standards (in addition to the standards set by Taumata Arowai)
- the appointment of an independent and credible economic regulator (eg the Commerce Commission) to administer the regime

MBIE anticipates issuing a public consultation document early in 2022 on the design of the economic regulation regime once decisions on the core elements of the reform programme have been taken (particularly the number of suppliers and their governance arrangements).

What other services will local authorities provide?

The Minister has publicly acknowledged receiving feedback from local authorities that they are concerned their role and functions are being eroded over time. Will roads be next? The Government has a separate programme to consider the future role of local authorities beyond roads, rates and rubbish in light of the “four wellbeings” in local government legislation - there is a prospect that this will remain cloudy in advance of local authorities being required to decide whether they are in or out.

What about stormwater?

The DIA intends that the new water entities will deliver all three waters, but the transfer of responsibility for stormwater is complex. A stormwater technical group has been established to develop a transition plan, which will need to:

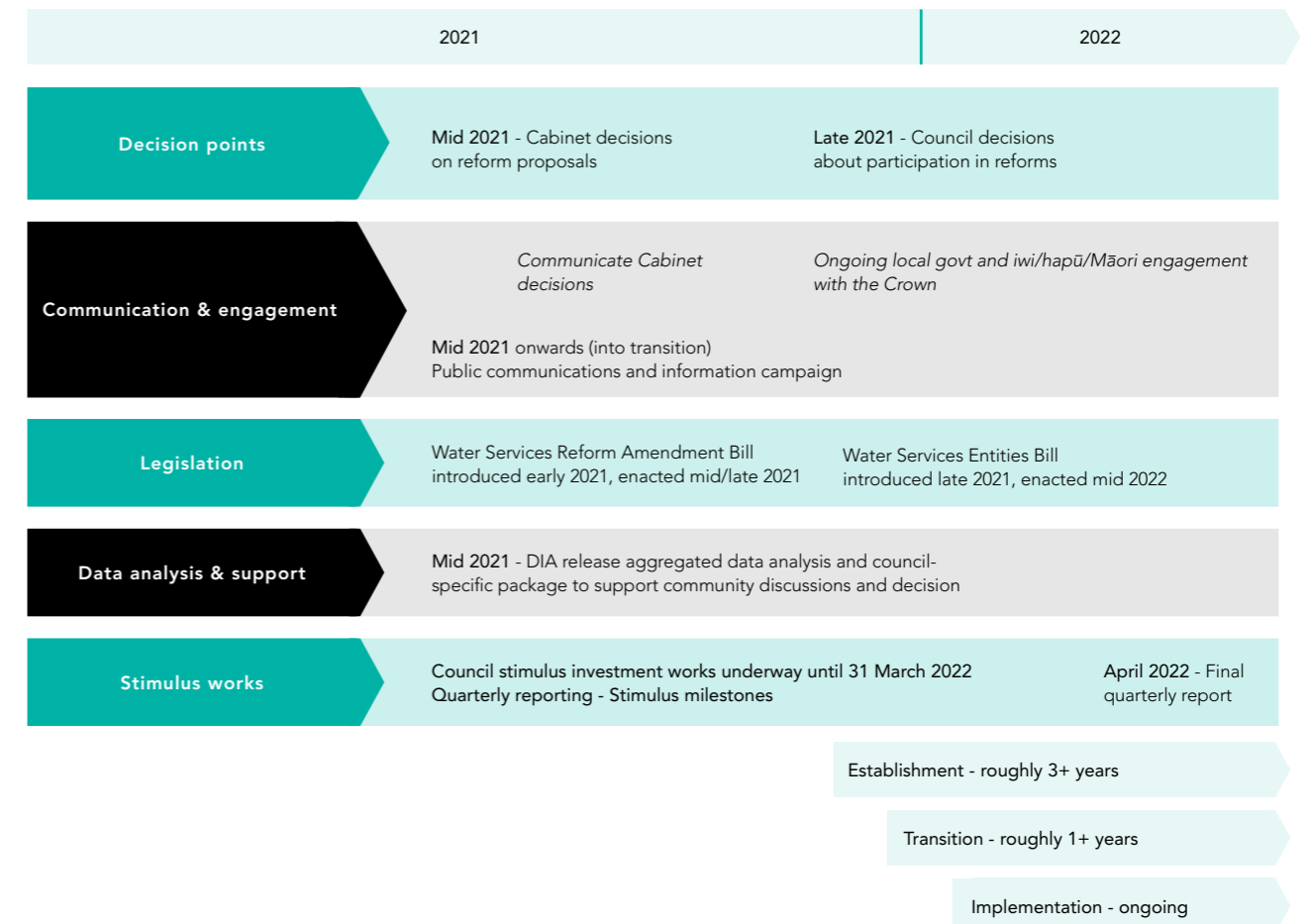
- ensure the new entities and councils can continue to work together to effectively manage stormwater; and
- identify a timeframe and process for transferring the responsibility for managing stormwater.

“ The Minister has heard from local authorities their concerns that their role and functions are being eroded. Will roads be next? ”

Where to from here?

Councils will continue delivering water services through the duration of the upcoming Long-Term Plan (until at least early 2024).

The Government is pursuing the following ambitious reform timeframe:



Our team

Here to help

Steeped in years of experience advising on some of New Zealand's most transformative projects, Russell McVeagh has the sophisticated sector knowledge and insight to advise a broad range of stakeholders on one of this country's most daring reform programmes. Our experience includes advising Watercare, for more than two decades, in relation to its water and wastewater networks, and bulk water supply dams and Fonterra on planning issues across the country, including on changes to water quality and in relation to Government policy reform.

We have the expertise to guide clients through the legal, regulatory and political challenges of New Zealand's changing water landscape. For more information please contact a member of our Three Waters team.



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