ECONOMIC REGULATION – FORGET THE THEORY, WHAT'S IT MEAN IN PRACTICE

Concept Consulting Group NZ

ABSTRACT (500 WORDS MAXIMUM)

Economic regulation. Yawn. It's hardly BBQ conversation but it matters to us all, and a lot more than most of us might imagine. Soon water service entities will be subject to two forms of economic regulation under the Local Water Done Well policy: information disclosure and price-quality. It's time to learn what this means for your team, your business and your customers.

Most discussion of economic regulation is heavy on theory, light on practice. This paper reverses that, focusing on the practicalities – what regulation is, and how it is developed, implemented and operated. It explores the practical challenges of design and implementation and ensuring transitional arrangements dovetail neatly into longer term regulatory models. It touches on the implications for asset managers, financial planners and executive teams as well as company directors.

Because it is written by a practitioner, the paper describes compliance burdens and practical headaches, but it also takes a step back and reflects on the benefits of economic regulation. This helps bring to life what economic regulation will mean for water users, water entities and New Zealand, and why it is likely to lead to better outcomes for all three. Lastly, it suggests how the water sector might learn and benefit from the experience of regulating energy and fibre networks and airports.

KEYWORDS

Economic regulation, Information Disclosure, Price Quality, Expenditure, Revenue, Pricing, Asset management, Commerce Commission

PRESENTER PROFILE

Jeremy is a principal at Concept Consulting. He joined Concept early in 2024, after 25 years' working in regulated utilities and for regulators in NZ and the UK.

He's been involved in five price-quality proposals (two as business owner), innumerable compliance statements, IDs and audits, the odd compliance investigation and (literally) hundreds of executive and board sessions.

1. INTRODUCTION

Under the Local Water Done Well (LWDW) policy, water entities will be subject to economic regulation by the 'infrastructure regulator'. The infrastructure regulator is expected to be the Commerce Commission, currently the regulator of electricity and gas networks, telecommunications and airports.

Enabling legislation had not been introduced at the time of writing so this paper is based on the LWDW policy, with some bold assumptions.

The LWDW policy anticipates Information Disclosure (ID) and Price Quality (PQ) regulation for water entities. This follows in the largely successful regulatory footsteps of electricity, gas and fibre networks and, to an extent, the three largest airports.

The paper mostly avoids theory, focusing on some of what the author considers the more important practical matters. It contains observations and opinions; these belong solely to the author. The examples used, like the best stories, are based on based on historical events.

<u>Guide to readers:</u> the paper starts with some basics then steps through the key stages (i.e. establishing the new regulator, developing rules, and applying rules):

> **Section 2.1:** the basics – if you know all about ID and PQ regulation, you can skip to section 2.2
>
> **Section 2.2:** navigating implementation of economic regulation
>
> > **Stage 1:** establishing the regulator
> >
> > **Stage 2:** setting the rules
> >
> > **Stage 3:** applying the rules
> >
> > **Stage 4:** repeat
>
> Go here for insights & observations
>
> **Section 3:** conclusions
>
> **The appendix** provides links to ID and PQ reference documents

2. DISCUSSION

2.1 CONTEXT: FIRST THINGS FIRST

Before getting into the practicalities we cover a few basics – what, why, how, who, and when.

2.1.1 WHAT IS ID AND PQ REGULATION?

Information Disclosure and Price Quality regulation are the two main forms of economic regulation applied to utilities in NZ. Similar regulation applies in other countries, notably Australia and the UK.

ID requires publication of detailed financial, asset, quality of service and other relevant information specified by the regulator on an annual (sometimes quarterly) basis. ID is considered 'light touch' regulation and can be applied on its own or in conjunction with PQ regulation. ID regulation is currently applied to gas and electricity network companies, four fibre companies and three large airports.

PQ is much more intrusive, with the regulator setting maximum allowable revenue (and/or prices) and minimum network quality standards. PQ is usually applied in conjunction with ID and currently applies to:

- Chorus (the largest fibre network company)
- Transpower (the national electricity grid owner)
- electricity distribution businesses not owned by community trusts
- gas transmission and distribution networks.

ID and PQ regulation is applied in markets where there is little or no competition and little or no likelihood of a substantial increase in competition. Its purpose is to promote the long-term interests of consumers by promoting outcomes consistent with those of competitive markets.

2.1.2 WHY APPLY TO WATER SERVICES?

A lot has been written about the challenges facing water services entities (from asset management, funding, quality, pricing, efficiency and governance) and their causes.

These challenges are not unique to water and have been addressed for other utilities by applying ID and PQ regulation. Coupled with other policy interventions (e.g. balance sheet separation), the regulation enables improved transparency, and incentives[1] to:

- innovate and invest – for example, by allowing an appropriate return on and of investment
- improve efficiency – for example, by rewarding efficiency gains (and penalising inefficiency)
- provide services at a quality that reflects consumer demand – for example, by setting quality standards and providing sufficient funding to meet these.

Regulated entities shouldn't be able to extract excessive profits but, importantly, they should have the opportunity to achieve 'real financial capital maintenance' (RFCM).

RFCM is regulatory jargon for the idea that *firms should be able recover costs over time, including a return on and of investment.* This is **very important** to investors and makes regulated utilities attractive to equity and debt investors.

ID and PQ achieve these policy objectives in different ways. Under ID, the accountability mechanism is, first, reputational and, second, the threat of further regulatory intervention. The regulator uses the disclosed information to evaluate and publicly report on the firm's performance: the quality of the service it is providing, whether it is investing prudently, the efficiency of its expenditure and its profitability. PQ, on the other hand, sets enforceable limits on prices/revenue

[1] This regulation is sometimes called 'incentive regulation' because it seeks to establish incentives for companies to appropriately balance competing cost and quality trade-offs and short- and long-term considerations.

and service quality/reliability. The accountability mechanism is enforcement through the courts.

2.1.3 HOW DOES ID AND PQ WORK?

Once the rules are established (see 'when' at section 2.1.5), and subject to any transitional arrangements, regulated entities will be required to comply with those rules.

For ID, each entity will disclose information using a format, methodologies and assurance requirements that have been specified by the regulator. They will draw on existing information but also require development of new information and the transformation of existing information.

ID requirements are extensive. They will be difficult to meet initially but the information produced will prove valuable for the regulated entity. The regulator will draw on information disclosed for 'summary and analysis' purposes – drawing out insights for stakeholders, and for its own purposes.

Appendix 1 contains typical ID requirements and links to ID rules and templates.

ID and PQ interact. The regulator uses disclosed information to understand firm performance and to inform future price-quality path resets.

For PQ, the regulator will, after careful consideration, determine a 'price path' and 'quality standards' that each entity is required to comply with.

To do this the regulator scrutinises an entity's plans to determine the 'prudent and efficient' level of capital and operating expenditure. It combines expenditure with other inputs to produce allowable revenues, taking care to ensure its decision allows for RFCM. PQ doesn't directly constrain a firm's expenditure, but it does constrain how much of its costs it can recover through prices to consumers, as well as the level of service quality it must achieve.

At risk of getting into the weeds, each entity will be subject to an 'individual' or 'default' price path. In very simple terms:

1. An **individual** price path is applied to very large entities or where entity specific issues need to be catered to. Examples include Transpower and Chorus.
2. A **default** price path is applied to (relatively) smaller or simpler entities and is intended to be lower cost to administer. Examples include electricity and gas distribution companies. Entities subject to default price paths may seek a 'customised' price path, which is an entity-specific approach similar to an individual price path.

Appendix 1 provides links to several PQ related documents.

2.1.4 WHO'S WHO?

The government sets policy and primary legislation. The legislation should be sufficiently prescriptive to give effect to its intent and purpose, but sufficiently flexible to allow for uncertainties and future developments.

The legislation is given effect to by the regulator. The regulator is empowered to set rules (called 'input methodologies' in other sectors) that it uses to specify ID requirements and price paths. The rules apply to:

- regulated entities – who must follow the rules in meeting all ID and PQ requirements (or risk enforcement action)
- the regulator – who must also adhere to the rules in performing its functions (or risk legal challenge)

Consumers and their advocates, communities and interest groups, investors and other stakeholders all play important roles as rules are developed and applied by the regulator and regulated entities. For example:

- regulated entities need to understand what matters to consumers and other stakeholders and demonstrate their plans appropriately account for this
- consumers and other stakeholders (including investors) help inform the regulator's evaluation of the regulated entities' plans.

Ultimately the regulator is an agent for consumers. It wants regulated entities to be innovative and efficient, have incentives to invest, and set prices that reflect the cost of providing the services consumers want, at the quality they demand.

Given this, there will be a healthy tension between the regulator and regulated entity, but ideally, also a constructive and respectful relationship.

2.1.5 WHEN WILL IT HAPPEN?

The government has indicated that enabling legislation will be put to Parliament late in 2024. Once the legislation is enacted, the process of establishing the infrastructure regulator, developing the rules, applying those rules and operating the regulatory framework can commence.

Table 1 lists the four key stages of economic regulation, their sequence, and their potential timing. It is worth bearing in mind that we have never in New Zealand imposed this type of sophisticated regulation on a sector that is currently unregulated. All the other Commission-regulated sectors were subject to some form of information disclosure and economic regulation before implementation of the current regime in 2008. So, there is a lot of work to do to hit this timetable.

Table 1: Key stages and potential timing

	Stage	Potential timing
1	**Establish** new infrastructure regulator	~mid 2025
2	**Develop rules** akin to the 'input methodologies' applied to energy, fibre and airports	~late 2025 to early 2027
3	**Apply rules** with first set of ID and PQ determinations	From 2028
4	**Repeat** with annual ID publication and periodic PQ 'resets'	From 2029

The balance of the paper is a journey through stages 1 to 3, with most focus on stage 3, which is where the rubber really hits the road.

2.2 THE PATH TO ECONOMIC REGULATION

Water entities are developing water service delivery plans (WSDPs) and exploring synergies and partnership/amalgamation opportunities. In parallel, the government is preparing legislation to enable execution of WSDPs and to establish the new economic regulation framework.

A transitionary period will be needed, where WSDPs apply while regulatory rules are established (as occurred for electricity lines and fibre network services) and a dovetailing of WSDPs into ID and PQ regulation, once the rules are established.

2.2.1 STAGE 1: ESTABLISHING THE INFRASTRUCTURE REGULATOR

After enacting primary legislation, the 'infrastructure regulator' will need to be established. The regulator will be charged with developing, implementing and operating the economic regulation of water services entities.

The basic decisions, some of which will be addressed in the legislation, are deciding *who the regulator will be*, *how it should be resourced and funded* and, for water entities, deciding *when and how you engage* with the fledgling regulator.

WHO SHOULD BE THE INFRASTRUCTURE REGULATOR?

Parliament has a choice between establishing a new regulator or expanding the duties of an existing regulator. The Commerce Commission (the Commission) is odds on favourite to be the infrastructure regulator.

The Commission has the right credentials, including its recent experience with water regulation. However, it has a full dance card so there is a risk of overload and its capacity and resourcing will need to be carefully consideration. It also risks missing an opportunity for fresh thinking and (tongue in cheek) having one party monopolise monopoly regulation.[2]

RESOURCING (AND AVOIDING FALSE ECONOMIES) AND FUNDING

A well-resourced regulator is better placed to progress through the steps outlined in Table 1, and to support and hold water entities to account.

Scrimping on resources for the regulator is likely to prove a false economy. It will, after all, be charged with regulating vital, at-risk infrastructure, with collective assets and investment needs greater than any other regulated sector.

The regulator should have capacity to build understanding of the sector and its challenges and to take these into account as it develops and applies the new rules. An under-resourced regulator will be forced into short cuts, for example, a 'lift and shift' from other sectors, risking ill-fitting rules.

[2] The monopoly comment is tongue in cheek, but bears thought. The job ahead for the water sector is big enough to keep a stand-alone regulator very busy, for a long time. A new regulator, might reducing Commission overload risk, bring new thinking and stimulate better regulator performance.

The **funding model** should be more straightforward, most likely an appropriation from Treasury funded via a new levy on water entities.

SIT BACK AND WAIT, OR ENGAGE EARLY?

Water entities have a choice to sit back and wait for regulation to happen, or to engage, helping the regulator learn about the sector and their businesses.

The former may be easier, but the latter sets you up better for what is to come. The regulator will be focused inwardly, building its team and plans, and worried about ‘regulatory capture’, but there’s still an opportunity to help it scale a steep learning curve.

2.2.2 STAGE 2: SETTING THE RULES

This stage is foundational, with many one-off, value-impacting decisions. It will be intense for all parties and has the potential to end up in court, as it did with energy networks and airports.

If one has the appetite, there is plenty of prior experience to study – with thousands of pages of consultations, submissions, decision papers, High Court judgements to pore over. This shows careful attention is given to the allocation of risk between regulated entities and consumers, with a basic rule of thumb that a given risk should be borne by the party best able to manage or absorb it.

We don’t go into the gory details in this paper, but list the key rules, their application to ID and PQ, and an indication of their financial and practical impact.

Table 2: Key rules, application and impact

Rule (input methodology)		Information disclosure	Price quality	Impact (H/M/L)	
				$ value	Practicality
1	Cost allocation	✓	✓	H	M
2	Asset valuation	✓	✓	H	L
3	Taxation	✓	✓	L	M
4	Cost of capital	✓	✓	H	L
5	Quality dimension	✓	✓	M	H
6	Specification of prices and revenues	×	✓	M	H
7	Capital expenditure	×	✓	M	H

Cost allocation, asset valuation and cost of capital are big, one-off, value-impacting decisions. They will be high priority areas for:

- consumers (and therefore the regulator) because they impact prices
- shareholders (and therefore Directors and CEOs), for the same reason.

Experience suggests there will be much debate over how entities have valued existing assets (and whether this is fair to consumers). Similarly, cost of capital will keep the economists (and potentially lawyers) busy. One interesting question is whether, if an entity is not dividend-paying, the regulator departs from its tried and tested cost of capital methodology. The Commission's position, which is probably right, is that it still needs to assess profitability because water suppliers will, at least, need to retain earnings for working capital purposes. But the Commission may look to overseas precedents to modify its typical approach. In Scotland, for example, the equity component of the cost of capital is closer to a debt return, reflecting the non-dividend-paying character of the regulated entity.

Taxation, while important and issues may arise, *should* be relatively non-contentious and cost allocation practices, while important, are well established.

The three areas below have real practical impact, with ongoing implications for business capability, systems, processes and, in some cases, core operations:

1. **Quality dimensions** and measures for ID, need to be meaningful measure of performance for the regulated entity.

   Quality standards[3] reflect the minimum acceptable performance. Non-conformance triggers an investigation and potential enforcement action.

2. **Specification of prices and revenues[4]** is where the mechanics of price/revenue setting are set out. In simple terms, this specifies how:

- first year prices/revenue is set
- year on year adjustments are made for each remaining year of the regulatory period (e.g. changes in forecast inflation, pass-through costs, etc.)
- 'unders and overs' are 'washed-up' from year to year, or between regulatory periods
- special circumstances are accounted for (e.g. projects approved after the start of the period, recovery of historic losses, etc.)

3. **Capital expenditure** rules set out how entities subject to entity-specific price paths must develop, justify and present planned capital expenditure. Similar processes apply for operating expenditure.

It's easy to focus on the 'big ticket' items like asset valuation and cost of capital, neglecting the more practical areas above. This would be a mistake. It's also worth bearing in mind that the Commission (if it is the regulator) will take its existing rules in other regulated sectors as its starting point. The onus will be on water entities and their advisors to identify the areas where water differs and therefore modifications to the 'default' rules are warranted.

2.2.3 STAGE 3: APPLYING NEW ID AND PQ RULES

In stage 1 and 2 the regulator is established, and new rules are set. In stage 3, which may overlap with stage 2[5], the rules are applied.

[3] Quality standards are referenced here, however are typically set as part of periodic price-quality decisions.

[4] There is also potential for rules specifying how tariffs are set.

[5] For example, if the regulator phases development of different rules (e.g. later development of ID for Transpower) or requires application concurrently with rule development (e.g. Chorus's first price-quality proposal was due just weeks after the relevant rules were finalised).

This section briefly describes what's likely to be required if an entity is subject to ID and entity-specific PQ regulation, elaborating on section 2.1.3. It then offers observations and 'takeaways' intended to ease the path to, and improve outcomes from, economic regulation.

INFORMATION DISCLOSURE

Each entity will be required to publish information specified by the regulator. Information varies according to sector (and associated PQ regulation) but typically involves 15 to 25 schedules covering four key areas:

1. **Financial:** actuals for the relevant year (expenditure, revenue, tax, profitability, etc.), various data to perform regulatory calculations, and forecast information including expenditure for future years (typically five)
2. **Asset:** asset volumes/quantities (by type, condition or 'health'), including commissioned and forecast replacement volumes
3. **Quality:** performance against measures defined for each quality 'dimension'. Sometimes this information is required to be published quarterly.
4. **Pricing:** pricing information, usually with splits by customer or product type, associated volumes, etc.

In many, but not all cases, the ID rules will specify exactly how this information is to be prepared – for example, how depreciation is calculated, how cost allocations are performed, and so on.

Water entities will also be required to develop and publish asset management plans. The WSDPs are a first step, but the Commission will expect entities, in due course, to target a higher level of asset management maturity, and to produce plans that provide robust support for five and ten-year expenditure forecasts.

PRICE QUALITY

As outlined in section 2, two forms of price quality regulation are currently applied – 'individual' or 'default' price paths. Both generally apply for periods between three and five years and are then reset. The basic mechanics for each are:

Individual price path: the entity prepares a proposal that sets out the amount of operating and capital expenditure it believes is required over a specified period to sustain its assets and meet the needs of its customers. The proposal also contains quality standards.

A proposal needs to address requirements specified by the regulator, be independently verified, audited and certified by Directors. The regulator then evaluates the proposal, including public consultation, before issuing a determination.

Default price path: the regulator takes data provided by an entity (through ID and information requests), performs various checks, adjusts where it considers appropriate, consults on a draft decision and having considered submissions, issues a determination. In contrast to an individual price path, the expenditure forecast is based principally on projecting forward historic average expenditure, rather than a ground-up forecast of that entity's specific needs.

If an entity is dissatisfied with the default price path it may apply for a 'customised' price path (similar to an individual price path).

The process to reach any price path determination is quite involved. This is especially so for individual or customised price paths.

OBSERVATIONS & TAKEWAYS

Taken together, ID and PQ regulation have profound implications for the regulated entity.

Sometimes this fact takes a while to sink in, leaving management and Boards playing catch-up. Particularly under PQ regulation, the regulatory process must be embedded into business planning to ensure regulatory outcomes that match commercial needs. Acknowledging the regulator as a key stakeholder in business planning is also a mind shift that may not come naturally.

The observations and takeaways below are intended as a head start, so you can capture the upside of economic regulation sooner. They are the author's views and, as a regulatory geek, he's happy to elaborate, discuss and be challenged.

1) WHAT MATTERS TO CUSTOMERS MATTERS TO YOU

It may seem trite, but all businesses exist to serve the needs of customers, and this is equally true for water and other utilities.

The regulator will expect water entities to demonstrate how customers have been engaged, that their views and concerns are understood, and that investment and other plans genuinely account for these. Where there are trade-offs to be made, for example between price and reliability, the regulator will look for evidence of consumer preferences to support the entity's preferred approach.

Some water entities may already have effective customer engagement. Those that don't will need to step up – finding or developing techniques that make it easy for customers to engage, and acting on what you learn.

This may seem like motherhood and apple pie, and it is, but it's also fundamental to success with your regulator. Your regulator is an agent for consumers, and your success will be dependent on how well you listen to and look after customers.

Takeaway: good customer engagement underpins regulatory success.

2) A NEW LEVEL OF GOVERNANCE, CONTROLS AND ASSURANCE

The regime will fundamentally increase transparency and external scrutiny of practices, decisions and performance.

You will need to describe governance, controls and assurance right across your business, from pricing to asset management, financial and risk, and beyond. It is not just a case of writing these down, you need to demonstrate how they are applied and certify that this is done in practice.

Your directors will be asked to certify, having made appropriate enquiries, that disclosures or proposals are a true and fair reflection of your business. They cannot do this unless satisfied that it is true. Along the way, you will get to know your auditors very well and experience 'independent verification' – this will be uncomfortable at times but will help improve your business and enable better outcomes for customers.

For executives and directors: if unsure, probe, and keep probing until you are satisfied. This will build understanding and your teams will come to appreciate your interest. It will also incentivise teams to prepare and address lingering doubts. Ultimately, there can be enforcement consequences for officers and directors that fail to understand and appropriately manage the entity's regulatory compliance.

Takeaway: formalise your governance arrangements and processes, and if you're unsure, ask the question and don't stop asking until satisfied.

3) PRICE PATHS AND QUALITY STANDARDS ARE MANDATORY

Complying with the price path and quality standards is compliance 101. Breaching either will trigger an investigation. An investigation is not enjoyable. At best, it results in a stern 'telling off', at worst it can include prosecution and large fines.

Sound straight forward? It should be, but there are plenty of examples of entities dropping the ball in the hustle and bustle of managing a business, controlling costs and delivering projects. Consider the scenarios below.

Price path: the pricing team is short-staffed and hasn't updated demand forecasts but is out of time so runs with an older demand forecast. It sets prices, and directors sign the compliance statement. Job done.

Quality standards: the CFO is looking to trim costs and looks for the biggest target – maintenance. Maintenance managers wring their hands but accept a 10% 'haircut'. CFO is happy, and the board signs the plan off. Job done.

Price path: the economy is recovering, and while this was expected it isn't shown in the older demand forecast, so revenue (price x quantity) exceeds the price path.

Quality standards: in tandem, maintenance costs come in higher than hoped. Seeing this, the maintenance manager pauses recruitment to stay in budget. A few months later response times blow out, breaching quality standards.

These situations happen – surely the regulator will understand? Probably not.

The regulator will require the entity to provide internal communications, decision papers and advice. When this reveals the breach is due to choices, poor data and oversights, it will need to decide what enforcement action is appropriate. Whichever path it chooses, it will be an uncomfortable time for staff, management and the board.

Takeaway: take positive steps to comply with the price path and quality standards.

4) ASSET MANAGEMENT CAPABILITY - A STRATEGIC IMPERATIVE

Structured asset management practices utilising high quality asset and condition data and fit-for-purpose analytical models can significantly reduce whole of life cost and asset risk. This improves transparency and repeatability, allows unbiased analysis, and better-informed trade-offs, taking account of the risk and criticality of different assets and portfolios. This is a powerful enabler for management and boards, replacing expert opinion with objective fact, allowing greater value-add and freeing headspace to focus on matters of strategic significance.

Hardly controversial, but easier said than done. It's been known for companies managing billions of dollars in assets to be reliant on a few staff – with remarkably little in the way of documentation, data, analytical tools and decision frameworks. That won't pass muster with the regulator.

Mature asset management is also essential to achieving good regulatory outcomes. When setting expenditure allowances, the Commission will expect you to explain how your expenditure forecasts are justified and supported by asset management policies, strategies, asset data, condition assessment practices, risk and criticality frameworks, costs estimation, capex-opex trade-offs (and so on).

When it comes to asset management maturity, success accumulates, but so does failure. Asset management improvements drive successful regulatory outcomes (price paths that compensate the entity fairly) but also business performance, leading to a virtuous circle. Equally, neglecting asset management improvements allows risks to accumulate, compromising business performance and regulatory outcomes and – in extreme cases – enforcement and substantial fines.

If an entity is up-front about current maturity and has credible improvement plans,[6] there's a good chance the regulator will provide leeway in the short term, and funding for capability improvement. Consider these alternatives:

Scenario 1: you know asset management capability is low but it's embarrassing to admit this. You spin the regulator a story about how good you are – what you describe is where you want to be, rather than where you are.

Scenario 2: as with scenario 1, but you are up-front with the regulator. You share your aspirations, plan to get there and the resources you need to achieve that.

Scenario 1: the regulator believes you but gives no extra resourcing (it's not needed after all). A few months later, the regulator asks for the suite of asset management models. These don't exist. You are provided no further resource, and credibility is lost.

Scenario 2: the regulator is a bit disappointed but respects your honesty. It provides the resources you need in return for delivery on your improvement plan. You are resourced and have regulator buy-in to your plan.

[6] An independent asset management maturity assessment is a good way for staff, management and directors to get the lay of the land and as the basis for an improvement plan.

Takeaway: invest in asset management capability, and don't overstate maturity.

5) INTERIM SOLUTIONS NEEDED, BUT CHANGE MUST BE EMBEDDED

Virtually every entity will initially rely on 'interim solutions' to meet new requirements. For example, meeting Information Disclosure requirements for the first time may involve some 'cobbling together' of information from disparate sources into spreadsheets that quality assurers and auditors need to review.

To an extent this is unavoidable but rolling interim solutions forward usually ends badly. This might be through errors and non-compliance, which can have significant financial, reputational and legal consequences.

Consider the scenario below of a newly regulated entity meeting ID requirements for the first time.

> Expert staff scramble to gather data inputs, create the formulae they believe is needed to transform that data and meet the new requirements.
>
> Peer reviewers and auditors, also new to the rules, review the calculations and sign off. The CEO signs off based on advice from staff and auditors, then directors sign off. Job done, nice work.
>
> --------------------------------
>
> Next year rolls around, and there's been turnover in the team so new staff pick up last year's 'interim solution', cut and paste updated data and re-run the calculations. Along the way a few 'tweaks' are made.
>
> Peer reviewers trust their staff and there's a new auditor on board who seems okay with what's been produced. Rinse and repeat for a few years.
>
> Then, a new joiner is asked to do this year's disclosures. She's done the same before and quickly sees something is amiss. It turns out minor errors in the original calculations and those 'tweaks' have added up to a material error.

In this scenario the entity may have lost millions of dollars (or over-charged customers) or reported inaccurate (non-compliant) quality, asset or price information. This likely triggers an investigation and enforcement action.

Takeaway: embedding ID and PQ as business-as-usual in processes, systems and people capabilities is essential.

6) HONESTY IS THE BEST POLICY, ESPECIALLY IF THINGS GO WRONG

Economic regulation is a long game where an entity's track record matters.

There can be situations where an entity identifies an opportunity for gain that isn't totally above board or due to a glitch in the rules. Similarly, things go wrong, and entities make mistakes or regrettable decisions.[7]

---

[7] For the avoidance of doubt: mislead or deceive the regulator at your peril (and, if circumstances change, make sure to inform the regulator).

These are difficult situations, and there might be a temptation to quietly sweep it under the rug and hope for the best. This is a risky choice that can have disproportionate and lasting consequences. The regulator has formidable information gathering powers (and remarkable perseverance when it senses something amiss).

The better course of action is usually to bring the matter to the regulator's attention, explain how it has arisen and work through a process to resolve it.

Takeaway: when things go wrong, own up (and never mislead the regulator).

7) ID AND PQ REGULATION HAS BUSINESS WIDE IMPACTS

Some types of regulation can be compartmentalised. This isn't the case for ID and PQ, where a broad-based understanding of the basics across the entity is essential. That said, the regulation can be complex (and boring), so education needs to be pitched at the right level, tailored to meet the needs of different teams and provided in an accessible form.

This education isn't just for staff working in the detail – it extends to the executive and board. Directors, who will be asked to make regulatory certifications, take this duty seriously and need to understand what they're signing off. They also want to know if the CEO understands and has done their due diligence so will 'eyeball' and ask probing questions of the CEO. The CEO should 'back to back' this with executives, and they with their teams.

In terms of general understanding, senior managers, the executive and board need to know, at a minimum:

- what the regulation is intended to achieve and how it works in practice, including key processes and how these interact with business processes
- compliance 101 and their duties when making a management representation or regulatory certification
- how regulators think, what they worry about and how they are likely to react to different scenarios.

The final point is especially true for those who interact with the regulator – usually this is regulatory staff, technical experts, the CEO and executives, and directors.

Takeaway: develop and conduct a tailored and accessible business 'education' programme so all relevant people know what they need to know to do their jobs effectively.

8) IT IS WHAT YOU MAKE OF IT

Each water entity will need to decide how it wishes to anticipate, respond to and engage with the new reality of economic regulation.

Some choose to resist the regime at every turn and some treat it as a matter for the regulatory boffins and lawyers. Others embrace it as an opportunity to enable better outcomes for their business, customers and shareholders. The accountability that comes from regulation also supports the entity's social license to operate. It is easier to ask a community to accept price increases when the need for those increases has been carefully explained, supported with evidence, assessed against alternatives, and approved after rigorous examination by the Commission. In the moment this can feel like a lot of hard work, but over the long run the process benefits both the entity and its consumers and other stakeholders.

At the risk of sounding doveish, those who commit and strive to make the regulation work for their business and their customers rarely regret it. Those who resist or try to ignore usually have a bad experience and eventually have a change of heart.

Takeaway: a win-win is on offer, but only if you take the opportunity.

2.2.4 STAGE 4: REPEAT

ID and PQ regulation are repeat games.

Each year firms need to publish ID for the prior year. Every few years (between three and five) a new price path will be determined. This provides an opportunity to learn, and means investing in people capability, business processes and systems provides good value for money.

The repeat game also means a regulated entity and the regulator will get to know each other well. The regulator will record statements, claims and commitments made by the regulated entity and revisit these in due course. There are many instances where regulated entities have made comments that sounded great at the time, and may have been expedient, but prove to be 'hostages to fortune' that they come to regret.

CONCLUSIONS

Economic regulation is coming. It will bring profound change for your business. Understanding this and acting accordingly allows the least-pain, most-gain journey for your staff, executive, board, owners and customers.

Effective change management, investing to build capabilities and embedding new requirements in core processes and systems takes effort, but pays off. If the CEO and executives champion the benefits of the new regime then staff will buy in, and change will happen naturally. In contrast, if staff sense the CEO and executive aren't fully on board, change will be slower and harder.

Building a mature, respectful relationship with the regulator is essential and will set you up for success. That relationship needs nurturing and involves give and take, and honesty – trust takes time to build, but can be destroyed in an instant.

Finally, does this mean a whole new set of TLAs and jargon? Unfortunately, it does!

ACKNOWLEDGEMENTS

The author thanks the following people for their thoughts and / or review of this paper:

- Ross Parry, Director, Concept Consulting
- Simon Peart, Partner, Chapman Tripp

- Jason McCarty, regulatory accountant, independent contractor

Each is expert in their field and bring deep knowledge of utility regulation.

REFERENCES AND LINKS

See Appendix.

APPENDIX: ID AND PQ SCOPE AND LINKS

The snips and links below relate to electricity distribution, equivalents information for other regulated sectors can be found on the Commission's website.

Schedule	Schedule name
1	ANALYTICAL RATIOS
2	REPORT ON RETURN ON INVESTMENT
3	REPORT ON REGULATORY PROFIT
4	REPORT ON VALUE OF THE REGULATORY ASSET BASE (ROLLED FORWARD)
5a	REPORT ON REGULATORY TAX ALLOWANCE
5b	REPORT ON RELATED PARTY TRANSACTIONS
5c	REPORT ON TERM CREDIT SPREAD DIFFERENTIAL ALLOWANCE
5d	REPORT ON COST ALLOCATIONS
5e	REPORT ON ASSET ALLOCATIONS
6a	REPORT ON CAPITAL EXPENDITURE FOR THE DISCLOSURE YEAR
6b	REPORT ON OPERATIONAL EXPENDITURE FOR THE DISCLOSURE YEAR
7	COMPARISON OF FORECASTS TO ACTUAL EXPENDITURE
8	REPORT ON BILLED QUANTITIES AND LINE CHARGE REVENUES
9a	ASSET REGISTER
9b	ASSET AGE PROFILE
9c	REPORT ON OVERHEAD LINES AND UNDERGROUND CABLES
9d	REPORT ON EMBEDDED NETWORKS
9e	REPORT ON NETWORK DEMAND
10	REPORT ON NETWORK RELIABILITY
10(vi)	REPORT ON NETWORK RELIABILITY (Worst-performing Feeders)

Schedule	Schedule name
11a	REPORT ON FORECAST CAPITAL EXPENDITURE
11b	REPORT ON FORECAST OPERATIONAL EXPENDITURE
12a	REPORT ON ASSET CONDITION
12b	REPORT ON FORECAST CAPACITY
12c	REPORT ON FORECAST NETWORK DEMAND
12d	REPORT FORECAST INTERRUPTIONS AND DURATION
13	REPORT ON ASSET MANAGEMENT MATURITY

Links below lead to current versions of the **ID template**, **underlying rules (input methodologies)** and **default price path** 'determinations'. For the latter, there is also a '**reasons paper**' and an '**analyst briefing**' that is intended to be accessible to the layperson.

Current ID requirements for electricity distributors Commerce Commission - Current information disclosure requirements for electricity distributors (comcom.govt.nz)

Current rules (called 'input methodologies') for electricity distributors Commerce Commission - Electricity distribution input methodologies (comcom.govt.nz)

Price quality path for electricity distributors Commerce Commission - Electricity lines price-quality paths (comcom.govt.nz) **analyst briefing** Analyst-briefing-slides-EDB-DPP3-final-determination-27-November-2019.pdf (comcom.govt.nz) and, '**reasons paper**' (does what the title says) https://comcom.govt.nz/__data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF