8.3 THREE WATERS REFORM - SEPTEMBER 2021 UPDATE

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References:
1. Three Waters Reform: Key Questions, Essential Facts
2. Three Waters Reform: Governance
3. Three Waters Reform: Consumer and Community Voice
4. Three Waters Reform: Planning Interface
5. Three Waters Reform: Interaction with Rural Schemes

Significance of decision – In terms of the Significance and Engagement Policy 2018, the recommended decision is not significant.

Recommendation

1. That Council notes the Government's June and July 2021 Three Waters Reform announcements and further information provided through August 2021, as outlined in this report
2. That Council notes that during this phase of the Three Waters Reform process it is required to understand the material released by the Government and identify issues of local concern and provide feedback to Local Government New Zealand on what these are and suggestions for how the proposal could be strengthened
3. That Council notes it is engaging with the community through September 2021 to understand questions that the community may have that may complement its own questions of the Government
4. That Council notes that it cannot make a formal decision to opt in or opt out during this phase of the reform
5. That Council notes that the Government intends to make further decisions about the three waters service delivery model after 30 September 2021
6. That Council notes that the Chief Executive will report back further once Council has received further information and guidance from the Government [Department of Internal Affairs (DIA), Local Government New Zealand and Taituarā] on what the next steps look like and how these should be managed

Purpose

This paper is intended to provide an update on our current knowledge of the government's three waters reform proposal. This report updates the Whanganui District Council on:

- requirements for councils over the eight week period covering August and September 2021
- the background and case for change
- the Government's June and July 2021 Three Waters Reform announcements and further information released in August 2021
- the specific data and modelling Council has received to date

- the implications of the revised Three Waters Reform proposal on Council and the community
- what would happen if Whanganui opted out in the future
- next steps (including uncertainties).

Following the discussion on three waters reform and the release of information on the $2.5B Council funding package at the Local Government New Zealand (LGNZ) conference in July 2021, Councils have been given an eight week period through to 30 September 2021 to understand the three waters reform proposal and how it affects their council and their community.

The eight week period through to 1 October 2021 is for councils to:

- engage with and understand the large amount of information that has been released on the nature of the challenges facing the sector, the case for change, and the proposed package of reforms, including the recently announced support package;
- take advantage of the range of engagement opportunities to fully understand the proposal and how it affects your local authority and your community; and
- identify issues of local concern and provide feedback to LGNZ on what these are and suggestions for how the proposal could be strengthened.

Councils are not allowed to make any formal decisions regarding the reform over the eight week period. There is no requirement for public consultation on a decision to opt in or out over this period because no decisions are to be made by councils at this point in time. Further, the Government will need to respond to the issues raised by councils over the eight week engagement period and this may result in subsequent changes to the reform proposal. The Government has stated that it will not make any further decisions on the reform until the eight week engagement period is over.

While council cannot formally consult on a decision to opt in or out at this time, council is aware that the community have significant interest in the three waters reform as the most significant proposed change to local government in decades. Our community rightfully expects to be kept informed and to eventually have a say in any decision to change how our three waters services are owned, governed and delivered.

Council has instigated a public communication campaign to provide information to the community about the government's proposed three waters reforms. In addition, we have provided the community with summary information on the proposal on our website along with frequently asked questions at Three Waters Reform Whanganui District Council. On this page we have set up an online portal for our community to raise with us any issues that they believe council should be raising with the government on their behalf during this eight week engagement period.

Under the Local Government Act 2002, councils would be required to formally consult with their community on any future decision to transfer the three waters assets to the water services entities, as this decision would be considered significant under council's Significance and Engagement Policy. However there is the possibility that the Government could mandate and legislate the three waters reform. We expect further information on this following the eight week engagement period.

Executive summary

The three waters reform is a government led reform to address what the government considers to be systemic issues facing New Zealand's three waters sector. The genesis of the reform was the Havelock North drinking water campylobacter outbreak in 2016.

The government wants to make some fundamental changes to look after the environment and ensure all New Zealanders have access to safe, reliable and affordable water services. It has identified urgent challenges for local authorities, including funding historical infrastructure deficits, meeting future costs associated with rising safety and environmental standards and expectations, meeting iwi/Maori expectations, building resilience to natural hazards and climate change, and supporting growth.

The government's modelling suggests that New Zealand needs to invest between $120B and $185B in its three waters assets over the next 30 years. These estimates have been peer reviewed by Farrierswier and Beca who agree on the broad scale of the investment needed. The government believes that changing the way we manage three waters will be more efficient, deliver better services, reduce the future costs for households and improve the environment.

It has proposed to set up four, multi-regional water services entities, each collectively owned by its constituent local authorities so that the assets remain in public ownership by the community. Whanganui is proposed to be one of 22 councils in Entity B, which covers the Bay of Plenty, Waikato, Taranaki and parts of Manawatu-Whanganui. The entities would take over the three waters assets, debt, associated reserves, service delivery and direct three waters staff from councils.

The government have stated that the reform proposition requires all-in participation of local authorities in order to affordably and sustainably address the water services delivery objectives over the next 30 years.

Alongside the proposed amalgamations are a series of regulatory reforms, including changes to how drinking water, wastewater and stormwater compliance is managed with the creation of Taumata Arowai, and the creation of an economic regulation regime that will require information disclosure, set minimum quality standards (in addition to those set by Taumata Arowai) and maximum prices, ensure appropriate investment in assets and drive efficiency gains.

While it is difficult to quantify the effects of these changes, it is likely that substantial additional investment in three waters will be required in the medium to long term. Importantly, opting out of the reforms will not allow councils to be excused from the proposed regulatory changes, and affordability will not be an excuse for not meeting the requirements. The government has clearly stated that the status quo for councils no longer exists.

The financial modelling released by the government suggests that the water services entities will be able to provide the increased levels of service at lower cost to our community than council can. While officers have concerns around some of the assumptions made in the council-level modelling such as the amount of local investment required, WICS sensitivity testing shows that even with conservative assumptions the reform option is still cheaper for customers than the same level of service being provided by councils. This is primarily due to the inability for councils to obtain cost saving efficiencies due to lack of scale, and debt to revenue restrictions that mean councils would have to fund more of the substantial investment programmes through price rises once debt limits become a barrier.

Experience from around the world suggests that water reforms do not necessarily provide savings to customers over what they pay pre-reform, but do provide significant service level increases and allow the ability for significant capital investment programmes to address drinking water and environmental standards that would otherwise have not been able to be undertaken due to funding constraints. Operating cost efficiencies obtained through amalgamation, leveraging debt at a higher level than councils are able to, and cost averaging across a larger connection base combine to help to minimise the impact of the significant capital investment programmes on customer's bills.

In late July 2021 the government announced a $2.5B financial support package for local government, if the reforms proceed. This includes a better off component of $2B of which Whanganui's allocation is $24M. This funding can be used for projects that contribute to sustainability, climate change, housing provision, local place-making and community well-being. There is also a $500M no worse off component available to assist with stranded overheads and to assist councils whose financial position is made worse off by the transfer of the three waters assets.

Councils are currently in an eight week engagement period ending 30 September 2021 where they are to understand the raft of the material on the three waters reform released by the government through June, July and August 2021, seek clarification where required, any raise any issues of concern with the government via LGNZ, including suggestions to strengthen the government's proposal. Council cannot make any formal decisions during this phase of the reform. The government intends to make further decisions on the reform after 30 September 2021.

Under the current Local Government Act 2002, councils would be required to formally consult with their community on any future decision to transfer the three waters assets to the water services entities, as this decision would be considered significant under council's Significance and Engagement Policy. However there is the possibility that the Government could mandate and legislate the three waters reform. We expect further information on this following the eight week engagement period.

As the largest proposed change to local government in decades, it is important that council thoroughly assess the reform proposal and undertake due diligence to ensure the best outcome for its community. Council has requested that the government provide further time to allow this to happen.

Background

Following the serious campylobacter outbreak in 2016 and the Government's Inquiry into Havelock North Drinking Water, central government have been considering the issues and opportunities facing the system for regulating and managing the three waters (drinking water, wastewater, and stormwater).

The Havelock North inquiry identified challenges with the way local authorities are set up to deliver three waters, but also inadequacies in national policy and stewardship of the sector as contributing factors.

The focus has been on how to ensure safe drinking water, improve the environmental performance and transparency of wastewater and stormwater networks and deal with funding and affordability challenges.

The Government's proposal is for four multi-regional water services entities with local authority ownership. The Department of Internal Affairs (DIA), in partnership with the Three Waters Steering Committee (which includes elected members and staff from local government) commissioned specialist economic, financial, regulatory and technical expertise to support the Three Waters Reform Programme and inform policy advice to ministers.

The initial stage of the process was an opt-in, non-binding approach where council received $6.3M to spend on three waters projects for providing information on its three waters assets through the Request for Information (RFI) process. Accepting the funding in this initial stage did not require councils to commit to future phases of the reform programme, to transfer their assets and/or liabilities, or establish new water entities.

Council completed the RFI process over Christmas and New Year 2020/21 and the Government has used this information, evidence, and modelling to make preliminary decisions on the next stages of reform and has concluded that the case for change has been made.

In June 2021 a suite of information was released by Government that covered estimated potential investment requirements for New Zealand, scope for efficiency gains from transformation of the three waters service and the potential economic (efficiency) impacts of various aggregation scenarios.

In summary the modelling indicated a likely range for future investment requirements at a national level in the order of $120 billion to $185 billion, an average household cost for most councils on a standalone basis to be between $1,910 and $8,690 by 2051. It also estimated these average household costs could be reduced to between $800 and $1,640 per household and efficiencies in the range of 45% over 15-30 years if the reform process went ahead. An additional 5,800 to 9,300 jobs and an increase in GDP of $14B to $23B in Net Present Value terms over 30 years were also forecast.

In July 2021 at the LGNZ conference the Government announced a $2.5B local government funding package to ensure that councils were financially better off, and no worse off, after the reform. This led into an eight week engagement period over August and September 2021 for councils to consider the full suite of information published by the government, request any clarification and advise of any issues of concern. No decisions are to be made during this period. The government is expected to consider the issues raised by councils and announce the next steps in October 2021.

Key issues

1. The Government's rationale for change

The government has identified that councils in general have under-invested in their water supply, wastewater and stormwater (three waters) systems. There have been many issues around the country, like the Havelock North water issues in 2016, pipes bursting in Wellington, sewage leakages into streams and lakes, and ongoing boil water notices in several locations around the country.

The Havelock North inquiry identified challenges with the way local authorities are set up to deliver three waters, but also inadequacies in national policy and stewardship of the sector as contributing factors.

While many councils, including Whanganui District Council, currently do a good job of delivering three waters services, the government believes that many councils will be unable to invest enough to maintain and improve their three waters assets and services in the long-term to meet the standards expected.

The government has identified urgent challenges for local authorities, including funding historical infrastructure deficits, meeting future costs associated with rising safety and environmental standards and expectations, meeting iwi/Maori expectations, building resilience to natural hazards and climate change, and supporting growth.

The government wants to make some fundamental changes to look after the environment and ensure all New Zealanders have access to safe, reliable and affordable water services.

The government's modelling suggests that New Zealand needs to invest between $120B and $185B in its three waters assets over the next 30 years. These estimates have been peer reviewed by Farrierswier and Beca who agree on the broad scale of the investment needed.

The government believes that changing the way the three waters are managed will be more efficient, deliver better services, reduce the future costs for households and improve the environment.

Further information is contained in the government's Transforming the system for delivering three waters services document.

The key issues identified by the government are:

1. Poor compliance with drinking water standards
2. Poor health outcomes – one in five New Zealanders are supplied drinking water that is not guaranteed to be safe from bacterial contamination.
3. A large, accumulated infrastructure deficit – the Officer of the Auditor General reported in 2017 that councils were not investing enough in their three waters assets.
4. Poor customer outcomes - no consistent set of performance measures and a general lack of high-quality information about the state and performance of three waters networks.
5. Poor environmental outcomes - wastewater treatment plant discharges are harming the environment in many parts of New Zealand and stormwater systems are facing issues with maintenance, resilience and climate change and natural hazards.
6. Lack of resilience - threats to water security, climate change is creating more of the extremes of flooding and droughts, and water losses in networks are increasing.
7. Poor outcomes for iwi/Maori - Maori express a relationship with water as kaitiaki. Iwi/Maori are clear that the system for delivering three waters needs to uphold, align and integrate with Te Tiriti and Te Mana o Te Wai.
8. Iwi are also often members of communities underserved by the existing three waters system and who receive poor quality three waters services or none at all.

The government state that the cause of New Zealand's three waters challenges are rooted in the way the system is currently designed. They have identified four root causes that contribute to the "persistent and systemic problems".

1. Limited opportunities to achieve benefits from scale
2. A significant affordability challenge
3. Misaligned incentives for critical water infrastructure decisions
4. Lack of effective oversight and stewardship for the three waters sector

Officers' analysis

There is no debate that there have been a significant number of public health, environmental and service quality issues with three waters across the country over many years. There are varying service levels from council to council, varying levels of understanding of three waters assets, and varying degrees of investment.

Many councils are facing challenges investing in their three waters assets due to competing priorities for councils and limits on borrowing, especially in high growth areas or where there are small population bases to spread costs over.

Stormwater in particular is a concern for many councils, including ours, with climate change creating performance issues in networks, the requirement for stormwater catchment plans, and the potential for stormwater to require treatment before discharge in the future.

Whanganui has invested heavily in its three waters assets over the past 40 years. We have increased rates in order to fund projects like stormwater separation and the wastewater treatment plant, in addition to using debt and selling some community assets like Energy Direct New Zealand (EDNZ) and our forestry holding to mitigate the impact on rates. Overall, our assets are in good shape and our debt is reasonable and being repaid appropriately. Further information on our three waters financial situation and our assets can be found in sections 7 and 8 below.

2. Local Government New Zealand's view

Local Government New Zealand (LGNZ) are working closely with the DIA and the government on the three waters reform under a Heads of Agreement. Parts of the negotiated heads of agreement was the $2.5B Council funding package (discussed further in section 21). LGNZ have offered councils support in obtaining the information they require during the engagement period, at no cost.

It is important to note that LGNZ supports the need for change on a national level. The Heads of Agreement between LGNZ and the Crown acknowledges that the Three Waters Reform Programme is *"a tested and robust package of reforms that will:*

(a) affordably and sustainably address the water services delivery objectives over the next 30 years; and
(b) require all-in participation of local authorities to do so."

While the Heads of Agreement does not bind LGNZ's members, LGNZ have committed to support the reform and the need for all-in participation to realise the full system benefits proposed.

The Heads of Agreement states that if, at end of the eight week period, the Government decides to adopt an "all-in" legislated approach, LGNZ will accept such a decision and will not actively oppose such approach.

Officers' analysis

While the government and LGNZ have a national interest, councils have a local interest and these interests may conflict.

It is important to note the increasing messaging from the Government that the reforms require all-in participation, and that the government may take an all-in legislated approach.

Officers believe that while the reform is at this stage voluntary, councils have some ability to negotiate and shape the details. If or when the reform becomes legislated, councils will have less influence over the design and details to ensure the best outcomes for their communities. It is therefore critical to use the eight week period wisely to achieve the best outcome for our community.

3. The status quo no longer exists

As the government's reform programme has progressed, the messaging from the government has become increasingly strong in indicating that the status quo for councils no longer exists. In late August 2021, the DIA added the following text to the Three Waters Reform website Frequently Asked Questions:

The status quo no longer exists

There is a common misconception that the Government is asking councils to consider and compare their current three waters operations and costs with a future under the service delivery reforms. This is incorrect. The status quo for water service providers is changing and council water providers and their communities will face very significant regulatory obligations and costs if they were to opt out of the reforms.

The Government is already reforming regulations to ensure all New Zealanders have access to safe and affordable drinking water. There will be tighter scrutiny on stormwater and wastewater services to ensure they meet community expectations and rising environmental obligations. The reforms will also introduce economic regulation. This will ensure that sufficient funds are collected from ratepayers and households for maintaining, renewing and upgrading infrastructure, and that providers deliver service levels and prices that are in consumers' best interests. Stronger consumer protection mechanisms will also be put in place.

The combination of health, environmental and economic regulation will ensure all New Zealanders' three waters services meet their expectations. The service delivery reforms are designed to ensure this will be affordable for communities across New Zealand.

Read more information on this Regulatory pressures and Three Waters Reform.

In the government's view, the three main areas of regulatory focus that will raise compliance pressures and likely require additional investment are:

- Taumata Arowai ensuring stringent compliance with drinking water safety standards;
- Taumata Arowai working alongside Regional Council regulators to provide national oversight on the performance of wastewater and stormwater networks;
- Economic regulation to provide water consumers with assurance of fair and affordable pricing, and ensure transparency, efficiencies and appropriate levels of investment across three waters services.

A Whanganui District Council standalone option in an increased regulatory environment is discussed further in section 26.

4. What are our options?

It is important to note that at this point in time councils are not being asked to make any decisions on whether they wish to be in or out of the reform. The eight week period covering August and September 2021 is for councils to fully understand the government's proposal, seek any clarification and raise any concerns, with proposed solutions.

The strong messaging from the government is that they hope that councils and the community will see the overwhelming case for change. They have noted that all-in participation of councils is required to manifest the stated benefits of the reform.

In the future, post-30 September 2021, council may need to decide between remaining in or opting out of the reform, if the government allows councils to make a choice. This would require formal public consultation (see section 5 below).

As discussed above, it is important to note that opting out of the reform does not mean that councils continue their current business as usual. There will be significant regulatory obligations and increased costs that council will face if it opts out of the reform.

5. Future consultation on opting in or out of the reform

Under current legislation, council would need to publically consult with its community on whether to remain in or opt out of the reform at a future date, as this would be a significant decision for our community. However there is the possibility that the government could choose to make the three waters reform mandatory through legislation. We expect to learn more about this after the eight week engagement period which ends on 30 September 2021.

If councils have a choice on whether to opt in or opt out of the reform, council would publically consult on these options with the community. We would seek community views through a wide range of engagement methods using different channels such as online, in person, and print. As a significant decision for our community, our engagement would need to be appropriate to the significant scale of the decision.

A referendum would not be council's preferred engagement tool for understanding community views on the three waters reform. The three waters reform is a complex and multi-faceted topic and officers do not believe that a referendum would capture the nuances of the community's views and concerns effectively. This is especially true as we will not be comparing the status quo against the reform option, as the status quo of council providing the services as it does now effectively no longer exists.

6. Key considerations

In considering whether Whanganui District Council remain in or opt out of the three waters reforms at a later date, we recommend the following are front of mind:

- The question is not so much to debate whether the significant expenditure plans are correct, the question is whether, irrelevant of expenditure levels, the amalgamated water services entities can achieve better levels of service at lower cost to our community than council can.
- We need to take a long term view in our decision making. The three waters assets have very long lives and today's view of our assets relative to others' assets is only a snapshot of a single point in time within a long lifecycle.
- Whether we remain in or opt out, we can expect that there will be a requirement to increase the levels of service and capital and renewal expenditure for the three waters, which will require a significant increase in investment over and above what is currently provided for in our Long Term Plan. The government has clearly indicated that the status quo no longer exists.

WHANGANUI'S CURRENT THREE WATERS SITUATION

7. Whanganui's three waters financials

Council's three waters asset values, debt, rates and overheads are as follows:

	Asset value (full replacement cost)	**Asset value (depreciated replacement cost)**	**%**	**Debt as at 30 June 2021**	**%**	**Rates 2021/22**	**%**	**Over-heads 2021/22**	**%**
Water supply	$172M	$90M	8%	$10.8M	11%	$6.9M	10%	$0.7M	8%
Stormwater	$190M	$135M	13%	$30.1M	29%	$6.2M	9%	$0.4M	4%
Wastewater	$339M	$196M	18%	$40.5M	40%	$9.4M	14%	$0.8M	9%
Three waters	**$701M**	**$421M**	**29%**	**$81.4M**	**80%**	**$22.5M**	**33%**	**$1.9M**	**20%**
Other	$1,204M	$643M	71%	$20.9M	20%	$45.2M	67%	$7.6M	80%
Total	**$1,905M**	**$1,064M**	**100%**	**$102.3M**	**100%**	**$67.7M**	**100%**	**$9.5M**	**100%**

The average residential rate for 2021/22 is $3,020. Three waters rates make up $1,020 of the average residential rate.

While water supply and wastewater are rated as fixed charges (i.e. each residential property pays the same amount), stormwater is a capital value based rate and therefore the amount paid differs dependent on a property's capital value. Some commercial properties pay metered water rates, and trade waste businesses pay trade waste rates and fees.

Council's three waters debt is $81M as at 30 June 2021.

Three waters activities currently fund $1.9M per annum of council's overheads.

8. The current state of Whanganui's three waters assets

Water supply

Whanganui's water supply provides safe and plentiful drinking water that already consistently meets New Zealand's drinking water standards, including council's rural supply schemes. Council's Infrastructure Strategy notes that the average condition rating of the water supply assets ranges from fair to very good.

The Water Services Bill and the introduction of the regulator (Taumata Arowai) could potentially still increase Council's costs, as eventually all private water supplies servicing more than one property will need to meet drinking water standards. The Government's expectation is that the water services entities (or councils if they opt out) would be the default provider of these services if private suppliers are unable to meet the standards themselves due to the burden of future compliance, and this could add considerable cost. We do not know at this stage how this might affect us. Councils are also required to contribute to funding Taumata Arowai itself.

Wastewater

Whanganui has a new wastewater treatment plant (WWTP) and discharges from the WWTP to the sea meet the majority of the outfall resource consent limits. The ocean outfall resource consent is due for renewal in 2026 and the effect of this is unknown; the elevation of Te Mana o Te Wai may have an impact on future consent requirements.

Biosolids are currently being disposed of in the settling pond onsite. Biosolids disposal routes for the long-term have yet to be determined.

Council's Infrastructure Strategy notes that the average condition rating of the wastewater assets ranges from good to very good.

Tamuata Arowai have an oversight role for both wastewater and stormwater and the effects of this are as yet unknown.

Stormwater

The stormwater network is not performing adequately in some areas and an $80M upgrade programme was identified and approved in the Long-Term Plan 2018-2028. The programme was set at $0.5M for ten years, and then $1M per year thereafter. At this level of investment it will take 85 years to deliver the $80M upgrade programme.

Climate change will have a major impact on stormwater systems. The $80M planned investment programme is anticipated to help to address some of the impacts of climate change.

Our Infrastructure Strategy notes that the average condition rating of the stormwater assets ranges from good to very good. The network is relatively new as most of it was constructed as part of the separation project in the 1990s to 2000s.

Stormwater currently overflows into the Whanganui River. Council does not have stormwater management plans in place as this is currently a permitted activity, but this will change in the future. No provision has been made for treatment of stormwater in the future.

Tamuata Arowai has an oversight role for both wastewater and stormwater and the effects of this are as yet unknown.

THE GOVERNMENT'S THREE WATERS REFORM PROPOSAL

9. Key components of the proposed government reform package

The key components of the government reform proposition are as follows:

- There will be four multi-regional water services entities across New Zealand – Whanganui is proposed to be in Entity B with 21 other councils covering the Bay of Plenty, Waikato, Taranaki and parts of Manawatu-Whanganui.
- Three waters assets, debt, associated reserves, service delivery and direct three waters staff would be transferred to the new water services entities.
- It is proposed that the new water service entities begin operation on 1 July 2024.
- The water services entities would be collectively owned by their member local authorities so the assets remain in public ownership. Safeguards would be put in place to avoid the risk of future privatisation.
- The water services entities would borrow in their own right and have completely separate balance sheets to councils.
- Charging would eventually be harmonised across each entity i.e. there would be one pricing structure for the entity. For the first few years, existing charging regimes will remain in place.

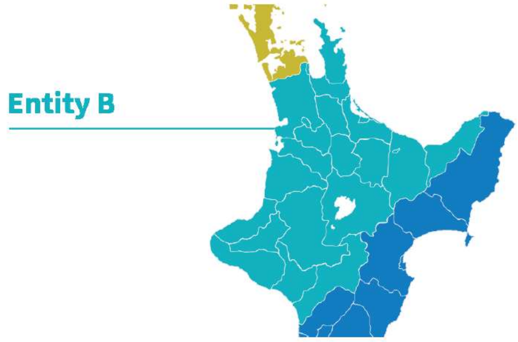
- Levels of service and standards will increase, whether we join the reform or not.
- The water services entities would be governed by independent competency based boards. The board members will be selected by an independent selection panel that is in turn selected by a regional representative group. The regional representative group will have no more than 12 members and 50:50 composition between local authorities and mana whenua.
- The regional representative group will inform the entity's direction via issuing a Statement of Strategic and Performance Expectations.
- Each entity will have a consumer forum and will be required to consult on its plans and pricing with its consumers and community.
- The modelling shows significant forecast investment requirements for Whanganui over the next 30 years ($35M per year on new capital projects alone).
- Efficiencies of around 50% are predicted over the 30 year period.
- An economic regulation regime would be established to ensure efficient service delivery and to drive the achievement of efficiency gains, and consumer protection mechanisms.
- A clear national policy direction will be set for the three waters sector, including expectations relating to spatial / resource management planning processes.
- An industry transformation strategy will be developed to support and enable the wider three waters industry to gear up for the new water services delivery system.
- Council's direct three waters staff will transfer to the new water services entities, retaining their current role, salary, location, leave and hours/days of work.
- A $2.5B funding package for local government, including $2.0B to be spent on community well-being, place making and environmental sustainability initiatives and $0.5B to ensure councils are no worse off as a result of the asset transfer.

10. Proposed entity boundaries

The proposed boundaries of the water services entities are summarised in the A3 Summary of the three waters reform programme and the Water service entities overview

The structure proposed has four entities, and Whanganui sits in Entity B which is comprised of 22 councils across the Bay of Plenty, Waikato, Taranaki and parts of Manawatu-Whanganui. The councils contained within Entity B are noted below:

Entity B



Hamilton
Hauraki
Kawerau
Matamata-Piako
New Plymouth
Opotiki
Otorohanga
Rangitikei
Rotorua Lakes
Ruapehu
South Taranaki
South Waikato
Stratford
Taupo
Tauranga
Thames-Coromandel
Waikato
Waipa
Waitomo
Western Bay of Plenty
Whakatane
Whanganui

The government is discussing the proposed entity boundaries with iwi to ensure they are appropriate.

Entity B has the smallest population base of the four proposed entities at approximately 800,000 people, but has the highest projected growth.

The modelling provided does not provide a picture of the state of the other Entity B councils' three waters assets.

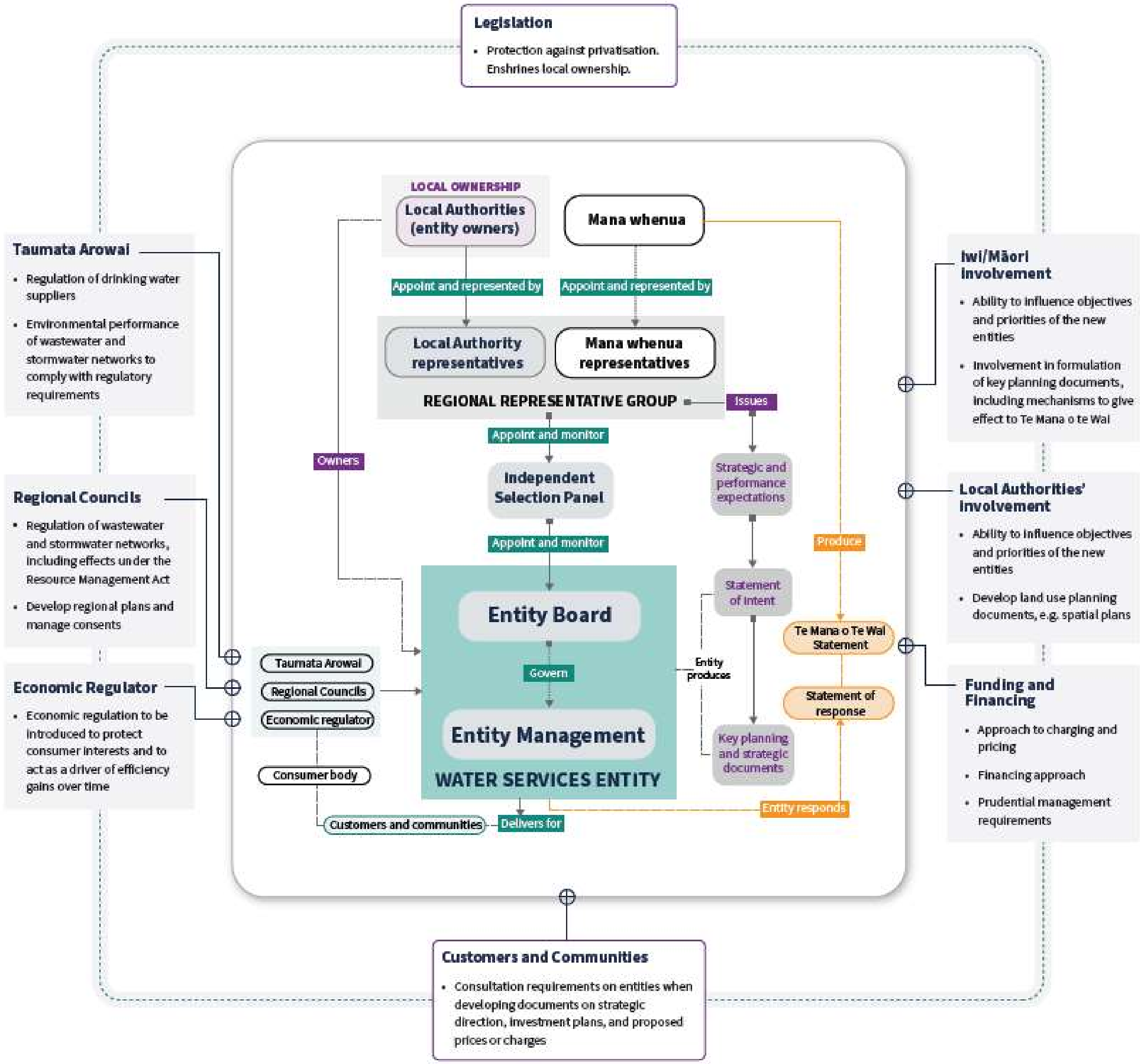
The current three waters debt of the Entity B councils is estimated at $1.4B, with annual revenues of $560M (2.5x debt to revenue ratio). The three waters assets for Entity B are estimated at a value of between $11.3B and $15.4B.

Officers' analysis

Entity B discussions have begun, with Mayors and Chief Executives of all 22 councils meeting in Taupo on 5 August 2021. An Entity B working group has been set up with six Mayors and six Chief Executives selected to represent Entity B. The Entity B working group's aim is to advocate for the stakeholders (water services consumers, mana whenua, staff and contractors), raise common issues with the reform proposal and provide recommendations to the government and DIA, as well as building relationships and working together to ensure a smooth transition if the reforms proceed.

11. Proposed ownership and governance structure

The proposed structure of the water services entities are shown in the A3 Summary of the three waters reform programme and below. Further information on the proposed ownership and governance arrangements for the water services entities was made available in late August 2021 in response to questions and is attached as Reference 2 (Three Waters Reform Proposal: Governance).



Ownership

It is proposed that from 1 July 2024 local authorities will collectively become owners of the water services entities on behalf of their communities.

The water services entities are proposed to assume ownership of the three waters infrastructure and service delivery arrangements, as well as associated debt and revenue. Reserves that councils have set aside in relation to these assets that are unspent at 1 July 2024 will also be transferred to the entities and will be spent in the area they were collected in.

There will be no financial recognition of ownership and no shareholding, and a prohibition on dividends to ensure all funds are reinvested.

Protections will be made in legislation against future privatisation. These include legislation specifying that local authorities that constitute each water services entity will be the owners of the entity, and that any serious future privatisation proposal would need to firstly pass a 75% majority vote from the Regional Representative Group and then be put to a referendum where a 75% majority would be required.

The entities will be able to borrow in their own right and will have completely separate balance sheets to the councils. This will allow them additional financial capacity to fund the required investments.

Governance

Regional Representative Group

Each entity will have a Regional Representative Group (RRG) that provides for representation of the owner councils and mana whenua, who have a joint oversight role in the entities. The RRG is designed to enable efficient oversight and strategic direction of the entity on behalf of a potentially large group of local authorities and mana whenua within the jurisdiction of the entity. The proposed functions of the RRG include:

- Establishing and monitoring the Independent Selection Panel that appoints members to the entity's board
- Developing and agreeing a Statement of Strategic and Performance Expectations that will guide the entity in its formation of key strategic and planning documents e.g. Asset Management Plans; and
- Monitoring performance against the Statement of Strategic and Performance Expectations and Statement of Intent.

The RRG can have a maximum of 12 members and must be made up of 50% local authority members (via elected members, chief executives or appropriately qualified senior officers of local authorities) and 50% mana whenua (via iwi/Maori representatives). RRG representatives will be subject to minimum requirements in legislation.

Local authority representation on the RRG will be required to comprise an appropriate distribution of metropolitan, provincial and rural councils and represent a georgraphic spread across the entity's area. Iwi will be required to collectively appoint their representatives through a kaupapa Maori approach.

The RRG will be required to consider the interests of the relevant jurisdictions within an entity area when making decisions. Each member will have a single vote. No member will have a right of veto to exert negative control over the group's decisions.

The RRG will appoint an Independent Selection Panel that subsequently appoints the entity's board to govern the entity. This means there are two layers between the representation on the RRG (50:50 local government/iwi) and the eventual entity board.

Independent Selection Panel

The Independent Selection Panel's primary role is to appoint and ensure the performance of the board. The Independent Selction Panel will conduct annual performance reviews for board members. The RRG can request a board member be removed and/or assessed by the Independent Selection Panel, with the panel having final discretion.

Entity Board

The entity's independent, competency-based board will be made up of no more than 10 members, with the chairperson holding the casting vote. Board members will require relevant knowledge, skills and experience competencies which will be set out in legislation, including the requirement to have relevant experience in managing three waters networks or similar network infrastructure and to have competence in understanding the principles of the Treaty of Waitangi, matauranga Maori, tikanga Maori and te ao Maori.

Board appointments and removals and annual performance reviews would be conducted by the Independent Selection Panel.

The board must be independent in order to ensure balance sheet separation from councils, as this is required to unlock additional borrowing capacity for the entities.

12. Local community representation and voice

The ability for our local community to have their voices heard in the new water services entities is critical, given that the water services entities will be servicing broad geographical areas and considerable populations. The government recognised the strong messaging from councils and communities regarding the importance of the local voice in the new water services entities and published two relevant papers in late August 2021:

- Three Waters Reform Proposal: Governance (Reference 2), and
- Three Waters Reform Proposal: Consumer and Community Voice (Reference 3).

There are two primary channels for local input under the new structure:

Local authority representation

The government's Three Waters Reform Proposal: Governance document (Reference 2) states that as entity owners, local authorities will have ongoing ability to influence the strategic direction, performance expectations, objectives and priorities of the entities, however the level of direct control is reduced as the independent competency based board will take over governing the entities' day to day management of service delivery. It states:

The Government has proposed a core role for local government and mana whenua in setting the strategic direction, performance expectations, and oversight of the entities. However, with independent competency-based boards governing the new entities' day-to-day management of three waters service delivery, and strong direct influence for consumers into the entities, the Government is proposing that councils will have a reduced level of direct control.

Consumer and community direct input

With reduced direct control by local authorities in a governance sense, the government has advised that the proposed structure provides for increased direct input from consumers and communities, including councils and iwi/Maori, to key strategic planning processes. The government's Three Waters Reform Proposal: Consumer and Community Voice (Reference 3) document states:

The Government is proposing a range of mechanisms for community and consumer voices to enable councils, iwi/Māori and communities to have influence over future three waters service delivery for their area. This includes:

- *Strategic influence and oversight by local authority and mana whenua including through representatives on the Representative Group to act on behalf of their communities (the subject of this paper);*
- *Requirements on the entities to directly engage and consult with consumers and communities (including individual councils) on the key business documents that affect them (see paper on community voice);*

- *Economic and water quality regulation, combined with consumer protections to ensure investment is undertaken in the best interests of the community (see separate document on the regulatory environment); and*
- *Requirements for each entity to establish a consumer forum to assist with effective and meaningful engagement (see paper on community voice).*

Entities will be required to engage with consumers and communities (including individual councils and iwi/Maori) on key strategies and plans that affect them, such as investment prioritisation and asset management plans, as well as proposed pricing plans. The entities will be required to show how the feedback received was incorporated into the final plans.

Economic and water quality regulation as well as customer protection mechanisms are aimed to ensure that investment is undertaken in the best interests of the community.

Drinking water standards will be enforced through Taumata Arowai, the drinking water regulator, who will be able to put in place compliance orders to ensure unacceptable risks to the community are resolved in a timely fashion. Taumata Arowai will also have an oversight role in wastewater and stormwater, working alongside regional councils.

The economic regulation regime (see section 20) will also set out information disclosure requirements and minimum service quality standards, in addition to the standards set by Taumata Arowai. The minimum service quality standards may cover things like water pressure, service response times, acceptable numbers of unplanned outages and sewer overflows etc. The economic regulation regime will also provide for a dispute resolution process and protection for vulnerable customers.

Each entity will also be required to establish a consumer forum (details of what these look like have not yet been provided).

Officers' analysis

The loss of direct control and influence over local three waters assets is a significant concern for council.

Ensuring that there is a continued local Whanganui voice in the new water services entities is critical, and this is a common theme that is running across the country given that there will not be representatives of every council on the water services entities' Regional Representative Groups (22 councils and only 6 places on Entity B's Regional Representative Group), and there will be no local authority representation on the entity boards due to the requirement for independence.

While local authorities will have a reduced level of direct control over the water assets and service delivery in their communities, there are a number of alternative mechanisms that provide opportunities for local authority, mana whenua, consumer and community input. These include the proposed consumer forum, Te Mana o Te Wai statements to ensure mana whenua rights and interests are reflected locally, entity consultation requirements on key business documents such as pricing plans and investment prioritisation methodology, and the requirement to report on how consumer and community feedback was taken into account in finalising these documents. In addition, the proposed regulatory regime and economic regulation regime are intended to set minimum quality standards and protect the long-term interests of consumers.

Council intends to continue to advocate for additional local influence in the water services entities.

13. The government's expert advisors

The government, via the DIA, have commissioned modelling and a number of reports from industry experts to advance the evidence base for the proposed changes to three waters.

The key advisors are as follows with links to their full reports. A summary of their opinions is contained in the sections that follow.

Water Industry Commission of Scotland (WICS)

WICS have been commissioned by the Government to model the potential investment requirements for New Zealand and scope for efficiency gains from transformation of the three waters service delivery system.

For further information, see the Phase 2 WICS reports:

Final report – economic analysis of water services aggregation

Supporting material Part 1 – required investment

Supporting material Part 2 – scope for efficiency

Supporting material Part 3 – costs and benefits of reform

Supporting material Part 4 – modelling the effects of ranges for key parameters for Auckland Council

Supporting material Part 5 – Council outcomes under aggregation

It should be noted that the terminology used in the reports in some cases differs from our local terminology:

- Enhancements – capital acquisitions i.e. capital for new assets (non-growth related)
- Replacement and refurbishment – capital renewals i.e. replacing existing assets

Farrierswier

Farrierswier reviewed the methodology and underpinning assumptions applied by WICS and the extent to which these are reasonable to inform policy advice.

For further information, see Farrierswier's report Three waters reform – Review of methodology and assumptions underpinning economic analysis of aggregation

Beca

Beca reviewed the standards and practices in the United Kingdom three waters industry and the relevance to New Zealand given WICS used United Kingdom data and benchmarks as part of its analysis.

For further information, see Beca's report DIA three waters reform – WICS modelling Phase 2 – Review of assumptions between Scotland and New Zealand three waters systems

Deloitte

Deloitte undertook a comprehensive study of the economic impacts of reform and the potential opportunities and challenges for affected industries.

For further information, see Deloitte's report Industry development study and economic impact assessment

14. WICS modelling and peer review opinions

The modelling undertaken by WICS indicates a likely range for future investment requirements at a national level in the order of $120B to $185B. This investment is estimated as necessary for New Zealand (within a 30 year time-frame) to meet current levels of compliance that water utilities in the United Kingdom achieved in 2019 (noting this still does not meet European Union standards). These standards are assessed by WICS (and confirmed by Beca) to be broadly comparable with equivalent New Zealand standards.

Two independent reviews were commissioned to provide assurance regarding the robustness of the WICS modelling and its appropriateness as a basis for policy advice:

- Farrierswier reviewed the methodology and underpinning assumptions applied by WICS and found that the overall approach WICS took to modelling the potential impact of amalgamation of water entities and associated reforms should give reasonable estimates of the direction and scale of impacts. Their report states:

  Importantly, WICS' sensitivity analysis…highlights that even if conservative values are adopted for key assumptions, that the estimated benefits from amalgamation and associated reforms are still positive.

- Beca reviewed the standards and practices that apply in the United Kingdom three waters industry and how relevant these are for a New Zealand context, given WICS used United Kingdom data and benchmarks to assess the future investment requirement for New Zealand. The Beca report considers that, on balance, the forecasts from WICS modelling may underestimate the investment requirements and timeframes, suggesting that WICS modelling of future investment may be conservative. Their report states:

  New Zealand is facing a period of major changes in land, air and water environmental legislation, and for regional and local government responsibilities. Taken as a whole, it is very difficult at this time to predict impacts on New Zealand three waters segment and on the timeframe and total costs (capital and operating) of subsequent changes in standards which apply to the proposed aggregated WSE's.
  On balance, the predictions from WICS modelling may well underestimate the necessary investment costs and could give overly optimistic timeframes for implementation due to supply chain limitations in New Zealand, and the pressures of managing and delivering improvement and asset renewals backlogs simultaneously.

It should be noted that the WICS modelling does not account for:

- Climate change
- Increasing standards beyond 2019 UK levels, even by 2050
- Maori expectations
- Seismic resilience

Officers' analysis

Given the peer reviews of the WICS modelling that have been undertaken by reputable and knowledgeable experts, officers accept the New Zealand level investment projections of $120B to

$185B and acknowledge that these forecasts may be conservative given the exclusions noted such as climate change, seismic resilience and iwi/Maori expectations.

15. Projected Whanganui investment levels

WICS estimated total capital investment for Whanganui over the next 30 years

The following table compares council's planned investments provided in our response to the government's Request for Information (RFI) completed over summer 2020/21 to WICS modelled proposed investments for Whanganui, as outlined in WICS modelling for Whanganui:

Capex type	WDC RFI submission $M/year	WICS modelling $M/year	WICS source
Growth	2.4	2.4	Based on WDC estimate provided in the RFI submission, extrapolated for 30 years
Renewals	2.7	11.2	Based on Whanganui's asset replacement cost per the RFI and the NZ average asset life per the RFI (capped at =/- 20% of Australian and GB asset lives) to calculate an annual depreciation estimate
Enhancement	2.7	35.0	Based on modelling the investment required in the UK/Scotland to ascertain the NZ level of investment required. Then apportioned to Councils based on population/density/area served.
TOTAL	**7.8**	**48.6***	

*Plus additional renewals (depreciation) for the newly created enhancement assets.

Renewals

WICS states that best practice in infrastructure management focuses on the careful and responsible stewardship of the assets under the control of the organisation before investing to expand or improve the service.

WICS view on renewals across the New Zealand local government three waters sector after assessing the RFI data is as follows:

- Capital renewals are consistently lower than depreciation (even when taking a longer term view)
- In addition, asset values are understated (unit rates provided for asset valuation are low compared with contractor rates for recent work undertaken)
- And further, asset lives are overestimated (too high compared to other countries with less challenging ground and seismic conditions)

The accumulation of these three issues suggests, in WICS view, a substantial accumulated infrastructure deficit.

Enhancements

WICS view is that significant investment is required across New Zealand to address improving water quality and the aquatic environment in line with Government expectations.

WICS state that New Zealand starts at a similar place to Scotland when it began its journey at best, based on the Ofwat Overall Performance Assessment score which takes into account things like inadequate water pressure, unplanned supply interruptions, water restrictions, water quality, sewerage leakage, sewer flooding incidents, customer service etc. The enhancement projections modelled by WICS take NZ to the same levels of service for water quality, aquatic environment and customer service by 2050 that the UK had in 2019.

National required enhancement investment

WICS developed four models for estimating the enhancement investment required for New Zealand:

1. UK comparative models – based on investment required in the UK from 1996 to 2020 to improve customer service, increase drinking water quality and the aquatic environment. Analysed relative to potential drivers of investment such as area served, surface to ground water, river length, length of coastline and population ($57B- $77B)
2. Scotland comparative models – similar approach to above ($77B - $100B)
3. Asset value approach – investment required in NZ to match UK asset value per connected citizen ($77B-$81B)
4. Council data (cross check with RFI) ($53B)

The models calculate the enhancement investment needed at total NZ level (excluding growth and renewals).

Council enhancement investment

The national enhancement investment has then been allocated to Councils based on averaging:

1) population density, and

2) the weighted average of population and area served.

Officers' analysis

In the allocation of the required national enhancement investment to council level there is no recognition of:

- The state of the assets individual councils currently have (condition and performance)
- Current level of compliance with standards e.g. drinking water
- Different water sources and stormwater and wastewater discharge environments (river/land/sea etc)
- Overdue or pending resource consent renewals
- Backlogs of work that require urgent attention

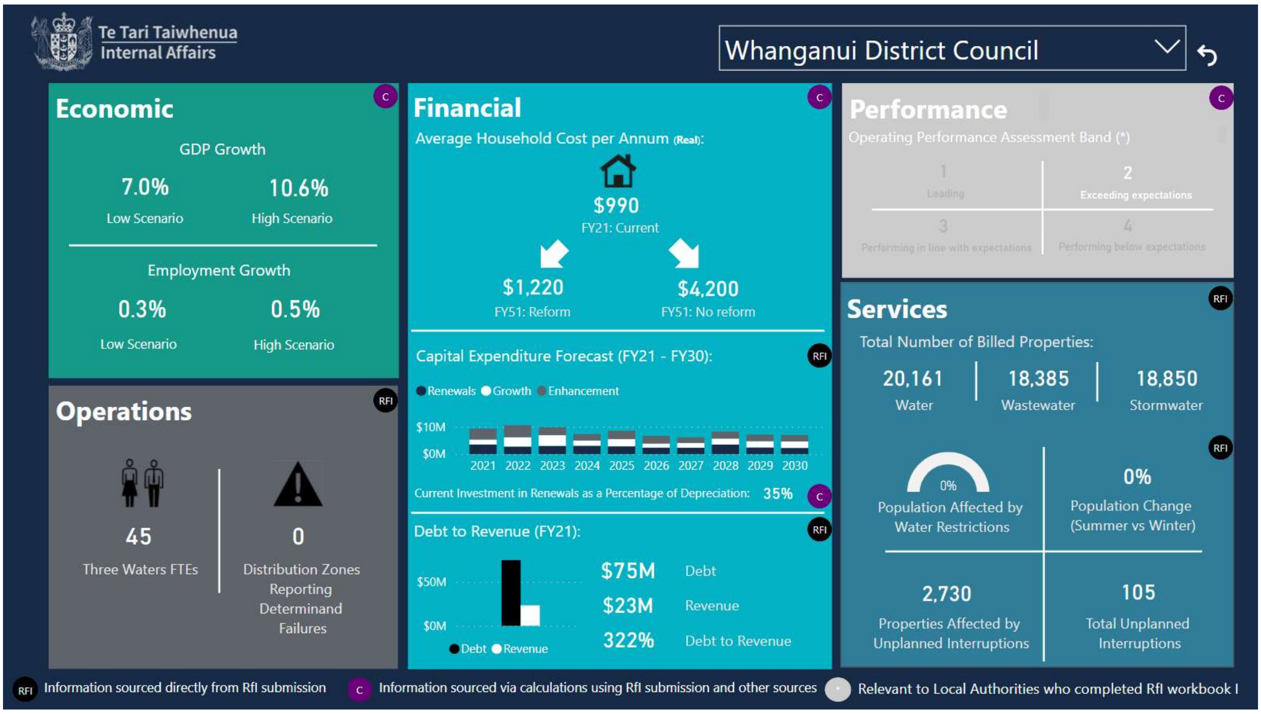
The council level capital enhancement investment forecasts are based solely on a model that only takes into account population, population density and area served, with no consideration of the three waters realities that apply to each council. This means the accuracy of the council level investment forecasts is questionable.

While we don't know where our enhancement investment requirements for Whanganui really lie in the new regulatory environment, what we do know is that in the medium to long term our enhancement investment requirements are likely to be significantly higher than we have allowed for in our Long Term Plan to meet the Government's expectations on water quality, environmental protection, customer service, climate change etc.

All else held constant, the larger the investment requirement, the larger the benefit from amalgamation.

16. Whanganui financial modelling by WICS

WICS modelling of Whanganui's three waters investment requirements has been used to populate the Whanganui District Council local dashboard. This is supported by a slide pack for Whanganui explaining the modelling assumptions and sensitivity analysis.



The forecast household costs for the reform and no reform scenarios presented by the government are as follows:

Current 2021 household cost per annum	$990
2051 no reform (WDC)	$4,200
2051 under reform (Entity B)	$1,220

The forecast 2051 household costs are based on the assumption that whether council or Entity B deliver the three waters services, they would need to deliver the significant investment programme modelled by WICS as outlined in the section above.

The key reasons for the vast differences in household costs between the reform and no reforms scenarios are:

1. Significant **efficiencies** assumed for the reform entities
   - The model assumes 56% efficiency in operating costs and 50% efficiency in capital costs are achieved by 2040 for Entity B, whereas it is assumed that council cannot

operate any more efficiently than it currently does due to its small scale. Efficiencies are discussed further in section 18 below.

2. Significant **debt leveraging** helping to keep prices low
    - The model assumes that Councils can only leverage debt at a maximum of 2.5 x waters revenue due to their borrowing limits, whereas the water services entities will be able to leverage debt at much higher levels (potentially up to 8 x revenue) due to their utility status. The 2.5 x waters revenue assumption for councils is not strictly accurate, because councils' debt limits are based on 2.5 x their total revenue, not just three waters revenue, and most councils (including ours) have higher debt on their three waters activities, offset by lower debt for other activities (e.g. regulatory or community activities that have little capital or debt), to achieve their overall debt limits.
    - That aside, the use of more debt has kept household prices lower for the reform option compared to the council option.
3. **Harmonisation** of household costs across the entity
    - The model works on harmonising pricing across the entity into one pricing scheme. This allows smoothing of those council areas with lower costs and those with higher costs to arrive at an average price.

WICS has undertaken sensitivity testing of the key modelling assumptions, and even with the worst case scenario modelled for every key assumption, the reform option remains cheaper than the no reform council standalone option.

<u>Officers' analysis</u>

There are a number of concerns around the council level modelling provided by WICS, the major one of which is the significant investment programme that is modelled for Whanganui but does not reflect the fact that our three waters assets are currently in good condition due the significant investment Whanganui has made in its three waters over the past twenty years. Both the reform and no reform options modelled by WICS are based on this somewhat unlikely investment programme.

While this does cast substantial concerns on the 2051 forecast household costs provided in Whanganui's dashboard, we have modelled a substantially lower capital investment programme and the reform option remains substantially cheaper than the council standalone option, primarily because of the efficiencies forecast and the increased leveraging of debt by the water services entities.

Officers expect that the water services entities will be able to reduce costs compared to a council standalone option because:

1. While in the short term Whanganui does not have any significant capital programme requirements, there will be increasing capital requirements in the medium to long term with the increasing regulatory environment.
2. All else held constant, the larger the capital investment requirement, the larger the benefit from amalgamation.

3. The water services entities will have stronger balance sheets and be able to leverage debt to a significantly higher degree than councils can, which will allow consumer prices to be lower.
4. It is likely that the water services entities will be able to achieve some degree of cost efficiencies through amalgamation due to their scale (discussed further in section 18).
5. The water services entities will have a larger customer base to spread and average costs over.

While we do not expect that the reform will reduce costs to consumers compared to current levels, we do expect that cost efficiencies, increased use of debt and price harmonisation will allow the water services entities to deliver the significant investment programmes proposed by the government at a lower cost to consumers than councils would be able to alone.

It should be noted that it is difficult for council to assess its own costs in 2051 from its own financial forecasts set out in its Long Term Plan 2021-2031 and Infrastructure Strategy 2021-2051 to compare to the dashboard. This is because alongside the reform the government has signalled a changing legislative and regulatory environment. There was (and still is) not enough knowledge of the impacts of these new requirements for these to have been forecast in these plans.

17. Community asset sales and three waters debt

The modelling undertaken by WICS assumes that the water services entity will take on each council's outstanding three waters debt. Whanganui has $81M of three waters debt as at 30 June 2021.

Council's three waters debt has been assisted over the past few years by the sale of two significant community assets, Energy Direct New Zealand (EDNZ) and our forestry holdings. Proceeds of the sale of these assets of around $20M was applied to three waters activities due to the cost pressures on the wastewater activity at the time with the construction of the wastewater treatment plant. Without the community asset sales being applied, council's three waters debt balance would be approximately $20M higher at around $101M.

Council is strongly advocating with DIA, LGNZ and the government for the $20M from the asset sales to be retained by the Whanganui community (see section 24 for council's questions and issues for the government).

18. Efficiencies and benefits of amalgamation

Efficiencies

WICS state there is potential to achieve efficiencies of around 50% on both operating and capital costs by 2040 through amalgamation. These efficiencies require a connected population of at least 600,000 to 800,000 per entity in order to be maximised.

Some examples of potential areas where efficiencies can be achieved are:

- Procurement - increased purchasing power through scale
- Increased use of automation and technology
- Effective asset management and monitoring of assets
- Optimising processes
- Standardisation
- Preventative maintenance
- Timely asset maintenance and refurbishment before problems arise, as this is more cost effective than responding to asset and service level failures
- Smart investments in capital equipment to reduce operating costs

It is assumed 60% of the efficiency gap will be closed in the first 5 years (by 2030), 60% of the remaining gap in the next 5 years (by 2035) and the full efficiency gap closed within the next 5 years (by 2040).

International evidence suggests that amalgamation does realise cost efficiencies when incorporated with other aspects of reform such as governance and regulatory reform, including economic regulation regimes which are used to oversee prices and service levels. The Frontier Economics report Review of Experience with Aggregation in the Water Sector states:

In summary, the evidence suggests that aggregation does not reduce total pre-aggregation costs, at least in the short term, but this is an inevitable consequence of improving standards of services and environmental outcomes. A significant driver of reforms in a number of jurisdictions was to facilitate significant catch-up investment in infrastructure. In many cases, the required investment was very large.

This does not mean that reforms of the kind pursued were costly and therefore not worth undertaking. Arguably, the significant investments undertaken as part of the reforms were necessary to restore or raise service standards, and the reforms were a means of delivering that required investment. In this regard the often-significant increases in costs following aggregation do not reflect a failure of the structural changes to the urban water sector in these jurisdictions but, rather, an inevitable consequence of improving the standards of services and environmental outcomes which were not previously being achieved.

There is also some evidence that there is typically a short-term increase in operating costs following mergers or aggregations due to the need to incur administrative and legal costs to establish the new entity, invest in new systems, pay out redundancies, etc. The magnitude of these costs can vary significantly depending on the nature and scale of the aggregation.

A key question however is whether the aggregation and related reforms have led to the provision of water and sewerage services more efficiently than they would have been provided in the absence of these reforms – i.e. whether the underlying efficiency of service provision has improved.

There is strong and consistent evidence that the structural and related reforms implemented in the jurisdictions examined in this review have led to significant improvements in productivity and efficiency.

The establishment of new entities in the jurisdictions included in this study clearly led to major transformation in the management of these businesses and the adoption of new systems and processes. It is difficult to conceive that the improved strategic management observed in these examples could have been delivered under the previous industry structures.

Scottish Water achieved a 50% reduction in its base costs in just 8 years (and improved levels of service). WICS state:

Experience suggests that the modelling does provide an accurate mirror and reflects current performance, Scottish Water has reduced its real terms operating costs by over 50% since 2002 (and improved levels of service)

Farrierswier, the peer reviewers, agree that there is significant potential to improve operating and capital efficiency in New Zealand, but they have identified some concerns about whether the same level of efficiencies can be achieved in New Zealand as in Scotland for a number of reasons, including:

- Location and small population

- Lack of international connection and scale
- Weak competitive pressures
- Skills constraints and mismatches
- Low rates of capital investment and research and development activity
- High construction costs in New Zealand

An early report by Castalia, commissioned by LGNZ, identified some concerns regarding the economies of scale that could be achieved through amalgamation. It should be noted that this report was focussed on economies of scale, rather than efficiencies, i.e. adding currently non-connected users into water networks or joining networks together, rather than the cost saving efficiencies that the government and WICS are proposing. Castalia's report was also focussed on amalgamation alone, rather than the broader package of reform including governance and regulatory change that is now proposed.

Castalia did believe benefits could be achieved through amalgamation via management and specialist services, procurement and standardisation of plant and equipment. They stated that larger entities tend to have greater market power to obtain volume discounts from service providers which results in average costs of goods and services reducing.

Other benefits

Some of the other benefits of amalgamation put forward by the government include:

- Greater borrowing capability and improved access to capital markets
- Strengthened governance and workforce capabilities
- Procurement efficiencies
- Smarter asset management and strategic planning/investment
- A more predictable pipeline of investment
- Strengthened ability to benchmark performance

These benefits are not available under current arrangements e.g. even Watercare suffers financing challenges while it is tied to Auckland Council's borrowing constraints.

No efficiency is assumed possible for the Whanganui District Council no reform option due to our lack of scale (i.e. it is assumed we are already as efficient as we can be for our size).

Officers' analysis

International evidence suggests that amalgamation combined with governance and regulatory reform can lead to substantial cost efficiencies. The water services entities will have significant purchasing power in the market place due to their substantial scale, and the significant pipeline of investment in three waters assets is likely to shape the market. Consultants we have spoken to have noted that the entities will be able to leverage IT systems and technologies that are not currently available in New Zealand due to the lack of scale of the current providers, such as satellite leak detection. They believe that while some councils, including ours, are operating very well given their current scale, there is an entirely new level of technology available that is not yet in use in New Zealand due to lack of scale and financial capacity of the current water providers.

While there are some concerns around cost efficiencies of 50% being achieved by 2040 in a New Zealand setting, the entities will certainly have the scale to achieve some degree of efficiencies that councils would not have access to.

19. Proposed charging to customers

There are no details on the proposed charging regimes to be employed by the water services entities, other than the comment that they will be able to use similar mechanisms to those that councils already employ, such as fixed and volumetric charging.

Charging will be harmonised across the water services entity. This means there will be price averaging which will result in cross subsidisation between council jurisdictions. This is a necessary and intentional part of the government's reform design, to ensure that all communities have access to good quality three waters services at an affordable price.

The water services entities will be required to be transparent in how they set their prices, and will be required to engage with their communities on proposed prices and charges. The economic regulation regime will also set maximum prices or revenue to avoid excessive/monopoly pricing.

It has been indicated that consumers will be charged on a similar basis to their existing arrangements, at least for the early years of the entities operation, and that initially Councils may be required to collect revenue on the water services entities' behalf.

<u>Officers' analysis</u>

Price harmonisation and cross subsidisation across water services entity areas is a key feature of the amalgamation. The larger amalgamated entities will enable average pricing across a much broader population and connection base which will help smooth the impact on households and businesses in individual areas, particularly when significant investment is required.

It is difficult to assess whether this is a benefit or risk for Whanganui. We are advised that Whanganui's three water rates are currently close to, or slightly below, the average three waters rates for the jurisdictions that make up Entity B. It is unlikely that prices to Whanganui customers will reduce under amalgamation, given the significant investment required across the country. However it is important to note that if Whanganui opted out of the reforms that rates would still need to increase in the medium to long term, above that indicated in the Long Term Plan, to fund the additional capital investments that will be required under new regulation. As a single council it is unlikely that we can achieve cost efficiencies in the same way as the much larger water services entities can. Additionally our borrowing would be restricted due to debt limits, which may force rates up to pay for the required capital programmes.

It is possible that in the short term Whanganui may subsidise other councils' infrastructure issues, however in the medium to long term there will be investment required in Whanganui. When comparing ourselves to other councils, we need to be mindful that we are looking at a snapshot of a moment in time for assets that have very long lifecycles.

Those councils that have not yet undertaken some of the projects that Whanganui has, such as stormwater separation and wastewater treatment plant upgrades, may require investment in the short term. But it is important to note that Whanganui will be transferring its three waters debt to the water services entity, whereas those councils who have not yet undertaken these types of projects should be transferring relatively lower amounts of debt to the entities, in addition to potential reserves they have collected.

The water services entities will be able to use volumetric charging, like water metering, however we would need to wait for consultation on the entity's proposed pricing plan before knowing whether this will be employed. Volumetric charging for water is already used in a number of councils, including Auckland (Watercare).

Whanganui's stormwater activity is currently funded by a capital value based rate, rather than a fixed or volumetric charge. It is unlikely that this approach will continue under the water services entities, as there has been no mention of the entities having the ability to rate.

The impact on charging for businesses and trade waste customers is unknown. We have asked for further information on this in our questions to LGNZ on 3 September 2021 (see section 24).

20. Proposed economic regulation

The government has confirmed that economic regulation will be a key feature of the reformed three waters sector. Further information on economic regulation is available in MBIE's paper What is economic regulation?

Economic regulation is used where natural monopolies occur to drive good long term outcomes for customers. In New Zealand, economic regulation is in place for airports, electricity, gas and telecommunications sectors.

The purpose of economic regulation for three waters is to ensure that there is a good quality service to the consumer, the right level of investment, and to drive efficiency gains. This includes a requirement to meet depreciation, protection against inefficiencies and the removal of opportunities for monopoly/excessive pricing. It will also require transparency around the costs and performance of the three waters services and infrastructure and strengthen accountability for performance.

The economic regulation is proposed to include:

- **Price/quality regulation** – puts a cap on maximum price or revenue alongside minimum service quality requirements (in addition to the requirements of Taumata Arowai). This will ensure the entities are operating efficiently, performing effectively and charging a fair price to consumers.
- **Information disclosure** – requires the provision of information to allow interested parties to compare and benchmark performance. The vast amount of information that Council provided to WICS for the three waters RFI process is similar to the type of information that would need to be provided periodically to the regulator under an economic regulation regime. These would be similar to those currently used on other sectors such as telecommunications, gas and electricity.
- **Regulator** – the appointment of a credible and independent economic regulator to administer the regime e.g. The Commerce Commission.

Economic regulation regimes generally have significant powers to ensure behaviour is as desired e.g. penalties for non-compliance.

MBIE have advised that they cannot confirm what the economic regulation regime will look like at this time; they expect to publish a discussion paper in late 2021 which will cover:

- The design of an appropriate dispute resolution process;
- The establishment of a consumer advocacy council (or the extension of an existing body) to provide expert advocacy on behalf of consumers;
- Options to protect consumers who are vulnerable due to their age, health, disability, or financial position;
- An ability for a regulator to mandate service quality codes;
- The process for setting prices, including requirements for pricing transparency.

Consultation with the sector and the public on the proposed economic regulation regime is likely to be held in early 2022.

Officers' analysis

The economic regulation regime will require water services entities to be very transparent about their pricing, the state of their assets, asset quality and reliability metrics, capital investment etc. We are advised that it is very likely that economic regulation will require the water services entities to renew their assets at around the rate of depreciation over the long term to ensure that the assets are being maintained appropriately, risks to service levels minimised and intergenerational equity funding considerations adhered to (i.e. the people who "consume" a portion of the asset's life pay appropriately for it). This will result in an increase to our currently planned three waters investments.

The government have stated that even if councils opt out of the reform, they would still be required to meet the requirements of the economic regulation regime. One of the key reasons the government is proposing reform is the concern that councils are underinvesting in their assets and the risk this presents. The economic regulation regime is a key part of the three waters reform proposal, along with amalgamation. It will shine a spotlight on how the entities/councils are looking after their assets, ensure appropriate service quality and pricing, and drive efficiencies.

Achieving the cost efficiencies desired by the government whilst meeting the investment requirements would be a significant challenge for council if it opted out of the reform due to lack of scale and lack of borrowing capacity.

21. The funding incentive package

At the LGNZ conference in Blenheim in July 2021, the Government announced a local government funding package to sit alongside the three waters reforms. There are two components to the package:

- $2 billion of funding to invest in the future of local government and community wellbeing, while also meeting priorities for government investment (the "better off" component).
    - Funded via $1B from the new water services entities and $1B from the Crown.
- $500 million to ensure that no local authority is financially worse off as a direct result of the reform (the "no worse off" component).
    - $0.5B fully funded by the water services entities.

These funds are in addition to the $296M previously committed through the 2021 Budget Package for transition and implementation activities.

Further information can be found in the DIA's Three Waters Reform Programme - Support package document.

What does the funding provide for?

The better off component ($2B) has been allocated to territorial authorities on the basis of a formula taking into account population, relative deprivation and land area. Territorial authorities are able to use this funding to support the delivery of local well-being outcomes associated with climate change and resilience, housing and local place-making.

Whanganui District Council's share of the better off component of the support package is **$24M**.

Territorial authorities will be required to demonstrate that the use of this funding supports the three waters service delivery reform objectives and other local wellbeing outcomes and aligns with the priorities of central and local government, through meeting some or all of the following criteria:

- supporting communities to transition to a sustainable and low-emissions economy, including by building resilience to climate change and natural hazards;
- delivery of infrastructure and/or services that:
    - enable housing development and growth, with a focus on brownfield and infill development opportunities where those are available,
    - support local place-making and improvements in community well-being.

The no worse off component of the package ($500M) is to ensure that no territorial authority is in a materially worse position financially to continue to provide services to its community as a direct result of the reform. Up to $250M of the $500M will support councils to meet the unavoidable costs of stranded overheads. The remainder will be used to address adverse impacts on the financial sustainability of territorial authorities e.g. for those who have low water debt to revenue and high non-water debt to revenue (to be established through undertaking a due diligence process).

The $296M previously committed through the 2021 Budget Package is for costs associated with the transfer of assets, liabilities and revenue to the water services entities, including staff involvement in working with the establishment entities and transition unit, and provision for reasonable legal, accounting and audit costs.

Will we still get the $24M if we opt out or the reforms don’t go ahead?

It appears unlikely that the funding will be available if we opt out or the reforms do not go ahead. See the quote from the FAQs on the support package below:

Is this funding contingent on reforms going ahead?

The Government’s support package provides certainty for local authorities that, should the reforms proceed, they will be supported through the transition process, the financial impacts of reform will be managed and importantly, all councils and communities would transition to the new system for delivering three waters services in a better position than where they are now.

Territorial authorities should consider the support package alongside the case for change the Government has presented, and the substantial amount of evidence and data that has been released, which shows that reform will deliver significant benefits both nationally and locally. The Government is confident that as elected members, iwi/Māori, and council officers consider the reform proposals and support package, they will understand the compelling need for reform to improve health, environmental and affordability outcomes for local communities and we can move forward with greater confidence.

When will the funding be made available?

$500M of the better off funding of $2B will be available from 1 July 2022, with the remaining $1.5B available from 1 July 2024 when the new water service entities are established.

The no worse off funding will be met at or after the transfers occur to the water services entities (i.e. 1 July 2024 or after).

Officers’ analysis

It would appear that the $24M will only be paid to Councils if the reforms go ahead and we participate in them. It also appears it will need to be spent on projects that meet the Government criteria outlined above and cannot be used to repay debt. It is possible that some projects currently outlined in our LTP e.g. the Davis Library extension, solar initiatives, housing, and youth places and spaces could meet the criteria for the better off funding and we could therefore use the $24M to fund these projects rather than using debt as we had planned, dependent on timing of the projects and funds availability.

It is notable that $1.5B of the $2.5B funding package is being funded by the water services entities themselves. Effectively the $1.5B will be paid for by three waters users via the water services entity's charges in order to pass the funding across to councils.

22. Impact on staff

The government have advised that all council employees who primarily work on three waters services will be guaranteed a role in the new water services entities. These roles will retain the key features of their current role in council, as well as salary, working location, leave provisions and hours and days of work. We are advised that roles such as senior executives and contractors will be assessed further by the reform transition team if the reforms proceed.

One of the government's stated benefits of the reform is that the larger scale of the water services entities will provide significant opportunities for the three waters workforce, in terms of attracting, developing and retaining talent, and through increased career pathways and opportunities.

23. The future of local government

The government has a number of large scale reforms underway that considerably affect the future of local government, such as The Future for Local Government review and significant changes to the Resource Management Act, as well as the Three Waters Reform.

The government has signalled that it is committed to working together with local government to ensure that local government is appropriate for the community's changing expectations now and into the future. The Central-Local Government Joint Position Statement on the Three Waters Reform states:

We are very aware that how we work together now sets the tone for other large-scale reform affecting the sector, especially the Future for Local Government review.

This review is a real opportunity for New Zealand to re-imagine the roles, responsibilities and resources of councils so that they can meet communities' expectations now and in the future. These expectations have evolved massively since the introduction of the current Local Government Act over 30 years ago. It's time for a genuine re-think about what's needed for local government to respond to communities' changing needs.

For this review to succeed, we need to be partners. Our three waters relationship has allowed robust, open discussions – and opened the door to a fundamental reset between our two tiers of government. Both central and local government are committed to a new way of working together, in tune with our diverse communities and our treaty partnership.

<u>Officers' analysis</u>

Local government is undergoing a period of significant transformation and change. Council will need to be forward thinking and agile to adapt to the changes that present themselves and maximise and leverage opportunities to provide our community the services it values now and into the future.

24. Key concerns and questions on the government proposal

Over the first month of the engagement period, council officers and elected members have considered their key concerns and questions on the proposal to put to the government via LGNZ, as requested. A number of council's key questions have been considered in the papers that have been released by the DIA in late August 2021, covering essential facts on the reform, community voice, governance, planning interface and rural schemes (attached as References 1 to 5). However there remain a number of issues that council would like further addressed by the government. Council's feedback provided to LGNZ on 3 September 2021 is as follows:

1. Whanganui fully supports the issue that has already been raised, i.e. that councils' plans for growth, as reflected in spatial plans, district plans or LTPs, are appropriately integrated with water services planning.

2. Whanganui also supports the position of many councils that these reforms, which are the most significant in the past thirty years, are progressing too fast to enable all stakeholders to fully engage in the process and understand the impact on local communities. The three water reforms are happening alongside other major reforms, such as the Future of Local Government and the Resource Management Act. It seems more appropriate to work through the Future of Local Government, and then in that context, to consider the impact of three water reforms.

3. If the reforms remain voluntary for local authorities there will need to be sufficient time for councils to fully engage and consult with their communities. The public advertising being undertaken by central government is woefully inadequate to meet any form of local community engagement and consultation.

Financial modelling

4. Whanganui accepts the case for the need for reform at a national level and that the amount of investment that is needed at a macro level. The issue for Whanganui (and many councils) is that the macro model has been applied at a micro level, i.e. based on population and density as opposed to actual requirements of individual councils based on asset condition etc. The model for Whanganui has a yearly enhancement amount of $35M, which we have difficulty accepting given the significant investment Whanganui has made in its three water networks over the past 20 years. In addition this amount suggests that Whanganui will, at least in the short to medium term, be subsidising those Councils that have not invested in their three waters.

5. Further to Q.4 – during this eight week period councils are being asked to fully understand the proposal and how it affects them and their communities. The difficulty we have in understanding the future impact for Whanganui is that there has been no detailed information released on what the new regulations for all three waters, including those of an economic regulator, looks like. The WICS financial numbers showing costs to ratepayers for those councils that opt out of the reforms are difficult to understand in absence of this critical information.

Equity

6. There needs to be some equity between those Councils that have been diligent and invested in their water assets to those that have not. Whanganui has sold community assets to pay for the significant investment it has made in its water networks, whereas some of our neighbours have underinvested in their water networks. How is this going to be recognised in the transfer of assets?

Stormwater

7. Most of the material that is available from DIA on the assessment of the investment that is needed in NZ ($120-$185B) has been around potable and wastewater. We also understand WICS is involved in only these two waters and not stormwater. The questions we have on stormwater are:

   - Approximately what portion of the estimated $120 - $185B relates to stormwater and how was this quantum determined?
   - What mechanisms will there be for communities to influence stormwater policies of the entities and regulators?
   - Is there an overall goal to have all New Zealand conform to one universal standard (LOS is part of this and noting that both potable and wastewater will have to meet national standards). This question seeks an answer to whether, or not, the entities will eventually all have to discharge stormwater to a single prescribed standard or will they even have to meet a single standard within their entity?
   - Councils may use road reserve, recreational and undeveloped land as storm event flooding/bund areas and/or develop as Wetlands to attenuate storm water flows. What incentives and funding will be provided to incentivise Councils to continue this (ecologically and economically sound) approach rather than utilising Council assets solely to deliver purely recreational amenity or fiscal return to our communities?
   - In relation to the above, what social/wellbeing outcomes may Councils expect/require of water entities in delivering their services?

Commercial businesses

8. For a community such as Whanganui, our large businesses, including our trade waste businesses are a vital part of our economy. We have worked hard with these businesses, including offering competitive rates, to ensure they remain in Whanganui. We do not want to lose these businesses due to a new water entity not appreciating the importance of them and charging non-competitive prices. Currently there is little information on the impact and proposed charges for businesses and trade waste customers in the reforms. Questions we have in relation to this are:

   - What certainty and protection is proposed to ensure these businesses are not disadvantaged by the reforms?
   - Will there be any mechanism to prevent the Water Entities from trying to attract larger users of three waters away from one Entity to another. i.e. poaching?
   - Whanganui uses a marginal cost approach to charging our major trade waste businesses for waste water services. Will these locally agreed charging methodologies be continued by the new Water Entities?

Development contributions

9. We have just updated our Development Contributions policy with a number of three water growth projects to be funded via DC's over the next 10 years. This means for sections developed in the next 3 years DC's will be charged by Council, however there could be

some inequities for sections developed after 1 July 2024 as Council will presumably no longer be charging DC's for these.

- Will the new entities charge Development Contributions or something similar?
- Should councils continue to charge DC's for three water projects for the next 3 years?
- Will the new entities take over the legal responsibilities to deliver on projects that DC's have been charged for?

Governance

10. Within Entity B there are 22 Councils. These Councils will appoint 6 representatives to the Regional Representative Group. There is no mention of how this process will work.

    - How will this process work?
    - How will Whanganui ensure it has a local voice within this group?

11. In the same manner as above, what is the process for the appointment of the remaining 6 representatives appointed by mana whenua?

12. What is the process or mechanism for removing group appointments where it is perceived the Regional Representative Group is not functioning properly?

As council engages with its community throughout September 2021, further issues may be identified. These will be coordinated for a final response to LGNZ and the government by 30 September 2021.

25. Frequently asked questions

What if some key players (e.g. Auckland) opt out of the reform?

We believe that the reform will be made mandatory if signs are that key players will opt out. The reform is based on connected populations of 600,000 to 800,000+ per entity to maximise efficiencies and benefits. The government's messaging is becoming increasingly strong around the fact that all-in participation is required to manifest the stated benefits of the reform. The government are likely to make a decision on this following the eight week engagement period.

How accurate is the council level dashboard and modelling of future costs?

The dashboard figures for each council are based on a modelled allocation of the national $120B to $185B and do not take account of the state of assets from one community to another. Therefore while the national level investment has been peer reviewed and confirmed as reasonable, the council level modelling is based on translating a macro model to a micro level and does not necessarily appropriately reflect the realities of each council's three waters situation.

The WICS forecast of $35M/year of enhancement capital alone for Whanganui is substantial and likely unachievable. The likely level of enhancements sits somewhere in between our current $2.7M/year and the $35M/year modelled by WICS.

We have tested the model with a $2M/year capital enhancements programme instead of $35M – even with this smaller capital enhancement, the model still suggests it would be cheaper for Whanganui if it remains in the reforms.

The higher the level of investment required, the larger the benefit of amalgamation.

What about stranded overheads?

The three waters activities currently contribute $1.9M per annum toward council's overhead costs. While some savings in overheads may be able to be made if three waters were no longer provided by council, there would be a considerable portion of these overheads that would remain and need to be funded by other council activities.

The $2.5B local government funding package includes $250M of no worse off funding targeted at stranded overheads (nationally) which council would be able to put a claim in for.

How can we retain the value of the community asset sales that have been offset against three waters debt?

We will need to politically lobby to retain these funds for our community. We have raised this issue with the DIA and will also raise it through LGNZ and Taituara and any other avenues that can be identified.

It is possible that the debt balance to transfer to the water services entities may be able to be adjusted upward for the community asset value, or funding could come from the no worse off funding package.

Will our community have to "prop up" other communities with larger issues than we have?

Charging will eventually be harmonised across the water services entity areas, so there will be cross subsidisation between council jurisdictions. This is a necessary and intentional part of the reform design, to ensure that all communities have access to good quality three waters services at an affordable price wherever they are located in the country.

It should be noted that Council's view of the state of our assets compared to others is relative at a point in time. Bearing in mind that the water services entities will be taking on council's three waters debt as well as its assets, those communities who have not yet done their work will have relatively less debt to transfer to the water services entity than councils such as ours have.

DIA have noted that the infrastructure is not being "bought" by the new entities. Local authorities retain ownership of the assets via the water services entity.

The government's proposal is being made around "NZ Inc". As a council we want to make sure benefits for our local community are maximised.

How do we ensure local input to the entity's decision making process to advocate for our district?

There are a number of mechanisms outlined by the government (see References 1 to 3). The water services entities will have consultation requirements, plus there will be a consumer forum, economic regulation and charging and pricing frameworks. Entities will produce a Statement of Intent to meet the regional representative group's strategic and performance expectations. There will be a competency based board. Service levels will be set by the regulatory regime. Councils retain an advocacy role on behalf of communities as owners of the water services entities.

What is the impact on our ability to borrow for other capital projects if we lose the three waters?

Council's borrowing capacity will not be affected by the potential loss of the three waters, as we have higher levels of debt on the three waters assets than we do on our non-three waters assets. The loss of three waters therefore does not negatively impact our borrowing capacity for the remainder of our operations.

What impact does the lack of modelling done on stormwater have, as overseas comparatives are generally water and wastewater only?

It is difficult to know what impact this might have on assumptions and outputs. We have asked for further information on how stormwater has been considered in our questions to LGNZ on 3 September 2021 and await a response.

What will the charges be under the reform?

Charging regimes and proposed prices for the water services entities are not yet known. The water services entities have a requirement to consult with their communities on their pricing plans, and will also be subject to economic regulation to ensure appropriate pricing and service standards. The government have stated that existing charging regimes may need to remain in place for the first few years of the entities' operation. This will depend on the progress of the transition.

It is unlikely that costs will decrease compared to what ratepayers are currently paying as there is a significant investment programme to fund to meet the increased standards. That said, the efficiencies, debt leveraging abilities and connection base of the water services entities means it is likely that they can deliver the required investment programme at a cheaper cost than council can as a standalone three water provider.

Will our water be metered?

There is no indication yet as to whether water will be metered. Each water services entity will need to come up with its own proposed pricing structure and consult on this with its community.

WHANGANUI DISTRICT COUNCIL STANDALONE

26. What would happen if we opted out?

If opting out was an available and viable option, the council would need to increase its levels of service to meet the standards set by the new regulator Taumata Arowai and any requirements of the new economic regulation regime as and when these occur. It is difficult to forecast costs associated with these aspects as there is not enough clarity at this point in time for council to be able to forecast the required investments.

There is a risk in the medium to long term that these costs could be quite significant. We may not have the capacity to afford this investment without significant rates increases as we do not have the borrowing capacity that the water services entities will have as utility providers. It may also mean we have to trade off undertaking other projects for our community in order to afford the three waters investment required. The government have stated that affordability will not be an excuse to avoid meeting the requirements.

We also need to be aware of potential difficulties in recruiting and retaining staff and sourcing contractors to undertake work for us when competing against the four very large water services entities in the market place.

Whanganui District Council's share of the better off funding package of $24M is only available if we proceed with the reform.

A full risk assessment of the options will be undertaken when the government has finalised the reform proposition following the eight week engagement period, if councils and communities retain the right to choose whether they opt in or opt out.

27. Next steps

Council officers and elected members need to stay fully informed of any further public information releases by the government, DIA, LGNZ and Taituara and take advantage of the engagement opportunities on the three waters reform such as the webinars run by LGNZ and the DIA which are covering areas of concern and adding detail and context to our understanding.

Council will engage with its community online and in print media throughout September 2021 with the aim of keeping the community informed and to identify any further issues the community would like raised with the government via LGNZ by 30 September 2021.

Council has recently begun working with Tūhura and Partners and Taituarā to undertake an impact assessment looking at the pros and cons of joining the new water services entities. This work is being funded by the DIA, and uses a balanced scorecard approach looking at the various factors driving the impact of the reform:

- Service
- Finance and funding
- Workforce, delivery and capability
- Social, community and well-being

The results of this work will be brought to a council workshop to assist council's future decision making.

The Chief Executive will report back further once council has received further information and guidance from the government [DIA, LGNZ and Taituarā] on what the next steps look like and how these should be managed.