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Wai + T Water Restructuring Evaluation Criteria Review

11 October 2024

Executive Summary

The Wairarapa (Masterton District, Carterton District, and South Wairarapa District Councils) and Taraua District Council (together Wai + T) are considering their options to jointly deliver water, wastewater, and stormwater services. This follows the Government passing the Local Government (Water Services Preliminary Arrangements) Act 2024 and policy announcements regarding the future legislative settings. There are several options for water services delivery being considered, including, a 10-council option, councils delivering water services on a stand-alone basis, and a Wai + T option.

The team advising Wai + T council executives has created evaluation criteria to evaluate the options for restructuring. It has asked Castalia to review these evaluation criteria using local and international best practice.

In this report, we address whether Wai + T's evaluation criteria are robust and how they can be improved.

Wai + T are following a robust policy process

When considering important decisions like how to improve water service delivery, councils should follow a standard policy process. A standard policy process should state the objective the councils are trying to achieve, develop a theory of change around the outcome sought, establish criteria to evaluate the options, and involve stakeholders to develop a consensus on the option best suited to the council's needs and objectives. It is good to see that the Wai + T team has adopted this approach for its initial stages (before stakeholders in the community are consulted). Wai + T's process should support robust decisions.

Wai + T's evaluation criteria support sound decision-making...

Taken in totality, the Wai + T criteria provide council decision-makers with a robust framework for assessing restructuring options. Applying the Wai + T criteria will enable councils to understand the pros and cons of different options and reach a sound decision.

We typically use six high-level criteria because these break down the key parameters for success distinctly from one another. Our criteria have been developed during major water sector reforms in several countries, and have been adopted by the New Zealand Government during the Local Water Done Well policy development process. The six Castalia-recommended criteria are:

- Maximising available economies of scale and scope
- Improving access to financing
- Lifting management and operational capability
- Flexibility to future change
- Improving incentive alignment
- Ensuring accountability to owners/customers and stakeholders.

These six criteria enable decision-makers to understand how each criterion affects the outcomes sought. There is significant alignment between Wai + T's criteria and how Castalia would evaluate reform options. Castalia's criteria differ somewhat, but overall cover the same matters.

... but we suggest some improvements for the next stage

Wai + T's criteria have some overlap with one other. Because of this overlap and some repetition, they may over-weight some factors over others.

We understand that Wai + T councils will consider more detailed design options for water restructuring/reform in the next stage. We recommend you make some minor changes to your evaluation criteria in this next stage to address the small degree of overlap and repetition we identify. This will ensure that the criteria are weighted appropriately and consider all factors for delivering safe, resilient, customer-responsive water services at least cost.

We recommend that Wai + T align its evaluation criteria with Castalia's approach across several areas. These are set out in detail in section 5 of the report:

- Financial: Split the criteria into access to financing and economies of scope and scale as this will provide appropriate weighting for each factor
- Level of service: When assessing how levels of service will change, separate out separate the alignment of governance and management's incentives from how management and operational capabilities will lift.
- Operational: Take care including economies of scope and scale here because size does not necessarily lead to improved operations
- Relationship and trust: Consider how accountability to owners, customers and stakeholders can be incorporated
- Strategic: Consider assessing accountability to customers and owners separately from how the entity option is flexible to future change.

1 Introduction

This report is structured as follows:

- We present Wai + T's evaluation criteria (section 2)
- We outline Castalia's recommended parameters for Local Water Done Well options analysis (section 3)
- We evaluate Wai + T's criteria against Castalia's recommended approach (section 4)

- Finally, we conclude and provide some recommendations for your next steps (section 5).

2 The Wai + T evaluation criteria

According to Wai + T's preliminary results, joint delivery will lead to some financial benefits, and the Wai + T option will improve relationships and trust. Still, the Wairarapa-only option is ranked highest.

While Wai + T has a theory of change, it is often not obvious which institutions will produce which outcomes, creating a risk of faulty reasoning. Therefore, it is helpful that Wai + T has developed criteria to evaluate the options available on a consistent basis. This will help Wai + T to reach a robust conclusion on the best option for regional water services.

The Wai + T project team has developed evaluation criteria with six key parameters: financial, level of service, operational, relationship and trust, strategic, and legislative. Each parameter includes weighted evaluation criteria to be scored out of 100.

Financial

This parameter includes criteria that will impact consumer affordability. It includes nine evaluation criteria: average price adjustments on day one, in the medium term, and in the long term, free funds from operations, borrowing capacity, whether the model reflects reasonable efficiency, establishment cost, transition cost, and the complexity and time of transition.

Level of service

This parameter includes criteria that evaluate customers' experience. It addresses the delivery entity's responsiveness to faults, funds for major disasters, increased delivery service for customers, ability to cater to growth, agility to adapt and improve, and responsiveness to emergencies.

Operational

The operational parameter evaluates the efficiencies and opportunities for districts. The operational parameter evaluates 11 criteria, including the procurement of resource availability, buying power, broader economies outcomes, attraction and retention of staff, managing risks of critical roles, spatiality logical, network similarity and connectivity, operational efficiency, values and culture, stakeholder relationship cost, and systems complexity and scale.

Relationships and trust

Ease to set the right values and culture to drive performance in the organisation and align with the Māori view. The relationship and trust parameter includes six criteria developed by Iwi and two criteria relating to the delivery entity's economic benefit to the community and the delivery entity's accountability and performance monitoring.

Strategic

This parameter will evaluate the achievement of the district's strategic goals. The strategic criteria evaluate the influence of strategic direction, transparency and clarity, alignment with other regional initiatives, and future optionality.

Legislative

The legislative criteria evaluate whether the proposed arrangement supports achieving the criteria required in any Water Service Delivery Plan (WSDP) to be accepted by the Minister.

3 Important parameters for Local Water Done Well

Castalia has advised the Government on implementing Local Water Done Well. Mr. Andreas Heuser was the chair of the technical advisory group. We have also advised Local Government New Zealand (LGNZ) on important parameters for evaluating reform options. Castalia has developed six parameters of our own to assess water reform options. We have provided these to DIA, and they are informed by local and international reform experience.

Figure 3.1: Castalia's six parameters for safe, resilient, customer-responsive water services at least cost



3.1 Maximising available economies of scale and scope

Economies of scale and scope can provide benefits in the delivery of water services. However, it is important to assess the specific facts of the reform and if the actual economies being generated (if any) are from the reform interventions.

When a firm's scale of production leads to lower average costs, there are economies of scale. The relevant output for assessing the existence of economies of scale in a structural reform is the number of connections: Does an increase in the number of connections lower the average cost of provision? As the number of connections increases, there may be savings in operating costs (for example, corporate head office services) on a per-customer basis. However, this is likely to be a small proportion of the total cost per customer.

Economies of scope are proportionate cost savings from producing two or more distinct goods. In water services this could be a cost saving from one service provider delivering both the clean drinking water and wastewater services. Economies of scope in water services are more often assumed than empirically verified. Economies of scope also exist between water services and other municipal services. This can be true for both small and large entities.

3.2 Improving access to financing

Water providers require access to the lowest risk-adjusted cost finance available on terms that align with their capital and operating cost needs. The market sets the cost of finance and reflects the market's assessment of the provider's ability to earn revenues to repay its lenders.

Water services involve high-cost assets with long lives and lumpy investments. Financing instruments like bonds need to reflect a long-term investment horizon. The water services of many councils in New Zealand are constrained in accessing finance due to the overall indebtedness levels of the council's consolidated balance sheet and caps imposed by credit rating agencies that, if breached, would increase the cost of debt. Castalia's access to financing parameter assesses reform options for the extent to which water service providers can access finance that reflects the riskiness and revenues of the water business and its projects alone.

3.3 Lifting management and operational capability

Capable and sophisticated management and operations occur when management meets organisational objectives, uses available resources efficiently, maintains high levels of employee performance and professionalism, and provides excellent service to customers. This is essential to safe, resilient, reliable water services at least cost.

Management and operational competence involve basic safety matters, such as ensuring filters are changed or chlorine drips discharge at the correct rate. Competence can be correlated to scale, competition between water services, outsourcing, regulatory enforcement, and profit incentives. The delivery entity should be evaluated according to the likelihood and extent to which the competence of management and operations is improved. There are several ways to achieve this, not all of which necessarily follow from increased size.

3.4 Flexibility to future change

Flexibility and adaptability to change following new information are desirable in water service providers. While water services are generally long-lived and high capital-cost businesses, technology, customer preferences, and society's expectations can change. For example, growth or decline can change investment needs. Society's environmental expectations can change, such as changes in historical attitudes to discharge waste into the environment. These changes or new information require water services to adapt in response.

Providers that are closer to customers can generally adapt more easily due to better local knowledge and understanding. Institutional settings can also ensure dynamism and responsiveness to customer demands over time. Castalia's criteria suggest that institutional settings should be assessed on the extent to which they are responsive to change and new information.

3.5 Improving incentive alignment

This parameter refers to the institutional settings that incentivise those charged with governance and management of the water service to make decisions that achieve the overarching objective. The incentives can be short or long-term. Ideally, both short and long-term incentives are aligned with the objectives.

Short-term incentives of governance and management can be aligned via performance contracts and financial targets. Institutional incentives generally arise from accountability to shareholders. Long-term incentives can also be aligned with more care.

Long-term incentives are a challenge in any institution, especially where assets have long lives, and investment needs span decades. One key issue is ensuring sufficient long-term capital investment. Institutional settings, such as ownership interests or regulation, need to ensure that management is incentivised to make costly capital expenditures even where the benefits will not produce immediate returns. Adequate regulation can also ensure long-term incentive alignment via statute.

3.6 Ensuring accountability to owners/customers and stakeholders

There is a cost and quality trade-off in providing water services. Service providers must remain accountable to customers for where the service sits on the cost and quality continuum. Customer accountability allows customers to act on concerns and receive the level of service they want for a given price. Water service quality can be highly variable, even above safe minima.

Consumers also want to ensure that water services are provided at a fair price. It is, therefore, important that the cost/quality trade-off is made by an entity or in a way that provides accountability to customers. Customer accountability can be achieved through local government (current model), independent regulators, regional/council-owned entities, and direct ownership by consumers. Various institutional options exist to give customers and communities accountability for price and quality preferences in water services. The institutional design options need to be evaluated to determine the extent to which they are likely to be effective in the New Zealand environment.

In New Zealand, accountability to hapu and iwi is also important. Hapu and iwi have significant rights and interests in waterways, other water sources and the receiving environment for treated wastewater (both land and water discharge). Many councils have obligations of consultation and have specific agreements that relate to natural resources affected by water service provision.

4 Castalia’s evaluation of Wai + T criteria

We evaluate Wai + T’s criteria alignment with Castalia’s standard approach in the table below. This table aligns the Wai + T evaluation criteria with the six important parameters Castalia developed to assess water reform options. We then provide our comments on the alignment.

Table 4.1: Castalia’s evaluation of the Wai + T criteria

Wai + T evaluation criteria	Equivalent Castalia parameter	Comment on alignment
Financial	Access to financing Economies and scope and scale	<p>Castalia separates Wai + T’s financial evaluation criterion into whether the proposed restructuring will realise cost savings to the council through economies of scope or economies of scale. Wai + T’s financial criterion include relevant metrics that indicate whether economies of scale will be achieved.</p> <p>Access to financing refers to the ability to readily access capital to pay for investment and operations. Access to financing can be achieved through various means, and is not necessarily related to financial cost-savings.</p>
Level of Service	Alignment of incentives with objectives Management and operational capability	<p>Castalia separates Wai + T’s level of service criterion into Castalia’s aligning incentives with objectives, and operations and management capability parameters.</p> <p>Alignment of incentives with objectives encompasses Wai + T’s service, response, and recovery concerns. It is important to consider how a reform option means those people in governance and management are incentivised to:</p> <ul style="list-style-type: none"> ▪ Deliver the level of service desired ▪ Accommodate growth ▪ Respond to emergencies ▪ Be agile. <p>Castalia’s operation and management capability parameter would include Wai + T’s sub-criteria for the delivery entity’s agility to adapt and adjust. The level of responsiveness to emergencies would also be included. This would ensure sufficient weighting to the models’ improved ability to respond to emergencies and growth.</p>

Operational	Economies of scope and scale Management and operational capability	<p>The operational criterion aligns with two of Castalia’s parameters: maximising economies of scope and economies of scale, and lifting the capability of operations and management. Castalia splits Wai + T’s operation evaluation criterion to recognise the different outcomes from economies of scale and the changes in operations and management capability.</p> <p>Wai + T’s procurement of resource availability, buying power, and broader economic evaluation criteria align with Castalia’s economies of scope and economies of scale parameter. Larger organisations can lift operational performance, but there are other ways that operational performance can be lifted. Organisations can also get too big, and have diseconomies of scale. Separating Wai + T’s economies of scale criterion will ensure any cost savings through economies of scope and scale are weighted correctly.</p> <p>There are several ways organisations can lift operational and management competence. Wai + T’s operational sub-criteria include relevant metrics that evaluate this, including managing risk of critical roles, operational efficiency, and values and cultures. However, there are several ways to lift operational performance that are separate from the size/scale (for instance outsourcing or sharing resources). Therefore it would be best to separate this criterion from considerations of size.</p>
Relationship and Trust	Accountability to owners and customers	<p>Wai + T’s relationships and trust criterion largely align with Castalia’s accountability to owners and customers parameter. Castalia’s criteria include further evaluation of institutional operations to give customers and communities accountability over the price and quality of water services.</p> <p>Hapu and iwi are important stakeholders and owners/holders of rights and interests in water sources and the receiving environment for treated wastewater. When applying our accountability to owners and customers criterion, we also include accountability to hapu and iwi.</p>
Strategic	Accountability to owners and customers Flexibility to future change	<p>Wai + T’s strategic criterion overlaps Castalia’s accountability to owners and customers and flexibility to future change parameters.</p> <p>Wai + T’s transparency and clarity evaluation criterion aligns with Castalia’s criteria for evaluating institutional options to give customers and communities accountability for price and quality preferences in water services.</p> <p>Wai + T’s evaluation of future optionality aligns with Castalia’s flexibility to future change parameter. This parameter evaluates the delivery entity’s ability to preserve the option for water services to change size and form over time.</p>

Legislative

Alignment of incentives with objectives

Wai + T's legislative criterion can be aligned with Castalia's alignment of incentives with objectives parameter. Castalia's alignment of incentives with objectives parameters will provide an evaluation of how long-term capital investment and other objectives are incentivised.

This encompasses Wai + T's concerns over whether the proposed arrangement supports achieving the criteria required in any water services delivery plan (WSDP) to be accepted by the minister.

5 Conclusion and suggested next steps

Taken in totality, the Wai + T criteria provide council decision-makers with a robust framework to assess restructuring options. As set out above, we typically use the six high-level criteria because these break down the key parameters for success distinctly from one another. The Wai + T criteria overlap to some extent. The overlap and some repetition mean that some criteria may be over-weighted. However, on balance, we think applying the Wai + T criteria will enable councils to understand the pros and cons of different options and reach a sound decision at this stage.

We understand that you will refine the option design for Wai + T water service delivery further in the coming months. As you refine the approach to joint service delivery, we suggest that you could assess your options considering the following advice:

Financial

We suggest splitting Wai + T's financial evaluation criterion into Castalia's access to financing and economies of scope and scale parameters to reflect the appropriate weighting for each criterion. Access to finance considers the delivery entity's ability to access financing through debt or equity. It is important to consider the cost savings through economies of scope and economies of scale separately to a water entity's ability to access financing

Level of service

We suggest changing Wai + T's level of service evaluation criterion in line with Castalia's approach. Level of service can be lifted by aligning incentives of those in governance and management positions with objectives, and separately by lifting capability of management and operations. Aligning the delivery entity's objectives with incentives is an important measure to ensure that those charged with governance and management of the water service make decisions that achieve the overarching objectives. Management and operations capability is an important measure of the delivery entity's employee performance and professionalism to ensure excellent service and the entity's level of responsiveness to emergencies.

Operational

We suggest addressing operational improvements in line with Castalia's approach and use separate criteria to assess this.

Maximising available economies of scope and economies of scale can reduce operating costs. Economies of scope and economies of scale consider the cost savings achieved through growing the entity, outsourcing staff, or management.

The parameter lifting management and operational capability zeroes in on how a particular option for change may lift capability and improve the entity's performance and efficiency.

Relationship and trust

We suggest Wai + T's relationship and trust evaluation criterion include Castalia's accountability to owners and customers parameter. Castalia's parameter further evaluates how a reform option or institutional structure can lead to better accountability to customers and communities for water price and quality preferences.

Strategic

We suggest splitting using our and assessing strategic issues under two parameters: accountability to owners and customers on the one hand, and flexibility to future changes on

the other. Customer accountability is necessary to allow customers and stakeholders to act on concerns and for the service provider to remain accountable for the cost and quality of the service. Flexibility and adaptability to change according to new information and changing preferences are important for service providers to continue to provide services that meet minimum standards and community expectations.

Legislative

We suggest you retain this criterion. Compliance with Local Water Done Well legislation and regulatory changes are critical.