

**UTILITY CONGRESS 2001**

**BRIGHTON**

**REGULATION, COMPETITION AND THE WATER INDUSTRY**

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## **Introduction**

Some months ago, when Paul Garrett and I discussed the subject matter of this speech, the Government was promising a consultation paper on its proposals for competition in the water industry by 'the summer'. Despite the balmy weather we have been enjoying for the last week, mid October stretches even Whitehall's elastic definition of the seasons. Later, the promised publication was due in 'the autumn'. There was still hope that DEFRA, attentive of course to the needs of this Congress would publish on, say, 15 October.

No such luck. In his speech to a rival conference last week, Michael Meacher said some interesting things about competition and water but also indicated that we were going to have to go on waiting for the consultation paper until the New Year. So this speech will focus on what the Government has said so far and what we in Ofwat are already doing. But inevitably, this will just be a warm-up for the main act in, hopefully, three months' time. That will give me room to say something about the other issues currently confronting the industry and its economic regulator.

## **Competition**

Michael Meacher confirmed last week that the Government wants to encourage new entrants into the market to compete with the existing regional monopoly water companies at both ends of the supply chain: water production and retail services. But this will require legislation. The Government is committed to introducing a Water Bill 'when Parliamentary time permits' – the Minister emphasised that it was a real priority for them.

The Minister also emphasised that competition will not be allowed to put at risk the standards of drinking water quality we enjoy and that the legislation must be consistent with the Government's environmental objectives and social goals. They are committed to retaining the existing structure of vertically integrated statutory undertakers. These companies will retain control over the public drinking water supply distribution network and continue to be responsible for water resource planning, drought plans and emergency planning.

Mr Meacher also recognised that the present system produces tariffs with a lot of effective cross-subsidy. Competition, for example, will have to cope with the fact that at present around 80% of domestic customers still have their water bill based not on the water they consume but on the rateable value of their home. I would add as another example the fact that most companies do not offer direct debit discounts to customers, which in effect means a subsidy from those who choose to pay by direct debit to others whose bills cost more to administer. The Minister recognised that some unwinding of cross-subsidy may be unavoidable, and to an extent this is starting to happen. But he went on to emphasise that water needs to remain affordable to all and to resist 'cherry-picking' by new entrant companies interested only in the most commercially attractive customers. He suggests, I am sure rightly, that the water sector needs to learn the lessons from what has happened in the energy sector. I think the Minister was giving some clear hints about some of the difficult areas which DEFRA is having to wrestle with and which explain the time it is taking to produce the consultation paper.

In my view, it is important to take the time to work out the approach to water in some detail. The sector is different from gas and electricity. Amongst the differences, as we are very aware, is the absence of a national water grid, and of the scope for substantial variations in taste, hardness, odour and appearance for drinking water even within the same national quality standards. Another factor is the much higher proportion of delivered cost accounted for by the distribution of drinking water than in the case of gas and electricity. But none of this should be insuperable. I look forward to a positive consultation in the New Year leading to the introduction of a Bill. One of the issues I hope will be tackled is the interaction between the Government's proposals on competition and those, already published, on abstraction licences. The Government has asked the Environment Agency and Ofwat to develop and publish a Memorandum of Understanding on this issue. We are in discussions with the Agency about this. We are looking for a flexible and adaptable regime which will allow competition to emerge whilst ensuring the protection of the environment. I believe that the right competition framework will sharpen incentives for the efficient use of water and that the integration of proposals for competition and abstraction can work effectively to this end.

## Recent Competition Work

But we are not waiting around for a Water Bill, which won't now be implemented for at least two years, maybe longer. We have done two significant pieces of work aimed at increasing effective competition (self lay and common carriage guidance). We have also been considering a growing number of cases under Competition Act 1998.

### Self Lay

We believe there is a good case for competition between incumbents and other operators (eg housebuilders, developers) in carrying out connections of new mains to existing infrastructure. Competition should reduce incidence of excessive costs and unreasonable terms being imposed.

We launched a consultation paper on 9 August 2001 on what we see as sound practice in companies' self lay policies and held a workshop in September. Comments welcomed by 31 October.

### Common Carriage Guidance

Common carriage is important in developing market competition. Companies published common carriage access codes in Autumn 2000. Since then, there have been some negotiations between companies for common carriage, but no agreements have been reached.

We have reviewed companies' codes and, in September, we initiated a consultation on best practice. Again we have held a workshop to discuss the issues. The consultation seeks views on draft guidance covering not only the access codes, but the way incumbents and applicants should make and implement common carriage agreements. It sets out the core principles on which a national code could be based, and begins to provide some of the detail. We think a national code is desirable as a way of ensuring that all companies follow best practice on the key issues. But we don't think it would make sense for a single code to cover every issue for every

company. A national code would provide a core to which companies could add things that are specific to their circumstances. Our draft guidance is a step towards this.

### Competition Act 1998 (CA98)

While we work on how to take competition forward and promote best practice, we also respond to complaints about companies' current performance.

CA98 complaints work is an increasingly important part of Ofwat's work. Have received almost 60 cases since CA98 came into effect in March 2000, and more coming on our desks every week. Have closed just over half of these. Complaints about excessive pricing, common carriage, self lay issues, amongst others. [No new inset appointments since 2000. No CA98 cases yet brought to court. Preferable to resolve issues satisfactorily.]

CA98 requires strict confidentiality from regulators, to protect complainants. Cannot be more specific on case details.

### **Other regulatory issues**

In three weeks time, Ofwat will be publishing its Draft Forward Programme for consultation on its work for 2002-03 to 2004-05, which will amongst other things, look to the next periodic review taking effect in April 2005. It may be helpful to offer a few preliminary thoughts.

### **Achievements of incentive-based regulation**

The starting point is to acknowledge what has been achieved by the industry, stimulated by price cap regulation. They have delivered efficiency savings on a scale that most would not have envisaged at privatisation. Operating costs are now at a lower level than any time since privatisation. Since 1995-96, the first year of the previous periodic review, operating costs have fallen by around 11% in real terms. This includes new opex associated with the large quality programme implemented

over this time. I don't believe that any other form of regulation could have delivered this, whilst at the same time completing a huge capital investment programme and producing marked improvements in drinking water and environmental quality and levels of customer service. The limited evidence we have suggests that these gains compare well with those in utility sectors more directly subject to competitive pressures.

### **The future of RPI-X**

Over the years, price cap regulation in the form of the RPI-X formula used by British economic regulators across the spectrum has rightly been analysed and tested. (Technically, because of the huge quality improvement programmes required from 1989, water regulation has taken the form of RPI+/-K rather than RPI-X.)

Recently, some commentators have begun saying that RPI-X has done its job. They argue that the industry has reached 'maturity' and that the efficiency gains have been driven out; that going forward the continuing requirement to finance a large capital programme is not suited to RPI-X.

We at Ofwat have been thinking about this issue ourselves as we look towards the next periodic review. We very strongly doubt whether a move to rate of return regulation is appropriate. Rate of return regulation might reduce the cost of capital to companies by giving them still more certain and easily achieved revenues. But it would introduce perverse incentives and reduce the pressures on companies to generate efficiency gains to the benefits of their investors and customers.

I accept that many of the easier efficiency gains may have been made. Managers are having to work harder to drive out further efficiency savings. But there is no sign yet that the scope is exhausted. RPI-X is still delivering significant opex and capital efficiency gains.

Companies have, on average, beaten Ofwat's efficiency targets for 2000-01. Thus operating expenditure is 4% less (£120m) than assumed in price limits. Capital expenditure in 2000-01 is well below Ofwat's projections. Efficiency savings of

around 5% at industry level have been reported. This excludes contractual slippage (I shall be monitoring carefully with my quality colleagues the shortfall on capital spending against targets).

We can expect to have to accommodate another significant capital programme at the next Periodic Review in 2004. This has been a feature of the industry ever since privatisation. It is certainly not something that is incompatible with RPI-X regulation. The regulatory requirements of capital programmes have always sat outside the 'pure' operation of RPI-X (hence the K factor in water) and should continue to do so in the future.

Of course, I fully recognise the difficulties of incentive-based capital programming. Ensuring that companies are incentivised to deliver their capital investment programmes is not an easy task and we will continue to look for ways to strengthen the incentives on companies to deliver their capital programmes on time and at least cost. But I remain convinced that our approach is superior to the simple cost pass through of rate of return regulation.

We do not know how large the programme will need to be because most of the components – European environmental requirements, lead reduction, capital maintenance for example, are uncertain. But the capital programme requirements need to be properly tested in terms of costs and benefits, and we need to pay proper attention to the financing constraints affecting the water companies in determining the overall scale and timing of the programme.

If we can get the programme and incentives right there is no reason, in my view, that RPI-X should not continue to deliver benefits to customers in the future.

Given the success of RPI-X approach so far it would have to be very clear that any significant change in approach, with the inevitable additional uncertainty it would bring, is in customers' overall interest.

I have not seen a case which persuades me that a fundamental change of approach is justified. But we remain open to fresh thinking on how to ensure that companies

have a stable regulatory platform to finance their programmes and be given the incentive to do so efficiently. Some commentators accept the broad price cap (RPI-X) approach, but see various possibilities for improving it. I have no doubt we shall be discussing some of these in the course of our thinking towards the next periodic review.

### **Periodic Review 2004**

The principles underlying the present price review methodology have been developed over the past ten years and have proved robust. We will not be re-inventing the wheel this time. The building blocks are likely to be the same as past price reviews. But we will of course take account of the conclusions of the Competition Commission review in respect of the price limits set in 1999 for MKT and SES.

Our aim will be that this is a process that is as transparent as possible, that achieves in price limits a package which will maintain incentives, share benefits appropriately between customers and investors, and enhance stability and certainty. No prior assumptions on whether limits will go up or down.

The 1999 review took three years. This was felt to be too long. We propose to shorten the 2004 review to about two years starting with a consultation on approach in October 2002 with Final Determinations set in November 2004.

Next steps include consultation on the process in the context of the Forward Programme which as I have said, we shall publish for consultation early in November.

### **Regulatory Certainty/Stability**

I would like to finish with a few thoughts on the need to avoid regulatory uncertainty. This has been a constant refrain through my first 12 months in office.

Uncertainty has been one of the factors cited by investors and their representatives in the City for weakness in the water companies' share price. The argument runs that if faced by the supposed threat of uncertainty investors won't invest; lenders won't lend; cost of capital soars; crisis looms.

Companies' share prices certainly seem to have been running below their regulatory capital values, by and large, over the last two years. I say 'seem to' because it is difficult with diversified businesses to isolate the regulated element. This is not necessarily indicative of a fundamental disconnect between markets' perception of risk and the regulator's view, as has been suggested. At this stage in the price control cycle, it is not too surprising to see some discount for the risk that companies may not succeed in meeting or outperforming the regulator's target. Nonetheless, over time, if efficient companies are to be able to finance their functions they must be able to reward adequately those who invest in them. It would be a cause of concern if widespread discounts were to prove persistent. But not necessarily a problem all down to the regulator – market trends are at work here too. Nonetheless, I need to play my part and to recognise the constraints on companies' ability to finance their functions when I come to set price limits.

I have been more than happy to take up invitations to speak to water company prospective investors and lenders to explain why regulators are not unpredictable mavericks. [Law unto themselves.]

We are bound by statute and, to a degree, precedent to act in a stable manner. It is my primary statutory duty to enable companies to finance their functions. We have developed techniques and procedures which have stood the test of time and which we shall not change on a whim. Our price limit proposals and licence change decisions are open to challenge either in front of the Competition Commission or by judicial review, both of which contribute to consistent decision making.

We also work closely with other regulators to ensure that where appropriate there is consistency between us. For example at the last review we worked closely on the cost of capital with Ofgem, which was at the time conducting a price review of its own. The result was that, despite all the grumbles we have heard about Ofwat's cost

of capital being too low, we adopted values which were very similar to those used for the Public Electricity Suppliers (though Ofwat's cost of capital was in fact a little higher than Ofgem's). Moreover, after adjusting for gearing the WACC just proposed by Ofgem for Transco is identical to that used by Ofwat.

Meanwhile, I recognise that five yearly price reviews themselves introduce an element of uncertainty. But at least for the foreseeable future, I think that five yearly reviews strike an appropriate balance. On the one hand, the industry needs a period of stability with clear regulatory targets to meet and beat. On the other, industry, customers and regulator alike need to take account of new developments, including capital requirements, and of the progress being made. An interesting issue though is whether we need to decide all elements of a review for a five-year period, as we have provision for interim decisions to meet particular circumstances. We all need to take a longer-term view of some matters eg capital maintenance and I do not rule out taking account of the longer term in setting prices.

Government too has a role in avoiding unnecessary uncertainty.

We shall go on looking to enhance consistent decision-making. We shall draw on all proposals, including those in the recent report of the Better Regulation Task Force. Whilst the authors did not include Ofwat in the study, we already follow their recommendations in most respects.

The report also recommended the inclusion of non-executive members for the boards of regulatory bodies. Any change to the structure of the regulator would require new primary legislation. Nonetheless, I announced recently that we would be recruiting independent non-executive directors to join Ofwat's advisory management board. We believe this will strengthen our decision-making and assist further in achieving our goals of clarity and consistency.

## Mergers

Talk about possible mergers within the sector is never far away. Could we manage with fewer comparators, having already gone from 39 to 24 since privatisation? My starting point has to be whether the proposed merger would be in the best interests of customers. The context is that all the water companies (of any size) Cholderton/Albion excluded, are now above the asset threshold set down in legislation. Any merger proposal that includes two England and Wales companies would result in an automatic reference to the Competition Commission. The Commission would need to assess the public interest detriment and decide on any possible remedies that could mitigate or eliminate this detriment. This expressly refers to the Director's need to be able to make comparisons in order to carry out his duties under the Water Industry Act.

In the last three cases examined by the MMC (as it was then), they concluded that there was a substantial detriment to the comparative regime and that there was no satisfactory remedy that could mitigate or eliminate the harm. The SoS accepted the Commission's advice and the mergers were blocked. The MMC was also conscious that, as the number of independent comparators reduces, the harm increases.

The other side of the coin is whether the proposers can demonstrate a reasonable likelihood that measurable long-term benefits will be realised, which can be shared with customers.

This brings us to the issue of whether we should as a nation be seeking to develop a national champion for a British water company to rival the Vivendis, Odeos or RWE giants. But the issue of national champions is not one for Ofwat. Our job is to encourage through regulation the development of efficient companies that can deliver good value to their customers.

Size may indeed be a relevant factor for new entrants in international markets, but in the UK context our comparative work does not suggest any clear correlation between size and either efficiency or quality of service to customers. In general, the UK water industry, small and large companies alike, is among the most efficient and

technically advanced in the world. And comparative competition has made an important contribution to that. I should be reluctant to see significant further reductions in the number of comparators.