



SETTING PRICE LIMITS FOR 2010-15: FRAMEWORK AND APPROACH – AN OFWAT CONSULTATION PAPER

Response by Aquavitae (UK) Limited

This Ofwat consultation paper about the price limits to be set by November 2009 for the five years from 2010 appears to be addressed primarily to the incumbent water companies in England and Wales. However, there are significant implications for water consumers and for prospective entrants to the industry. Aquavitae therefore makes the following general comments on the framework and approach proposed by Ofwat.

1. The effects of competition

Aquavitae is in wholehearted agreement with the comments made by Ofwat about the importance of competition in the Foreword and in the Executive Summary. In section 1.3.1 in particular, Ofwat stresses that 'competition is fundamental as a driver of efficiency, choice and value' and that each incumbent company '...must take account of our initiatives to promote competition in its business plan'. However, we have a number of doubts about the implementation of this laudable objective, to which there are few references in the main body of the consultation document. There is indeed a tendency in the document to assume that competition is a long way off (see 2 below) and to discuss what should be done in its absence. Ofwat still appears to be relying on 'comparative' competition and other unsatisfactory substitutes for real competition: in section 3.2, for instance, on 'Understanding consumers' preferences', Ofwat puts forward the discredited idea that, absent competition, consumer research (where consumers are



detached from a real purchasing situation) can assess what consumers want and are willing to pay.

We cannot see what impact the prospect of a competitive market has had on Ofwat's approach, which is still essentially one in which a regulator conducts a dialogue with a group of incumbent regional monopolists who have no incentive to let newcomers into 'their' market, have little idea of what measures to stimulate competition (if any) might be introduced or when they might appear (see below). In general, the consultation document fails to recognise that the promotion of effective competition, at the same time as ensuring that incumbents are able to finance their licensed activities, will require a radically different approach to price control setting in the future, compared with Ofwat's past approach.

2. The timescale for introducing competition.

Aquavitae has on many occasions pointed out to Ofwat that its timescale for introducing competition – which it has a duty to do – is inordinately long. The Competition Appeal Tribunal (CAT) in the Shotton case concluded that Ofwat could change its interpretation of existing legislation to allow profitable entry to the industry, with the clear implication that competition could appear in the near term. Nevertheless, Ofwat continues to insist that new legislation is required, leading to great uncertainty about when such legislation might be passed (indeed, whether it will ever be passed). Ofwat's statement in section 1.3.1 of this consultation about competition initiatives that 'It



is possible that some of these initiatives will take effect during and immediately after this price review period', and its statement in 2.1.1 about the 'development of competition' in the 'medium term' can only reinforce that feeling of uncertainty. The Water Industry Act 2003 was supposed to permit entry to the large user market, as well as giving Ofwat a competition-promotion duty, yet Ofwat is evidently unsure whether in the 2010-15 period any competition-promoting initiatives will be taking effect. However, as explained in 1 above, the key issue in relation to the forthcoming price controls (which will still be in place seven years from now) is that the framework of these controls should be consistent with the introduction of competition into the water industry.

3. Recent experience and 'taking account' of competition in business plans

Given the uncertainty over the timetable for introducing competition, it will be difficult for incumbents to 'take into account' the promised competition-promoting initiatives in their business plans. Moreover, as there has been not a single entrant since the large users market opening' in December 2005, neither the incumbents nor Ofwat have any experience of competition in water, introducing another problem in 'taking account' of future competition. Properly constructed price controls would facilitate the development of competition and allow incumbents to adapt to it in those activities where competition is feasible, whilst effectively regulating (as a surrogate for competition) where natural monopolies exist.

4. A fundamental change in the approach to regulation

There is considerable experience in other utilities of how regulation needs to change fundamentally as competition is introduced. Briefly, 'naturally monopolistic' sectors of the utilities, such as pipeline transport, have been separated from potentially competitive sectors such as production, storage, metering, meter reading and retailing. The natural monopoly sectors have become separate price-controlled businesses, whereas competition has been introduced into the other areas and over time price controls have been removed. Without such unbundling and the consequential changes in regulation, experience in other regulated utilities suggests that the introduction of competition will be extremely difficult. Yet, there is no indication in this consultation document that Ofwat recognises that the introduction of competition requires a radical revision of its approach to price control regulation. We suggest that it should address this issue as a matter of urgency and produce proposals that facilitate and take into account the development of competition, as well as the need for price regulation of the natural monopoly network for the foreseeable future.

5. Accounting separation

The only example Ofwat gives of an 'initiative' to promote competition is accounting separation into three activities - retail, network and production and treatment businesses. Since publication of the October 2006 judgment of the CAT (which criticised Ofwat's failure to collect disaggregated cost information) Aquavitae has been pressing Ofwat to



collect such information. The proposal for accounting separation should go well beyond the three activities Ofwat suggests. Moreover, we would point out that accounting separation can mean many things. If the intention is, as we assume, to reveal the costs that would be incurred if each activity were operating as a separate business, that should bring into the open costs which are at present concealed such as transport costs, promote efficiency and reduce a barrier to entry. It requires, however, rigorous separation of activities (including staff associated with those activities) along the lines recommended by the Monopolies and Mergers Commission (MMC) report on gas in 1993 and subsequently implemented by Ofgas. That kind of rigorous separation, against clear regulatory guidelines, is quite different from simply asking incumbents to make their own assessments of what the present costs are of their different activities. We would suggest that Ofwat study in detail the recommendations of the MMC and the work that Ofgas did to implement them, taking the lessons carefully into account. A more detailed note about these recommendations, submitted to the Ofwat Accounting Separation Workshop (to take place on January 25), is attached.

6. Constructing separate price controls

To promote competition at the same time as protecting consumers requires a critical re-evaluation of the appropriate coverage of the water undertakers' price controls. This includes considering whether some activities should be removed from the price control immediately or over time, and whether other services presently excluded from the

control should be included within it. As to the latter, all the natural monopoly transportation network, serving large as well as smaller consumers, should clearly be included with the water undertakers' price-controlled activities for the foreseeable future. In potentially competitive areas, the form of the price control needs to provide for removing the protection for final consumers that price control affords, alongside the promotion and development of effective competition.

Fully effective accounting separation should ensure that potentially competitive services provided by water undertakers are not cross-subsidised from their natural monopoly pipeline businesses by the inappropriate allocation of business-specific costs. However, to promote competition and regulate effectively, important considerations when unbundling and setting separate price controls for the various monopolistic and competitive activities include the treatment of group-wide overheads, the appropriate division of the regulatory value attributed to the integrated water undertakers and the unbundling of the aggregate 'cost of capital' between various activities. For example, it is possible that if the potentially competitive parts of a water undertaker's business are separated from the core natural monopoly transport system, the rate of return on the natural monopoly part of the business can be reduced, so lowering prices for users of those services. Ofwat's consultation document does not address any of these important issues.

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