HOUSE OF LORDS SELECT COMMITTEE ON REGULATORS: INQUIRY INTO UK ECONOMIC REGULATORS

Memorandum of evidence by Indepen

Background

1 Indepen is a consultancy that advises organisations addressing the challenges of regulation, deregulation, competition and restructuring. We work with clients at a senior level across the energy, water and transport infrastructure sectors and for regulators and government departments. We have considerable experience of the regulatory bodies and matters in which the Committee has expressed interest.

2 We welcome the Committee's inquiry and the opportunity to submit evidence. Our input focuses on "working methods and effectiveness" and we have looked mainly at issues to do with the Ofwat and the water sector, which is currently illustrating a number of relevant matters.

3 There are opportunities for cross-sector and agency learning, however, and we also refer to comparisons between Ofwat and some of the other regulators on the Committee's list, namely Ofcom, Ofgem and the CAA.

Overall assessment

4 The working methods of the regulators that are of interest to the Committee differ substantially and each can learn from the others.

Ofcom

5 Since its creation, Ofcom has promoted competition, adopted a 'light touch' approach, set regulatory parameters as opposed to prescriptive regulatory requirements and operated with a 'bias again intervention', seeking 'the least intrusive regulatory mechanisms'[1]. Unusually compared with other regulators, Ofcom has recently simplified BT's regulatory financial report thereby reducing the burden on the company and the regulator.

6 As well as reforming the content and methods of the regime Ofcom has paid attention to the calibre and seniority of its staff. Its approach is, we believe, leading to better regulation as a result of having better regulators.

Ofgem

7 The focus of the regulatory regime for electricity and gas has been different from that in water, although the mechanics have a lot in common. Offer and Ofgas, and Ofgem since 2000, have concentrated on ensuring a competitive market for the supply of electricity and gas to all retail consumers and in some unbundled ancillary markets.

8 It is generally agreed that the regulatory framework served customers well through times of surplus gas supplies and power generation capacity in the 1990s. A tight supply position then led to high energy prices and these have dominated the sector in the last three or so years. There is now a prospect that normal service will be resumed although there is a question about whether market mechanisms will ensure sufficient energy supply at the same time as delivering an increased proportion of low carbon energy sources.

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[1] Ofcom's *Statement of Regulatory Principles*.

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CAA

9 In its regulation of BAA's airports, the CAA has recently adopted an innovative approach to customer involvement that we believe could be beneficial in other sectors. The CAA has encouraged the industry (airports and their airline customers) to take responsibility, under a process known as "constructive engagement", for service quality, incentives and investment. Evidently, these are central to the regulation of the airports and they have been controversial and contentious in the relationships between BAA and the airlines.

10 The process is described briefly in the Annex to this memorandum. We are not suggesting that it could apply directly in other regulated sectors rather that with thought and commitment a constructive approach can be devised to deliver benefits even in contentious situations.

Water

11 At a top level, our assessment of water regulation is that it has substantial achievements under its belt but that in current circumstances the way in which it is implemented has become inappropriate.

12 There are concerns that the regime will not address important challenges facing the industry. There has been criticism in Westminster and the media on a number of fronts: levels of leakage in some companies, response to the drought in South East England, wider concerns about the security of supply, unreliable data, lack of progress on competition and poor performance by some companies in meeting the needs of customers. Ofwat has been the butt of much of this.

13 In our view, the issues arising in the regime are to do with working methods and many concern engagement.

Working methods and effectiveness

14 The following observations apply to the way in which the regulatory regime is implemented in the water industry.

15 Our theme is the need for better engagement and it follows that not all of the issues we identify are the sole responsibility of the WSRA (formerly Ofwat). Evidently, other interested parties including the companies and other regulators have their part to play in improving engagement.

Internal focus

16 The statutory duties of UK regulators are broad, as are their powers. It is important to remember, however, that regulators can only promote the national welfare via the decisions and actions of others. The main actors in regulated industries are the businesses and their investors, and their customers. In some cases other stakeholders play a key role, often where there are important externalities. For example the impact of the water industry on the aquatic environment makes the environment an important consideration in water regulation.

17 Experience suggests that regulators fail when their thinking focuses on their own duties and approaches to the exclusion of the motives and duties of others with interests in the sector. When this happens, regulatory policies and decisions and their implementation will be sub-optimal and will result in unexpected and unintended consequences.

18 As an example, it might seem likely that shareholders, customers, Ofwat and the EA would all want water and sewerage infrastructure that is properly looked after and capable of providing good services to customers and the environment over the long term. Of late, the water industry's performance on this has been patchy and the assets of some of the companies are not in good

condition. We argue that Ofwat has been overly focused on its methods and processes and that in the mean-time assets in some parts of the country have been deteriorating over a number of years.

19 A related observation is that after more than 15 years of regulation intended to promote the interests of customers, few water companies could reasonably claim that customers are central to their business. Some believe that Ofwat has too much say in what the outputs of the sector should be and that these do not necessarily reflect consumer preferences and expectations. Such comments could be made of other regulated sectors.

20 Regulators should engage more completely and more explicitly with others. They should begin by agreeing how their duties fit or conflict and then decide how to deal with those who have legitimate interests that are in conflict with those of the regulator. This process of joining up the silos might involve co-operation or compromise, or joint work on defining the problem and interpreting the evidence. In extremis it would involve changes in duties and roles.

21 As consequences of the inward looking approach we observe that

- there is insufficient understanding and involvement among the most senior people on all sides
- there is insufficient input from senior people to important decisions, and decisions can be made on inappropriate technical grounds
- judgements about materiality may be inappropriate
- there can be excessive attention to obtaining and validating data not all of which is required and used to good effect in making regulatory decisions.

Lack of flexibility

22 The way the water regulatory regime is implemented has changed relatively little since privatisation in 1989. As a result, innovation and regional diversity have been stifled and possibly desirable changes in the industry's structure have been constrained.

23 If anything, this has strengthened the regional monopoly positions of the companies and despite pro-competitive legislation in 2003, service competition, which has been effective in other privatised sectors, is struggling to begin. To date no industrial customer has switched supplier and the regulators have shown no interest in promoting market mechanisms for raw or treated water or to deliver environmental policies.

24 Consideration should be given to why there has been no progress, both in terms of the market parameters set and the access pricing arrangements within which Ofwat has had to work[2].

25 Given the quite different situations of the water companies in different parts of the country, there is an obvious need to promote more diversity among the companies driven by regional customer preferences, rather than the current one-size fits all approach.

Institutional arrangements

26 A conclusion of the House of Lords Science & Technology Committee Report on Water Management (June 2006) was that the institutional arrangements were too fragmented. The creation of the Water Services Regulation Authority in 2006 should be taken as an opportunity to reform the regime in England and Wales.

[2] Ofwat wrote to the Minister of State at Defra outlining these concerns in November 2006.

27 Even if there is no change in the statutory arrangements, reform should give high priority to improving engagement among Ofwat, the companies, the quality regulators, and customers and the Consumer Council for Water. Ofwat's role relative to these bodies should change. Its recently acquired statutory duty of contributing to sustainable development suggests it should be facilitating trade-offs between the interests of investors, customers and the impacts of the sector on the environment and society rather than the more deterministic approach it currently adopts.

Short-term focus

28 The regime has pushed the companies towards short term planning in five-year cycles and this has been inimical to the development of strategies to deal with the challenges facing companies and the industry. Regulatory mechanisms such as comparative benchmarking and the Overall Performance Assessment promote short-term efficiency rather than longer-term approaches to sustainable water resources, security of supply and good asset condition and serviceability. In some cases, they have not resulted in sustainable, resilient infrastructure.

Information overload

29 Another undesirable consequence of water regulation is that the reporting burden is substantial and not proportionate to the uses to which the data are put.

30 Regulators often say that they do not require any information that a well run business would not need. Currently, however, the information requirement is driven by the regulator. It is for the companies to decide on their strategic directions and the actions and behaviours to achieve them, develop plans and performance measures and then agree what information their Boards will need if they are to know whether the businesses are on track and that they are taking account of the risks and opportunities in scenarios about the future.

31 More effective engagement between the company and the regulator about this process would make sure that both understood what data they needed to derive the necessary information. It would help to streamline regulation and resolve issues that are currently contentious.

Lack of evaluation

32 There is a need for explicit evaluation of key existing aspects of the regime and any important changes, in particular their effect on incentives and the creation of unintended consequences. One way in which this might have happened would have been at referrals of licence amendments to the Competition Commission. In recent years there have been no referrals (with the exception of water merger referrals, the subject matter of which is narrowly defined) and therefore no opportunities for independent scrutiny of many aspects of the regime.

33 This has not always happened in the past and the implications for customers, investors and stakeholders of many aspects of the water regulatory regime have not been evaluated.

Indepen Consulting

Friday 9th February 2007

HOUSE OF LORDS SELECT COMMITTEE ON REGULATORS: INQUIRY INTO UK ECONOMIC REGULATORS

Annex to Indepen's memorandum of evidence on the process of constructive engagement between BAA and its airline customers

In its regulation of BAA's airports, the CAA has recently adopted an innovative approach to customer involvement that we believe could be beneficial in other sectors. The CAA has encouraged the industry (airports and their airline customers) to take responsibility, under a process known as "constructive engagement", for service quality, incentives and investment. Evidently, these are central to the regulation of the airports and they had been controversial and contentious topics in the relationships between BAA and the airlines.

The process is described briefly in this Annex. We are not suggesting that it could apply directly to other regulated sectors rather that with thought and commitment a constructive approach can be devised to deliver benefits even in contentious situations.

Developing and agreeing Principles of Engagement was an important first step in the process and it took some time to discuss and agree the Principles with BAA and the airlines, their alliances and their representative groups.

The agreed Principles covered

- the general purpose, scope and objectives of the engagement
- the expected benefits from successful engagement
- the broad approach
- the nature of the discussion process and forum
- the outputs of the process in terms of agreement or disagreement on issues
- representation of the customers in the process
- the approach and plan to addressing the different issues
- behaviours.

The core of the approach was a statement in the Principles that on any topic or issue a statement would be produced denoting either agreement (and stating what had been agreed) or disagreement (setting out the different positions). There was an incentive to agree on issues because if no agreement could be reached it would be for the CAA to decide.

Evidently, this was a process designed to work with a manageable number of corporate customers. At Heathrow, for example, there are 90 airlines. They agreed that the constructive engagement meetings would be attended by the three big Heathrow based carriers, the three alliances, three representatives of the smaller airlines and a representative of IATA - the airlines' trade association. The meetings were followed by open briefings of all airlines.