

 Indepen

# Refilling the bath: a discussion paper on water policy and regulation

Indepen

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## **Discussion paper on water policy and regulation, Indepen, 2010**

This discussion paper is the second arising from a project that Indepen is leading on the reform of water policy and regulation<sup>1</sup>. The motivation for this project is the need for policy and regulation to respond in a timely way to the pressures for change in the water sector.

### **Indepen**

Indepen is a strategy and economics consultancy. We seek to create value with clients who are facing the challenges of regulation, deregulation, competition and restructuring. We help formulate strategy and manage the political and regulatory risks. We add value by developing business and regulatory strategies that take account of stakeholder interests and alignment with public policy.

We advise boards on transforming their organisations to implement the strategies. This builds on our understanding and experience of government and regulators and businesses and investors. We use our knowledge to challenge constructively. Our thinking, grounded in the underlying economics, is independent and rigorous.

We have worked with the water sector in the UK and elsewhere since the early 1990s and have advised government departments, regulators, water companies, the supply chain and investors in the sector.

### **Acknowledgement and responsibility**

Five water and sewerage companies are sponsoring this part of the project.

Anglian Water  
Scottish Water

Thames Water  
Wessex Water

Yorkshire Water

Sponsorship entails working on the issues, taking part in workshops and funding.

As well as working with the sponsors, we have engaged widely with stakeholders, including investors, policy makers, regulators and consumer organisations. We are grateful to our sponsors and to the others who have contributed to the work on which this paper is based.

Indepen has written the paper and is responsible for its conclusions and for any errors of omission or commission. The sponsors, while believing the paper to be an important contribution to the debate, do not necessarily agree with all of it.

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# 1 Introduction

This discussion paper is the second arising from a project that Indepen is facilitating on the reform of water policy and regulation<sup>2</sup>.

We have been struck by gaps in understanding between those making policy and designing regulation, those on the receiving end of policy and those responsible for delivering and financing the outcomes. This paper looks at policy and regulation from a number of these perspectives but gives particular emphasis to the view from the investment community, for which the gap in understanding, communication and engagement seems particularly significant.

## Background to the Indepen reform project

The motivation for Indepen's reform project is the need for policy and regulation to respond to the pressures facing the sector. There is consensus on the pressures but not on the necessary changes in policy and regulation or on how to implement them. Conclusions on policy from our earlier discussion paper included the following.

### ***Box 1 – Conclusions on policy from "Changing the bathwater"***<sup>3</sup>

The complexity of water policy means that not only is an overall framework necessary but also that to create a useful one will be difficult.

External reviews have resulted in numerous recommendations for change, some of which would have far-reaching implications. Some of the proposals remain controversial, and in the absence of a coherent policy framework, it is difficult to see how to integrate them and adopt a package to encourage rational responses from regulators, companies, investors and others with an interest in the sector thereby leading to the outcomes we seek.

Continuing uncertainty among investors and potential investors in the sector will have undesirable and expensive consequences for the cost of the services on which we all depend and now would be a good time to initiate a better process for refining water policy. This conclusion applies with added force given the prospects for UK infrastructure investment generally and the need to continue to access capital at a reasonable cost.

These conclusions have met with broad agreement among those with whom we have discussed the paper.

Policy implementation is with Defra and the regulators, but the relationship between them is not well specified. In response to the absence of policy or priorities in some areas (e.g. affordability) and conflicting Government statements in others (e.g. low carbon, enhanced treatment standards) regulators make their interpretation of what is required as well as how to deliver it. This may not deliver desired outcomes. Instances that are most often alleged are

- Ofwat's interpretation of the Water Supply Licensing regime
- Ofwat's competition programme generally
- the 2009 draft determination

- Ofwat's interpretation of its duties, including its duties about financing and non-regulated activities
- positions of the quality regulators that have not acknowledged costs and other trade offs
- over-emphasis on end-of-pipe solutions.

From the investor perspective, the most controversial of these is Ofwat's competition programme, although even on this different investors respond in different ways. Least worried are those who think there has been no political weight behind plans for competition and restructuring and that Ofwat will not get legislation on this. Those who are more exercised think Ofwat's intentions have increased uncertainty about the sector and that this may affect UK infrastructure generally.

In conditions that are less benign than formerly, investors want clarity about policy and its implementation, hence this discussion paper. While the regulatory regime continues to function effectively, we believe that consistent and directed development is essential to maintain the success of the sector and meet the changing objectives of water policy.

## **Purpose and structure of this discussion paper**

It is in the interests of customers as well as companies and their investors that the water sector can finance itself efficiently. This means that the companies and their investors should provide input to how Government implements its policies and that policy makers and regulators should take account of this. Box 2 summarises the matters about which investors and other decision makers<sup>4</sup> would welcome greater clarity and commitment.

### ***Box 2 – Framework of direction and guidance for implementation***

In the interests of customers, investors and stakeholders, policy should provide direction and guidance to those who have to implement it in the areas of

- 1 Objectives and scope
  - a clear objectives and scope of water policy
  - b credible policy objectives, among other things by being clear about how the objectives are to be achieved,
  - c consistent and transparent policy so that investors and other decision makers can form reasonable expectations about the risks and rewards in the sector
- 2 Direction and guidance within which regulators and others who have roles in implementing water policy, including
  - a the implementation of national policies in the water sector
  - b the trade offs between water objectives
  - c roles and responsibilities
    - clarity about who will take policy decisions of various kinds, and how
    - governance - arrangements whereby Defra and Parliament will hold other policy departments and water regulators to account
- 3 Regulator conduct and approaches that are consistent with specific sector policy and better regulation

These items are the subjects of the next three sections of the discussion paper. The final part contains a number of questions for discussion.

The paper discusses water policy implementation and its effect on financeability and identifies aspects of policy and regulation that need attention if the outcomes are to be financeable. Its purpose is to stimulate discussion generally and to provide input from the sponsor group to Defra's review of Ofwat due to report early in 2011, Defra's work on the White Papers due next year and the development work that is under way in the regulators. It does not purport to determine what Government's objectives should be or design policies to deliver them.

## 2 Policy - objectives and scope

This section considers the objectives and scope of water policy and comments on their implications for implementation.

### Policy objectives and scope

Defra is currently refreshing its policies across the board. Defra's draft structural reform plan<sup>5</sup> (SRP), sets out its priorities as being to

- support and develop British farming and encourage sustainable food production
- help to enhance the environment and biodiversity to improve quality of life
- support a strong and sustainable green economy, resilient to climate change.

As part of the last of these, Defra plans to 'reform the (water) industry to enhance competition and improve conservation'. The milestone on this is to publish a Water White Paper in June 2011. As yet, the thrust and scope of this paper is unclear, not least with regard to how Defra's water policy will relate to its other policies, how the suggested vehicles of 'competition and conservation' will deliver against its stated priorities, what further options will be considered and how any evaluation and policy choices will be made.

The following provides some considerations and suggestions for an approach to tackling this.

There is agreement that the high-level objectives of water policy should support the pillars of sustainable development. There are also important constraints. A possible formulation, which we believe, given the responses to our earlier discussion paper, would command reasonably broad support is in Box 3.

#### **Box 3 – Possible formulation of water policy objectives**

##### Objectives

- Environmental - sustainable water cycle and aquatic environment
- Economic - sustainable water and waste-water services for customers
- Social – sustainable external benefits, especially those related to public health

##### Constraints

- Customers must be willing and able to pay for the objectives to be met – legitimacy and affordability<sup>6</sup>
- Investors must be willing to invest in meeting the objectives – financeability
- Implementation must be consistent with national policies, including inter-temporal trade offs
- Stakeholders must be sufficiently satisfied with the process of policy making and the effects of the policy on them that they do not wish to derail it
- Implementation must meet legal (including EU directives) and fiscal constraints

The sustainability objectives are problematic, with as yet unaddressed challenges of defining what the sustainable outcomes will be and striking a balance over time between the various elements. If a refreshed water policy is to work, as a minimum

it will have to include long term objectives and markers along the way and provide a framework within which trade-offs can be made. Helpfully on the last, Defra's draft SRP, contains an action to

*"Revise guidance on Impact Assessments, the Green Book and other policy appraisal guidance to take account of sustainability and the value of nature."*

Where great uncertainty remains, the policy should describe how research and engagement will be deployed to firm up the preferred policy options.

Sustainability has implications for all those who affect any stage of the water cycle and those whom the water cycle affects either directly or indirectly via externalities. Defra's document on its Natural Environment White Paper<sup>7</sup> includes the following.

*The natural environment touches upon all aspects of our lives and so the White Paper will need to be broad in its scope, addressing policies on biodiversity and habitats, the marine environment, water quality and availability, air quality, soils, trees, woodlands, forests, landscapes and recreation. It will also need to reflect the important contributions of farming, food, waste, land use and the planning system. Climate change mitigation and adaptation will be key themes; as will the impact of England's footprint on the natural environment overseas. These issues will, for the first time, be addressed in a holistic way designed to reflect the interdependency of the services and resources we receive from nature and the wide range of different factors that impact upon them. (Page 3)*

If this holistic approach is to apply to water policy, then the scope of the policy will be the water cycle and the aquatic environment, and the material effects on them that human activity has, including

- the effects on the aquatic environment of domestic, agricultural and industrial water use and other services including waste management
  - effects on water resources and quality
  - effects on surface water flows
  - effects on biodiversity
- the contribution to those effects of
  - the actions of the providers of such services and of their agents and sub-contractors
  - the development and operation of any structures and facilities that affect the aquatic environment.

The focus of Defra's Natural Environment White Paper is, unsurprisingly, on the environmental objective. Given the other objectives in Box 3 and the constraints listed in the Box, the scope of Defra's policy will have to include many indirect effects of water related activities, including those arising from monopoly and externalities such as public health and affordability issues, which will widen the scope of the policy still further.

This breadth of issues means that the policy will be complex<sup>8</sup> and that there will be ramifications for other policy portfolios – not least the food and farming portfolio within Defra and other portfolios such as planning (DCLG), climate change (DECC), health (DH) - with even more need for clarity and transparency.

## Implications for implementation

### Objectives

From the perspective of investors and other decision makers in the sector<sup>9</sup>, a new statement of water policy should

- explain the objectives and constraints
- say what they mean for those who will have to implement them, including the regulators
- describe how government intends to assess the success of its policy
- update the duties of the regulators and clarify their relationships with each other and with Defra.

Much of this is not sufficiently clear at present. For example, the implications of Ofwat's existing duties are not particularly transparent.

#### **Box 4 - Ofwat's existing duties**

The duties date from 1991, modified in 2003, before sustainability had become a significant factor in government policy.

The duties make no reference to Defra or the other water regulators or to other policy departments or sectors.

The duties are an opaque and patchy mixture of

- objectives - those including words such as 'promote' and 'have regard' - and constraints - those with the words 'protect' and 'ensure'
- inputs - for example, efficiency, protection from land sales, promotion of competition and outputs - for example, interests of customers and functions properly carried out
- primary and secondary duties.

Sustainability as defined by government is an inclusive notion making it unnecessary and probably unhelpful to have additional duties, such as those relating to efficiency and regulatory practice, which are themselves elements of sustainability. These might be dealt with better in guidance about implementation - which could expand sustainability without diluting or distorting it as an objective.

### Credibility, consistency and transparency

The capital markets play a central role in the water sector and other infrastructure sectors, although not all. Economic efficiency<sup>10</sup> requires that investor considerations be taken into account in the design of policy and its implementation, including those aspects of implementation that fall within the remit of the regulators.

Water policy has been stable and investors have responded well to this. Policy may not have been entirely transparent but in a benign environment with little by way of new challenges, this has not been a problem. Regulation has evolved slowly and this has given comfort to investors. In circumstances where there are new challenges and more radical change is on the agenda then investors want clarity about what decisions are to be made and when with transparency about by whom they will be made and on what basis.

There are consistent themes about what investors value when considering sectors, such as water, which have significant doses of public policy<sup>11</sup>. Change is now on the agenda and investors will welcome policy that is credible in that it is unlikely to be abandoned or reversed unpredictably or without good reason. A credible policy, in this sense, will be one that

- is transparent and understandable with changes well signalled and implemented
- recognises the need for commitment given the timescale of the investments in the sector
- is legitimate with customers in that they are willing to pay
- acknowledges the importance of investors and their expectation of a reasonable return on investment they have made
- is clear about how different risks are allocated as between taxpayers, bill payers, investors and others.
- covers cross-sector issues some of which are currently fudged, for example, the energy and carbon content of water costs and the affordability of infrastructure generally
- provides for regulation that is consistent with water policy
- maintains the independence of the economic regulator.

This would mean that investors could form reasonable expectations about how government and its agents would be likely to deal with issues that might affect investors' interests.

## **Investor concerns**

### **UK infrastructure generally**

Experts expect that spending on infrastructure, running at some £30bn/yr in the last ten years, will have to increase to £40-50bn/yr with energy and transport investment dominating. The low carbon agenda for energy and transport, combined with ageing existing infrastructure and an increasing population, presents a complex set of demands on infrastructure. The public purse is empty and the government is looking for an increase in the share of private investment.

In addition to the well-known uncertainty about climate change and its effects, politicisation of the environmental agenda in the UK has increased the political and regulatory risk associated with infrastructure investment. Threats to independent regulation and the stable investment environment that investors have valued in the UK are leading investors to consider alternative opportunities.

EC Harris<sup>12</sup> conducted a comparison of how attractive the policies of ten countries competing for energy funding were to international investors. It concluded

*Ranking on average 5th out of 10 in a comparison of country energy policies, the UK's lack of policy guarantees, financial support and opportunities of scale hinder its ability to attract the investment needed to ensure a viable future for UK energy.*

*The new coalition government needs to decide UK energy policy quickly, as prolonged uncertainty is agitating investors. The UK scores unfavourably mostly due to the lack of clarity over future energy policy measures – UK investors need to see direction.*

It would be fair to say that if UK policy towards energy and climate change lacks direction, there is no policy at all for decarbonising transport. Historically, the transport sector has been dependent on state funding. Evidently, water will have to compete with these other UK sectors for private investment, not to mention the requirements in other countries. How will it fare?

### **Investing in UK water**

While there is uncertainty surrounding climate change and the need for investment, the rate of increase in investment in water is likely to be less than that in energy, although there is a question about whether the water companies should play a bigger part in delivering sustainable development, for instance with regard to flooding and coastal protection or energy from waste. Any role extension would affect how trade offs are made in the sector, currently focused on protecting consumers with a narrow definition of sustainability.

Given performance since privatisation, the sector might expect to do well in the competition for investment. On the historical model, presumably investors would be happy to fund necessary investment in adaptation and resilience, provided the regime continued as before with investment going into the regulated asset value (RAV) and a reasonable return on this allowed by the regulator.

The sector is not insulated from uncertainties about climate change and population growth and the future need for initiatives on water efficiency and demand management. These may add to the risk faced by the sector including asset redundancy. Policy should clarify how it wants these risks to be allocated between taxpayers, customers and investors with the objective of encouraging more innovation and ensuring a continued flow of funding to the sector.

### **“The RAV problem”**

Even in water, however, investors are expressing concerns about what they see as political and regulatory risk that might affect the ability of the sector to attract and retain capital. Existing investors in the sector have expressed a concern about the effects on the RAV of changes in policy and regulation. This is an issue for all privatised infrastructure but is of particular importance in the water sector, given the financial structures of some of the companies and the size of the privatisation discount<sup>13</sup>.

The RAV has been instrumental in allowing the sector to finance its negative cash flow at low cost. A less positive consequence is that the prevalence of the RAV in investor thinking brings a degree of inflexibility to change. The question is how changes in industry structure and regulation that might be beneficial from a public policy and a customer perspective can happen without jeopardising the financing benefits. Unless this can be managed, there is thought to be a risk that changes, such as restructuring and competition, might cause a disproportionate increase the cost of capital and a need for more equity finance. Neither the Government nor the regulator has given other than general reassurance about the treatment of legacy investment. The current position with Ofwat pushing for competition and government declining to give explicit support is undesirable and will have adverse consequences in the medium to long term.

We think this is a matter for government rather than regulators. If the Government decides that opening up the policy options for the sector will add economic value, it should be clear about and explain to investors

- how it expects this value to arise
- the principles it requires regulators to adopt when dealing with the consequences of change for existing investment
- how it proposes that transition costs and any asset stranding during the transition period or subsequently will be dealt with.

The economic value created by a soundly based decision to change would be sufficient to cover compensation to investors and still leave customers better off. It will be for the regulator, with detailed knowledge of the sector, to develop and implement the approach in detail.

## 3 Direction and guidance for regulators

There are national policy issues that affect water as well as water specific policy issues where there will be benefit from Ministers and Defra setting clearer direction and timescales. This might take the form of legislation as the most effective way of demonstrating commitment to high-level outputs<sup>14</sup> and changes in the duties of the regulators.

From our earlier work, we concluded that there was a need for "... greater clarity about the roles of policy makers and those who are responsible for implementing, including how joining up will happen<sup>15</sup>". Infrastructure UK (IUK) has expressed a similar view.

*Aligning the different layers of the framework will provide increased stability and transparency for infrastructure developers, financiers, operators and consumers.*

This section discusses national and water policy issues, raises some questions about roles and governance and briefly comments on precedents from other sectors and regulatory convergence.

### **National policy issues that affect water**

National policy issues are of particular relevance at present with the need for the UK to invest to meet the demands of a growing population, improve the country's competitiveness, stimulate economic growth and meet the challenges of climate change. Government anticipates a substantial increase in the required rate of infrastructure investment at a time when the public finances are in tatters with public expenditure, especially capital expenditure due to fall, and taxation to rise.

As far as national infrastructure policy is concerned, our first discussion paper proposed that water policy should have regard to the work of IUK<sup>16</sup>. IUK will be addressing these issues in its autumn strategy and, other things being equal it will make sense for water policy to have regard to this. Given that investors in water invest in other UK infrastructure as well, water policy should be consistent with parallel considerations in other sectors<sup>17</sup>. On these national matters, it will be unhelpful for water policy to diverge from the national approach. Unexplained diversity in the implementation of any "national" policy implies inefficiency, adding to customers' bills thereby diluting the legitimacy of the policy and causing confusion among investors, which adds to unnecessary risk.

Matters for government decision or guidance include

- cross sector matters
  - how policy will be joined up across devolved administrations, departments and other levels of government, for example the interaction between economic development (HMT, BIS) and new housing (DCLG, local government) in areas of water stress (Defra)

- the standards of resilience required of infrastructure assets and services generally to guide decisions on how much to spend on resilience and climate change adaptation using a national approach to assessing risks and reflecting the extent to which customers and society expect to see them managed<sup>18</sup>
- the application in regulation and decisions about capital programmes of national policies on environmental externalities, for example on climate change mitigation
- innovation – where national policies on research funding and the protection of intellectual property already exist
- customer matters
  - legitimacy - localism and how the customer voice should be reflected in regulation
  - how to capture customer views generally
  - poverty insofar as it is affected by the affordability of water bills for vulnerable customers and the effects of high charges in some areas
  - inter-generational transfers and other inter-temporal considerations – how to value the interests of customers and the aquatic environment now and in the future
  - the level of risk that customers should bear
- financeability
  - managing material changes in risk<sup>19</sup>
  - issues of risk allocation between investors and customers.

### **Box 5 – Financeability as a national policy issue**

As noted in Section 2, financeability is a constraint on the objectives of water policy. The water sector's capital programme must be attractive to the capital markets at a reasonable cost to customers.

The financeability issue affects all infrastructure sectors where private finance is required and is thus an issue for national policy. Nevertheless, under arrangements at present, the cost of capital, financeability and the related issues of risk and its allocation are regarded as matters for Ofwat under its statutory duty to secure that the businesses can finance their functions. Generally, Ofwat declines to be explicit about the effect of changes in incentives or its interpretation of its so-called risk mitigations on the cost of capital and financeability. Determinations referred to the Competition Commission have not provided any clarity.

Given the importance of financeability, it is not appropriate that decisions which materially affect risk and the cost of capital or financeability should rest entirely with the economic and competition regulators. Trade offs between financeability and other objectives and decisions concerning whether and if so how stranding should be compensated ought to be subject to policy guidance. It may be the role of IUK to advise policy departments from a national perspective and for policy departments including Defra to direct or guide the regulators.

## Water specific issues

It will be important for the policy to provide direction on certain issues and changes specific to the water sector, for example

- long term objectives for the sector (say, 50 and 10 year – as suggested by IUK)
- changes in the scope of the sector's activities, for example to include responsibility for flood defences or SUDS
- changes in the way that EU directives are implemented<sup>20</sup> and quality standards are enforced – having regard to costs and sustainability in the broadest sense, including the balance with other desirable outcomes, e.g. defence against floods and drought
- a consistent approach to water resource allocation involving the water companies, the EA and Ofwat in a system that encourages the most efficient allocation and use of water and economic transfers of water within and across catchments
- charging principles for the sector.

These issues are significant to investors and other decision makers and they might variously require changes in one or more of the duties of regulators, the structure of the sector and the sector's risk profile. Where there are conflicts between the objectives, a refined water policy should describe the desired balance between them, particularly if they are matters where implementation falls to different agents, for example, higher environmental standards (EA) and affordability of bills (Ofwat). This coordination is important to avoid political and regulatory uncertainty and inefficient outcomes due to inconsistency of policies, persistent indecision on critical matters and unpredictable and retrospective regulation.

## Governance

Under this heading, we consider role clarity and how regulators are held to account. Matters relating to Ofwat's own governance are covered in the next section.

### Role clarity

It will be appropriate for government to be more specific about the roles of the sector's participants so that investors and other decision makers know who is responsible for what. The duties and roles of Ofwat should be related more transparently to those of Defra, the other water regulators, regulators in other sectors and IUK. Making these matters more explicit will reduce both political and regulatory risk and if these risks are systematic will reduce the cost of capital. This will be attractive to investors, provided it does not imply that the independence of the regulator will be undermined.

### Role of customers in decisions

The Coalition intends that customers should have an enhanced role in decisions about the services they pay for. In the case of water and sewerage services, this could be through some combination of

- choices in those markets where competition can be introduced or extended
- changed duties of the regulators or changes in the way they are implemented such as greater customer engagement as part of the regulatory process
- choices in a political market, by voting, for example for city mayors.

Such changes would have significant implications for the roles of all parties including the regulators and for the way in which government would hold them to account. Even so, government might decide that there would be limits on the scope of customer preferences in areas where there are significant externalities so that customer choices will not be socially optimal and government would need to act or guide.

### **Independence of regulators**

Historically, investors have gained confidence from the protection of their property from opportunistic appropriation that was provided by the independence of UK economic regulators. It would be helpful for the new administration to re-affirm its commitment to independent regulation, clarifying its thinking towards infrastructure generally including being clear about

- what is meant by independence
- how independent regulators are supposed to relate to government policy
- how independent regulators should interact with others, some of whom are not independent
- how they should be held to account.

### **Accountability of regulators**

A propos the last point, there is a case for reviewing the effectiveness of performance reporting by regulators, which would be better if it was more specific in terms of the how the regulator had used its independence in the delivery of public policy objectives. It might be helpful for government to specify part of the contents of regulators' annual reports.

Processes for the review and referral of regulators' decisions are part of their accountability. Policy on review and referrals is a national matter that affects all those infrastructure sectors in which private capital plays a significant part.

There are concerns about the effectiveness of these processes in water. Survey results indicate that investors attach little or no value to the processes for the referral of proposed licence amendments to the Competition Commission and to the substantial adverse effects clause. The fact that these processes are seldom used may reflect that the processes are seen as somewhat one-sided<sup>21</sup>.

## **Precedent from other sectors and regulatory convergence**

There may be lessons from other sectors and some possible sources are as follows.

- An interesting area is the statutory requirement for Transport Ministers to set the High Level Outputs for Network Rail. This process could operate quite separately

from matters to do with the rail subsidy. There is a need for ORR to balance Ministerial desires with what customers, in particular freight customers, say they want and are prepared to pay for. An equivalent statement for water would be about priorities where there are legal obligations and broader strategy issues where there is not.

- In the case of the CAA, the DfT has published a Sponsorship Statement and Directions. The Sponsorship Statement sets out the relationship between the Secretary of State and the CAA, the framework within which the CAA operates, the financial conditions and other guidance relevant to the exercise of its functions, and how the CAA will be held to account for these. It was drawn up by the Department in consultation with the CAA. There is also a letter from the previous Secretary of State to the then new Chair of the Authority which set out his priorities for the Chair.
- The Scottish Government plays a central role in specifying the outputs that Scottish Water is to deliver and the overall price constraint within which this is to be done – currently stable prices. It does this in conjunction with those responsible for quality issues, Scottish Water and the WICS. It is then for the WICS and Scottish Water to determine the details in the strategic review of charges. It would be interesting to consider how this might work with the water industry in England at a regional level.
- Another precedent, in principle at least, might be derived from National Policy Statements, which could extend beyond planning matters to have a broader policy focus. This might be something that IUK is thinking about for its autumn statement although the effectiveness of the Statements is untried.

The sector economic regulators began life as separate entities and so they have remained. There is little joint working and few common approaches to what are ostensibly similar situations even though their statutory duties are broadly similar and they regulate sectors which seek to raise capital from the same or similar investors. The scope for convergence certainly includes the national policy issues identified earlier in this section and could be broader.

The notion that precedents can apply across sectors is at one end of a spectrum with other points being regulatory policy convergence, joint working across sector regulators and ultimately merger of sector regulators, for which Ofgem and Ofwat are apparently candidates. Given the central role of the capital markets in UK infrastructure, considerations of consistency and transparency lead to the question of whether the advantages of such a move would outweigh the disadvantages.

## 4 Regulator conduct and approaches

### Background

In essence, this section addresses better regulation in water. It focuses on economic regulation but many of the points apply to the environment and quality regulators. It refers specifically to the other regulators in some cases.

The regulators are undertaking work on a number of the matters referred to below. Ofwat's Future Water programme, which includes projects on

Accounting separation  
Future price limits  
Future scenarios  
Future water charging  
Regulatory compliance

Retail markets  
Sustainable drainage  
Upstream market arrangements  
Water rights trading

It is an ambitious agenda for change. Ofwat has commissioned reports from consultants and engaged the advice of an expert panel. The Future Price Limits project is itself complex and contains sub-projects on the following.

Form of control  
Regulated and unregulated activities  
Risk and risk allocation  
Incentives  
Customer engagement  
Beyond limits - how should prices for monopoly services be controlled?  
Reviewing price setting – aims and approach

Cost assessment and cost recovery  
Risk mitigants  
Cost of capital  
Outputs  
Future scenarios  
Reviewing price setting – our aims and approach

The project has produced some discussion papers and will start to produce proposals for consultation in the first part of 2011. Indepen and the sponsors of this project are working with Ofwat's Future Price Limits project team.

Our suggestions relate to regulatory philosophy and approach and the design and use of regulatory tools.

### Regulatory philosophy and approach

The purpose of economic regulation is to prevent abuse of customers by state licensed monopolies. At the same time, the government of the day will require regulation to be consistent with its broader policies for the sector and infrastructure generally.

This means that the approaches of regulators should meet the following criteria.

- Objectives and clear guidance should be provided by policy makers, and regulators should not only have regard to them but also explain how they have done this.
- Regulatory policies, decisions and proposals for change should be in a form and a language that is accessible to sector decision makers, investors and stakeholders, as well as regulatory technicians.
- Regulators should evaluate, and show in their annual reports, the effects of their work and explain how their policies and decisions have contributed to the prevention of monopoly abuse and other policy outcomes. In particular, regulators should report on how changes they have made and proposed would affect the cost of capital and financeability.
- Regulators should have an effective dialogue with policy makers so that they can advise them on how to implement their policies effectively and avoid unintended consequences.
- This will require, in turn, an effective dialogue between the regulators and the regulated businesses so that the regulators understand how the companies respond to regulation – in Ofwat parlance the transmission mechanism.

The regime is opaque to decision makers in the sector because neither approaches nor changes are systematically rationalised relative to government policy. In part, this may be because policy has been absent or fudged and the regulators have filled the void. Rationalisation will require regulator's policies to be set out more explicitly. This will entail the following.

- Regulators should specify the purpose of their regulatory tools including: price reviews; interim determinations and other change, review and appeals processes; and monitoring and compliance.
- Regulators should provide a zero-based justification for each of their tools. The justification should be in terms of their duties and government policy.
- Regulators should provide a zero-based justification for the information they require from the regulated. The justification should be in terms of their duties and government policy.
- In describing the approaches they favour, regulators should make explicit, with reasons and referring to government policies, their intentions as to
  - the balance between market mechanisms and regulation
  - the strength of regulatory incentives, for example for innovation
  - the use of measures to regulate the risk of financial distress, for example ring-fencing provisions
  - the balance between carrots and sticks, including enforcement.
- Consultation on changes should be real, rather than procedural.
- Proposals for changing regulation should be explicit about how the change will deliver government policy and how it will add economic value.
- Such proposals should be explicit about the transition arrangements especially where they would have a material affect on risk or its allocation.
- Proposals should be supported by arguments and evidence indicating any limitations and describing judgements that have been made and why.

- The approaches of the sector economic regulators should converge where possible and continuing differences should be justified by specific policy differences or differences in circumstances.

The Coalition Government wants regulation generally to be less intrusive and less detailed. The changes listed below have been widely discussed in water and would not only reduce the regulatory burden on regulators and companies but also make the process more effective.

- Linking regulation to policy outcomes so that some existing regulatory activity would fall away.
- Setting outputs at a higher-level of aggregation, for example customer satisfaction in place of more detailed measures.
- Addressing a set of substantial issues such as those identified by Severn Trent<sup>22</sup> as suffering from excessive detail and ineffectiveness, including maintenance, quality, enhanced service, supply and demand.
- Adopting more flexible, risk based, approaches to compliance.
- A risk-based approach to regulation with more reliance on self-regulation
  - one option here would be to make the regulation of good performers less burdensome, so that the regulator's scarce resources could focus on areas of poor performance.
- Rationalising reporting arrangements
  - a range of options includes reduced scope and frequency, co-ordination between regulators, using companies' own reports.

## **Design and use of regulatory tools**

### **Current position**

It is widely acknowledged that the incentives as deployed at PR09 may be unfit for purpose for the next periodic review and may be driving behaviours that are inimical to meeting future challenges. As part of its Future Water project, Ofwat commissioned Europe Economics to produce a report<sup>23</sup> that focuses on risk and the way that incentives allocate it and considers the implications of vertical separation and competition.

Ofwat's expert panel discussed incentives and raised issues, including

- the dominance of the RAV incentive
- the extent to which the full catalogue of incentives and their purpose is understood by the companies and the regulators
- the implications of different financial structures and business models
- the extent to which a "one size fits all" approach by each regulator is appropriate given the increasing diversity of company circumstances and strategies
- the extent to which elements of the regulatory package and the actions of different regulators lead to conflicting incentives
- how the way in which incentives are applied and communicated by regulators and are applied or responded to by companies and their agents undermines positive outcomes – in Ofwat terminology, the transmission mechanisms

- the role of non-strictly-financial incentives provided by the regulatory regime, for example reputational incentives and variations in the degree of regulatory scrutiny.

Ofwat's Future Price Limits project is taking a fundamental look at its toolkit and has issued a series of discussion papers that introduces this work including one on the topic of future price limits<sup>24</sup>.

## Implications

Much of what *Beyond limits*<sup>25</sup> says makes sense and has been made public before. We will have to await subsequent papers for substantive detail. One point, however, is conspicuous by its absence, namely the importance of Ofwat changing not only what it does, but also the way it does it in terms of communication, explanation and engagement.

The paper contains the following statement (Pp 8 & 9)

*In 'Delivering sustainable water - Ofwat's strategy', published in March 2010, we explained that these new challenges are quite different in nature and scale from those of the past. They will make delivering the level of services that customers expect increasingly difficult. As a result, they may require a different set of responses and fresh approaches from the wider water and sewerage sectors. This is why we are exploring the part we can play in helping the companies overcome these challenges by considering the tools we use to regulate them. That includes the way we control prices.*

This does not acknowledge the importance of how Ofwat operates, and the level of trust this engenders, for the responses companies make to the financial incentives that Ofwat deploys. It is not only the regulated who will need to change but also the regulators. We observe the need for regulators not only to reconsider the tools they use but also how they engage with the companies and other parties and the knowledge, skills and experience they will require to develop and implement new approaches.

The Europe Economics report makes a number of points of principle that are relevant to a redesign of incentives of the type Ofwat is contemplating<sup>26</sup>. These imply that the design of incentives individually and even more so in a package cannot rely entirely on recommendations from theory. Ofwat's expert panel has also made this point and the complexity of the objectives of water regulation adds more weight to the conclusion.

A related point that has emerged as important in the earlier part of our reform project and in the proceedings of Ofwat's expert panel is the importance of regulators understanding how regulatory incentives (individually and in combination) will affect decisions. The focus of this is primarily the decision processes and multiple incentives within the companies and their investors but the point is also relevant to other decision makers who can affect the outcomes, including water customers and polluters. Ofwat refers to this as the transmission mechanism issue and agrees that there is a need for further work. We have

suggested that this should be experimental in nature and involve practitioners, namely company executives and regulators.

As part of our reform project, we are seeking to understand better how the companies' strategies, governance arrangements, decision-making processes and reward systems work in the context of regulation and as the first step we are working with our sponsors to

- make sure we have a full catalogue of existing incentives
- identify where there are unnecessary conflicts or perverse incentives
- indicate ways of dealing with failings in the incentives
- describe the risk characteristics and information requirements of the incentives
- consider specifically non-strictly-financial incentives that arise from the regulatory regime and how the companies respond
- identify how, management arrangements - for example strategies, governance arrangements, decision-making processes and reward systems - affect how the companies respond to incentives.

Phase 1 of our project gave rise to a series of issues to do with incentives and these are listed in Box 6. In the current phase of the project, we intend to identify a number of these as priorities and to work with Ofwat and our sponsors on testing the options.

**Box 6 – Incentive issues to be addressed**

Separate price controls and forms of control for different parts of the supply chain

Treatment of unregulated activities

Measures of performance to which incentives are linked

- Higher and more inclusive or holistic output measures
- Longer term measures incorporating sustainability
- Innovation
- Customer satisfaction

Linking financial incentives to performance

- Arrangements to more directly link financial returns to a company's performance
- Menu approach to include opex as well as capex in place of the current efficiency assessment, the catch up model and the extensive use of company specific factors
- Linking the benefit retention proportion to the extent of out-performance

Non-financial incentives

- Arrangements that would vary the detail depending on historic performance of the companies – the better the performance the more light touch the regulation
- Use of league tables and publication

Simplification

- Higher level outputs
- Attention to issues identified by Severn Trent<sup>27</sup> as suffering excessive detail and ineffectiveness – maintenance, quality, enhanced service, supply/demand
- Rationalising reporting arrangements – reduced scope and frequency, performance linked, self assessment, co-ordination between regulators, company formats

Other

- Incentives to attract more equity investment
- Incentives to encourage innovation and collaboration
- Removing biases in incentives, for example between opex and capex
- Change the balance between carrots and sticks
- Application of different approaches to infrastructure and non-infrastructure
- Regulated (single till) and unregulated (dual till) options, for example sludge

## 5 Issues for discussion

The following ten questions arise from the paper and we would welcome thoughts on them and on other salient questions from readers.

1. Is the distinction between objectives and constraints (p3) helpful? If it is, are the items correctly categorised? What are the implications for policy and implementation?
2. Is the distinction between national and water policy issues (p6) appropriate? What should the distinction entail for how Defra defines its water policies within a broader framework? What does it mean for the roles of Defra and the regulators? More specifically, is the argument (Box 4) that financeability is a national policy issue valid? If so, what are its implications for who 'owns' this policy at national government level, and for regulators at price reviews and in considering changes to regulation?
3. Do a context of greater uncertainty and a less benign economic environment justify a call (p5) to place a greater premium on consistent and transparent policy than we have had to date?
4. As they stand, are the review and referral processes barriers to more transparency and consistency? How could they be shaped to play a more constructive and effective role without diluting the clarity of the regulatory regime?
5. What will be the economic value of giving customers an enhanced role in decisions (p9)? If this were achieved, what would be the implications for the roles of Defra and the regulators? Equally or more importantly, how should we do it?
6. How might the precedents noted on p10, and others, benefit the situation in water? What are the pitfalls to avoid?
7. What would be the high-level pros and cons of merging Ofwat and Ofgem (p10)?
8. Would more rationalisation of regulation in terms of achieving policy objectives (Section 4) excessively fetter the discretion of regulators? Would it be consistent with independent regulation?
9. What safeguards can there be for holding policy makers themselves to account to avoid them opting for political interference?
10. If Ofwat concludes that different companies, for a variety of reasons (p14), will respond differently to the incentives it adopts, what should it then do?

## End-notes

<sup>1</sup> The first discussion paper was *Changing the Bathwater*, Indepen May 2010

<sup>2</sup> Ibid.

<sup>3</sup> Ibid, p.10

<sup>4</sup> Including customers, service providers and stakeholders, i.e. individuals or groups that are affected by externalities and who might be able to influence or even derail a policy.

<sup>5</sup> <http://www.defra.gov.uk/corporate/about/what/documents/defra-srp-100716.pdf>

<sup>6</sup> This is affordability to customers generally not vulnerable groups. Some have interpreted this to mean stable prices in real terms, or relative to income growth.

<sup>7</sup> *An invitation to shape the Nature of England, Discussion Document*, Defra, July 2010

<sup>8</sup> The nature of the complexity was described in Section 2.1 of *Changing the bathwater* and is consistent with the material in Defra's consultation on its Natural Environment white paper.

<sup>9</sup> See footnote 4

<sup>10</sup> Usually expressed as timely and efficient investment and an appropriate cost of capital.

<sup>11</sup> This debate is better developed in the context of UK energy policy but we believe it is important in the water context, and will become more so.

<sup>12</sup> EC Harris, October 2010

[http://www.echarris.com/reference/news/uk\\_lags\\_behind\\_in\\_global\\_race.aspx](http://www.echarris.com/reference/news/uk_lags_behind_in_global_race.aspx)

<sup>13</sup> High gearing makes the issue of changes to the RAV concept sensitive because the low cost of the sector's debt finance is based on the stability of the RAV. The privatisation discount reflects the difference between what investors paid for the assets at the time of privatisation and the replacement cost of those assets. In water, the sale value was less than 20% of replacement cost. It is an issue because any structural changes in the sector, for separation in the interest of competition, will require the discount to be attributed to the separated parts and the way in which this is done will have wide-ranging effects.

<sup>14</sup> This might be the water equivalent to the commitment to 2020 and 2050 carbon targets.

<sup>15</sup> Indepen, op cit, Section 3.3.2

<sup>16</sup> The following is an extract from our earlier paper (p.14) that summarises IUK's position at that time.

Infrastructure UK has proposed a National Infrastructure Framework to take a long-term, cross-sector view of infrastructure needs. The elements that are relevant to water are

- 50 year vision of the role that the UK's infrastructure should aim to develop and sustain
- specification of the outcomes required from infrastructure development and investment over the next 10 years
- priority policy interventions that will encourage the necessary investment.

<sup>17</sup> Ideally, national would mean the UK, with policies applied similarly across all jurisdictions whether in Westminster or devolved. It is interesting to note that Defra's consultation its Natural Environment policy relates only to England.

<sup>18</sup> Resilience may be a matter for local decision dependent on the circumstances but within national guidelines about how to decide. The latter are required on grounds of efficiency – cross sector and inter-regional resource allocation.

<sup>19</sup> Such as that which might arise from a change in the scope of competition in water services.

<sup>20</sup> It will be necessary for Defra to resolve the position of the WFD for PR14 and possibly to re-balance the contributions that fall on water customers and others.

<sup>21</sup> The other possibility is that, as some commentators (Helm) think, Ofwat has provided for generous returns. The survey results do not support this view.

<sup>22</sup> *Changing course*, Severn Trent Water, April 2010

<sup>23</sup> *Future Price Limits – Risks and Incentives: Option Appraisal*, Europe Economics

<sup>24</sup> *Beyond Limits*, Ofwat July 2010

<sup>25</sup> Ibid.

<sup>26</sup> Ibid. - various pages

Because of the way in which incentive mechanisms move risk between shareholders and customers, there are relationships and trade offs which make incentive design problematic, for example

- Stronger efficiency incentives are likely to lead to higher levels of economic rent to shareholders
- Limiting price volatility for customers will also limit the efficiency incentive

Any material change in incentives will affect the cost of capital but it is not obvious how

Symmetry of incentives, while much discussed is hard to achieve in practice and has little precedent in theory or application

Financial and reputational incentives are often deployed together and as a result, there is no compelling evidence about their relative effectiveness. Theory suggests that reputational incentives may become more powerful with the introduction of competition.

<sup>27</sup> Severn Trent Water, op cit