INDUSTRY COMMENT

NEW MARKETS: SHORT TERM COSTS AND LONG TERM GAINS

Economic Insight's Sam Williams explores the case for allowing for additional costs in new markets if they are necessary to reap long term rewards.

TWR comment:

In February this year, Severn Trent published a report by Economic Insight examining the key issues relating to how any future price control for the retail household market in water might be set. One of the issues identified in the report is that the nature of costs incurred in liberalised markets can differ from those in regulated monopoly markets; and that in some cases, "additional" costs arise - even if in totality, costs are reduced. Given the future direction set by Ofwat in its Water 2020 policy, with a strong emphasis on a greater use of markets in areas such as sludge, we asked the report's author – Sam Williams – to expand on this theme.

In economics, the benefits of competition are long-established, their origins being traceable right back to Adam Smith. Indeed, a belief in competition's ability to help deliver lower prices, improved services and foster innovation is at the core of regulatory and competition policy in most western democracies. This has influenced the evolution of regulatory frameworks in two main ways over time: (i) a general preference to use competition, and liberalise markets, in place of formal regulation where possible; and (ii) where regulation is required, for it to be increasingly "principles based", where the goal is to create incentives, instead of imposing a command and control approach.

However, competition does not conform to any one simple, neat, model. In fiercely competitive markets there can still be winners and losers. Similarly, economic profit might arise for limited periods of time, but may not persist. Also, products, services and costs of providers should not necessarily be expected to converge over time.

From a regulator's perspective, the questions of "when" and "how" to help facilitate competition in markets highlights another well-known issue: the trade-off between static and dynamic efficiency. This matters because, in a competitive market, firms (and other agents) often have to undertake activities they would not have to absent competition – and these activities may themselves drive costs. Similarly, there may be costs associated with the establishment of the market itself. Therefore, it is easy to envisage circumstances where, whilst competition has the potential to deliver net benefits overall, this includes the recovery of some additional costs.

In our report for Severn Trent, we identified the need for companies to invest in their brand (via marketing) to support customer acquisition and retention activities. We noted that: (i) by definition these costs have not been incurred historically, because monopoly providers do not need to undertake such marketing; (ii) consequently, there has been no explicit allowance for these costs in previous price controls; and (iii) yet in a competitive environment, retailers will need to be able to recover them in order for a market to be viable. Our report noted evidence that these costs can be material and that other regulators have made explicit allowances for similar costs in the past.

Additional capacity

If we apply the same above principles to Ofwat's proposals in relation to how future markets for bioresources (sludge) might function, what additional costs may arise? Ofwat's May publication included an impact assessment that identified: costs to companies of information provision to support any sludge market information platform; costs to companies of separate price controls, including ensuring accurate accounting separation; one-off costs of revaluing sludge assets; and regulatory costs to Ofwat of running a separate price control for sludge. However, our area of focus here is the extent to which companies (and other players) might need to behave differently, and accordingly undertake different activities, relative to the status quo – and in turn, whether these might result in any additional costs. One obvious area for consideration is the question of the capacity required to support trading.

Here, the start point is a simple one: that for trades to occur, there needs to be spare capacity somewhere in the system. However, at present it is unlikely that this spare capacity exists to any material degree – primarily because the prevailing regulatory approach by definition should only have funded the companies for the investment and costs required to meet their own individual needs. As an important point of clarification, one should not confuse the headroom required to accommodate operational outages with spare capacity that could be used for trades. This is because, to the extent that companies need to carry some headroom for operational reasons, this need will persist in future – and so trading capacity will invariably be over and above this. This view is borne out by the findings of the OFT market study from 2009. The OFT found that, on average, spare capacity across the WaSCs averaged 20%, but that: "operating headroom... amounted to around 13 per cent of the total." In other words, genuinely spare capacity (of the type that could be utilised to support trades) was, on average, just 7%.

It is further important to note that how companies manage the need for operational headroom at present is likely to vary materially. For example, access to landbanks for the purpose of recycling bioresoures is a critical issue. As the availability of suitable land varies substantially across England and Wales this has knock on implications for how companies will have configured their networks in order to manage operational outage related headroom. In simple terms, companies with smaller landbanks and/or fewer reconfiguration options might need more capacity or storage facilities to achieve an equivalent level of operational headroom. The implication is even if a company appeared to have more headroom than was needed for purely operational reasons (and so, one might infer, could have trading capacity) this might not, in fact, be the case.

Following from the above, it seems reasonable to assume that capacity will be required in order for trades to develop and so realise the potential benefits identified by Ofwat. The raises a number of questions, not least whether this invariably gives rise to any additional costs. From a long-run perspective, one could argue that capacity is fully variable. In addition, the total amount of bioresources that will require treatment, transport and disposal will be unchanged under a more active trading market. Consequently, seen through this long-term lens, when thinking about England and Wales as a whole, it may be reasonable to assume that there is no need for additional capacity (and therefore any associated additional costs) relative to the counterfactual of the prevailing limited examples of bioresources trading. Indeed, the aspiration behind Ofwat's proposals is that additional capacity is added where it is most efficient, rather than being delineated across company boundaries.

From a short-term perspective, however, it would seem logical to suppose that additional capacity (and therefore cost) will be required. That is to say, companies have already made decisions about how to configure their operations today, and have made investments that reflect this. Relatedly, existing installed capacity cannot be easily reduced in a continuous manner in order for it to be viable to outsource sludge treatment to a more efficient company, an effect that would be magnified by scale economies. Consequently, in order to realise any trades in the nearer term additional capacity over and above the counterfactual of no increase in trading, would seem to be essential.

Short/long term links

Critically, the short and the long term might be connected. Consequently, without any funded uplift in capacity in the short term, the overall gains from trades may be more limited and/or may take longer to accrue. This is best illustrated with a highly stylised example. Assume we start from the status quo of no, or very limited, spare capacity. A sludge treatment site currently operated by WaSC A is coming towards the end of its life and this, coupled with population growth, means WaSC A needs to expand its bioresources capacity over the following plan period. It believes neighbouring WaSC B may be more efficient at undertaking treatment, transport and disposal, and so before determining to self-build, enters into preliminary discussion.

However, at the time at which WaSC A requires additional capacity, WaSC B will not have any. Therefore, the outcome of the discussion turns on whether it becomes viable for WaSC B to develop the new capacity itself on behalf of WaSC A, and whether it has available sites and resources that could be used for this purpose. In this instance, let us suppose the volumes WaSC A wishes to outsource to B are simply too small to make the development viable, given WaSC B's own internal resource requirements. The outcome is that the trade does not occur and WaSC A self-builds. In turn, this could also preclude longer-term trades because, having self-built, the avoided costs to WaSC A from outsourcing will be more limited.

Of course, even if the market did follow a pattern similar to the above, this is not to say that long term trading would not develop at all. However, the scope of it would seem to be reduced – and/or it may take a long time. This is because it is dependent on there being a coincidence of requirements and capabilities between WaSCs at similar points of time in nearby geographies. It might also suggest trading would only arise in relation to "incremental" demand (i.e. no benefits would accrue in relation to existing volumes of bioresources) and so would only develop at a pace in line with population growth.

In short, a key difference between water resources and sludge is that, in the former, there are already large differences in supply across the companies (and areas of "excess" supply) because it is a function of geographic, topographic and environmental factors. Whereas, in bioresources, supply simply reflects demand in each company's area.

Beyond bioresources

The specifics of the issues described here in relation to bioresources are by no means clear cut. However, they illustrate an important wider point: that there are often entirely legitimate reasons to suppose that changes to how markets operate (particularly in relation to liberalisation or a greater role for competition) can give rise to additional costs.

Even more importantly, these costs can relate to activities that are essential for markets to develop in the first place – and so without them, the intended longer-term benefits may never arise. The appropriate policy response clearly needs to be determined on a case-by-case basis. However, there are some general points of principle that should always apply:

- *Firstly, that the right way to proceed should be to develop robust evidence as to what these issues and costs might be and evaluate it transparently with care. For example, it might be that some costs may be immaterial to the successful development of markets, or can be recovered through efficiency savings, rather than being funded through prices. However, determining this still requires those costs to be identified and quantified as robustly as possible.*
- *Secondly, that the customer harm arising from the regulatory failure risk of setting "too high" prices in the short run (static inefficiency) should be expected to be lower than the customer harm of the regulatory failure being that "the market never develops" or "develops to a more limited degree" (dynamic inefficiency).*

In summary, in a sector where focusing on the long-run has (rightly) been an increasingly prominent theme in recent years, the risk of an overly narrow focus on short-term cost minimisation remains.

Sam Williams is a director of Economic Insight.

Don't spoil the ship...

It seems short sighted to disallow short term cost increases if they are genuinely necessary to lead to long term gains – particularly in a world where the thoughts of policy makers are increasingly turning to the longer term.

Sam Williams ably sets out the arguments as they apply to a sludge market. Ofwat's Water 2020 quantification of sludge trading benefits assumes no capacity constraints. These benefits may not materialise – at least quickly – if additional capacity is required to chivvy the market along but remains unfunded.

The arguments can be applied to other markets, too. Take non household retail. Ofwat has not allowed for marketing or customer acquisition costs in default tariffs, stating companies can recover these through improved efficiency and innovative pricing. This will help keep immediate costs down, which is welcome, but not perhaps if the price is a sluggish market because innovation and efficiency savings prove elusive.

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