

INDUSTRY COMMENT

GETTING THE HOUSE IN ORDER

Sam Williams and Aastha Mantri welcome the Industry and Regulators Committee’s diagnosis of water’s problems, but question some of the recommended solutions.

There is an interview question we sometimes like to ask at Economic Insight: if the scarcity of water is increasing over time, why has the regulated price been falling in real terms? Economics can be made to sound complex; but, in essence, it often isn’t. As economists, rather than hydrologists, we wouldn’t claim any great knowledge of the water cycle. However, the total supply of water on Earth is, effectively, constant (other than over the very long run) whilst global population continues to grow. Efficiency and behavioural changes might, of course, be able to mitigate this somewhat. However, in the end, there’s no escaping the basic laws of supply and demand.

In that sense, the House of Lords report addresses a particularly large elephant, which has made itself rather too comfortable in an overly cosy room (prices must rise). This is to be welcomed.

What is also to be welcomed is the balanced way in which the report identifies shortcomings across the relevant water industry stakeholders, rather than seeking to paint certain actors as ‘heroes’ and ‘villains’, without nuance. It

cites companies needing to “dramatically” improve their practices, as regards to addressing pollution. It similarly finds that Ofwat has chosen to “keep bills low at the expense of investment”. The EA is called out for not sufficiently holding companies to account. Finally, the Government is criticised for not sufficiently engaging with the sector to secure future supply, and specifically for not giving Ofwat “clear guidance as to how it should balance and prioritise its duties”.

This shared responsibility feels like a reasonable position to adopt. Mainly because, whichever agent is explicitly responsible for certain decisions or behaviours in the past, all actors here are (to differing degrees) implicitly implicated in where we have ended up (and yes, economists are included in that).

Time and money

The report, however, perhaps finds itself on stickier ground when it moves into recommendations for how things can be done better in future. In terms of the role of Government and Ofwat,

and the issue of prioritisation, the report recommends that Government should make clear to Ofwat that it must meet SPS priorities; and furthermore, should “provide a clear steer to Ofwat on how to balance its priorities, particularly in relation to the need to ensure higher levels of infrastructure investment.”

This is problematic for a couple of reasons. Firstly, rather than there being trade-offs across Ofwat’s duties, the issue is perhaps more accurately characterised in terms of there being a question that applies equally in relation to all of the duties. Namely, what is the time period over which Ofwat should seek to achieve them? For example, the consumer objective merely requires Ofwat to “protect the interests of consumers”; leaving it open as to how one balances the interests of ‘current’ and ‘future’ consumers. Similarly, the financing duty requires that companies can “finance the proper carrying out of their statutory functions”; but again, the balance between financeability ‘now’ versus the ‘future’ is left open. There is, then, no tension between these two duties (in fact, they are mutually reinforcing). The difficulty is that both require judgment to be exercised as to the timeframes.

The above leads to the second problem under this recommendation: perhaps no one wants to be responsible for making that judgment, particularly if it means bills increasing. The suggestion that Government should take this on may quickly run aground. Governments work to five-year electoral cycles. Their priorities and

decision-making reflect that. It is fundamentally hard to incentivise politicians to make decisions that are objectively best for the long term (that’s democracy, for you). It is therefore somewhat hard to imagine Government wanting to get too involved in the functioning of an independent sectoral regulator.

Similarly, Ofwat itself (as said independent regulator) may have mixed views on the extent to which this is Government’s, rather than its, responsibility. One might equally note that (as with any company) management teams and investors in the water industry may face short-term incentives, which trump longer-term considerations.

In short, a time-inconsistency problem arises across all of the stakeholders to some degree. Objectively, we can all see that we ‘should’ care about the long run. However, ultimately decisions must be made by individuals, who face incentives with a rather shorter-term horizon.

What does this mean? In our view, whilst perhaps a stronger steer from Government (as regards greater investment) would help, ultimately as the independent regulator, it intuitively feels that this challenge sits mainly with Ofwat. If the economic value of water is increasing over time, so must prices; and the regulator must develop an approach that reflects that, whilst still (rightly) driving efficiency.

There is a related interesting question around whether companies and their investors can similarly be better incentivised to take a longer-term view. Perhaps executive pay can be structured both to

attract and retain executives committed to delivering performance over the long term for companies (and only rewarding them for doing so).

Similarly, there are various tools that could perhaps better attract longer-term investors into the sector (for example, one could consider whether there is too much flexibility around capital maintenance profiling and fast / slow money ‘judges’). Clearly, such changes may put certain individuals and investors off from getting involved in the water industry; but that’s the point.

Delivery difficulties

Another recommendation that seems problematic relates to ‘how’ the report envisages increased, large-scale, infrastructure projects should be delivered in future. There are a couple of dimensions to how the report sees this occurring, which it is helpful to distinguish between.

Firstly, the report finds that “more of the sector’s investment will need to take place outside of the (existing) Price Review process in future.” This seems a sound conclusion, in the sense that the risk-reward balance and incentives that arise under the current regulatory method appear ill-suited to delivering certain large-scale and long-term investments. Indeed, this is consistent with our report for Thames Water, early on in the PR24 process, whereby we concluded that “there is a compelling case for a differential regulatory approach to apply to large and complex (investment) projects”. Here, we highlighted that such projects are prone to significant budgetary and delivery risks, the controllability of which is hard to ascertain ex-ante, or assess ex-post. Thus, we advocated a differential regulatory approach, under which there were limits to risk exposure (both for customers

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and investors) to help secure the delivery of much needed investment over the longer-term.

Secondly, however, the report also advocates for the delivery of such projects being increasingly subject to competition (with assets built, operated and owned by entities other than the regulated incumbent companies). This recommendation has the potential to be more problematic, if we are to really drive better outcomes over the long-term (and avoid repeating previous procurement mistakes in infrastructure). A critical issue here is, not so much that there may not be benefits to competition; but, rather, that these have been somewhat conflated with other factors.

Starting from the ‘in principle’ benefits of competition, the activities associated with the development of new assets have always been subject to competition (even where the incumbents design; build; operate; and own them). Companies go out to tender, drawing heavily on the UK’s construction industry. So, the benefits of competition should, to a degree, already be there.

Of course, there may be incremental gains if, for example, one believed that company procurement processes could be more effective and / or if the scope of what is competed for is increased. Those seem like reasonable considerations (and, as such, an ‘open competition’ based model, in

which incumbents and other entities are able to compete across a spectrum of activities, is one we ourselves outlined in our report for Thames).

However, it is concerning that comparisons of financing costs and outcomes between (for example) Thames Tideway and other incumbent investors are themselves positioned as evidence of the benefits of competition. This is disingenuous. The regulatory model (and thus, risk-reward balance) faced by investors was fundamentally different under Tideway than that faced by investors in incumbent companies. This is not to say that Tideway isn’t a good example of how a differential regulatory model can succeed (it is); but this should not be conflated with the benefits of competition.

The above is related to a more material concern that should be on our collective radars, under the House of Lords’ recommendations. If the delivery of future investment (and ownership of critical water infrastructure assets) is increasingly put in the hands of entities other than the incumbent regulated companies, the potential for moral hazard appears not insignificant. History has surely taught us that, if something is essential to society, ultimately, the risk always sits with taxpayers (or customers). As we previously commented for The Water Report, is this not just PFI, all over again?



Sam Williams is a director, and Aastha Mantri an associate director at Economic Insight.

So, in short, whilst a differential regulatory approach to large-scale investment is (in our view) to be welcomed, the presumption that this should also go hand-in-hand with non-incumbent delivery requires careful deliberation, if we really want to avoid short-termism (i.e. bid low; win the contract; but never face the risk).

Support for support

Finally, alongside the report’s clear finding that bills “have to increase”, the recommendation that there should be more support for customers that need it, is welcome. Work towards a single social tariff is, of course, well underway (and certainly greater commonality would seem to have some advantages). Whilst there is a clear need to correct the intemporal trade-off moving forwards, we can surely ensure that those in society who are most vulnerable are protected, whilst doing so.

In conclusion, a public articulation of where we may have gone wrong is an excellent starting point, and one the Industry and Regulators Committee deserves credit for. By resisting the temptation to attribute blame to any one party, the Committee has also paved the way for a more constructive dialogue across stakeholders, and makes change possible without anyone feeling that this represents a concession, or admission of guilt. The solutions, however, continue to raise questions.

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