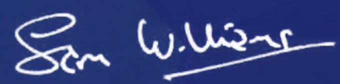
OUR VISION FOR A FUTURE REGULATORY MODEL FOR THE WATER INDUSTRY IN ENGLAND AND WALES

The water industry in England and Wales stands at an important junction. Not since the establishment of the original RPI-X model (a happy accident of the BT Buzby Bond) has there been such an opportunity to rethink the way in which the UK finances, regulates, and delivers this vital and scarce resource. Nor, in light of increasing evidence of dissatisfaction amongst customers; investors; those working in the sector; and politicians, has there been a more pressing need for change.

Having had the privilege of working with all key stakeholders in the industry over decades, it is a subject matter we care deeply about at Economic Insight. We are therefore delighted to make this submission to the Water Commission Review, Chaired by Sir Jon Cunliffe. In the spirit of our recommendations, which include a call for simplicity, we have kept our response brief.

We hope the Commission finds it helpful.



Sam Williams, Director

SUMMARY

The existing regulatory model should be replaced with one that delivers:

1. A longer term approach that ensures appropriate investment and asset maintenance.

- Tramlines for investment, which must be: (i) funded within regulatory determinations; and (ii) spent by companies.
- Abolish the totex approach, or remove ability to flex the form and speed of cost recovery under the totex approach.
- Minimum term appointments for senior industry stakeholders.

2. Consistency and predictability.

- High hurdle for reforms of the regulatory framework, once the new model is established.
- Hard limits on regulatory discretion within the model.

3. Simplicity.

- Narrower focus on aggregate efficiency and outcomes.
- Rationalisation of regulatory duties.
- Smaller-scale, more efficient, regulator.

FUTURE MODEL

A LONGER-TERM APPROACH THAT ENSURES APPROPRIATE INVESTMENT AND ASSET MAINTENANCE

A key feature of the water industry is the need to continually reinvest in, and maintain, long-term assets. A challenge this gives rise to is that it is inherently difficult to distinguish between cost efficiency savings and cuts or deferrals in investment and maintenance (because the negative consequences of any cuts or deferrals for customers may not become visible for decades). This challenge remains unaddressed under the existing model.

The key limitations of the existing regulatory model causing this are:

(i) An absence of any method for: determining what the appropriate amount of overall investment and maintenance should be; ensuring regulatory determined revenues are consistent with that; nor then ensuring said investment is made.

(ii) The totex regime allows stakeholders to flex how, and the speed at which, costs are recovered. This flex allows long-term affordability and underinvestment problems to be masked, because short-run bills / cash flows can be made to appear sufficient.

(iii) Inadequate attention being paid to key financial indicators relevant to spotting long-term underinvestment problems: depreciation rates; ratios of investment and maintenance to totex; average asset age; real capex per head of population.

(iv) An increasingly siloed approach to considering costs and outcomes, whereby an incorrect assumption has arisen that individual outputs / outcomes are funded or promised, and that individual cost categories are linked to them. This fails to reflect the trade-offs inherent in a network industry.

(v) Incentives for companies to agree with the regulator, rather than challenge it (both within the price control process and via CMA redeterminations).

(vi) Insufficient long-term incentives on key senior stakeholders within the industry.

SOLUTIONS

1

Tramlines for investment, which must be: (i) funded within regulatory determinations; and (ii) spent by companies.

Whilst it is essential to ensure the new model delivers appropriate investment, there must also be honest recognition that determining the optimal amount of investment for the long-term is impossible. Therefore, a pragmatic approach is required that sets tramlines for investment and maintenance, based on transparent anchors (such as investment and maintenance ratios observed in other countries with the desired asset quality). From that starting point, the model should then: (a) ensure regulatory determined revenues include allowances for investment / maintenance consistent with the tramlines; and (b) require companies to make total investment / maintenance in line with this (e.g., no outperformance rewards or penalties for over or under spending in this vital area).

2

Abolish the totex approach, or remove ability to flex the form and speed of cost recovery under the totex approach.

The totex regime should either be abolished, or the ability to continually revise the form and speed of cost recovery (changes to the pay-as-you go and RCV run-off rates) within it should be removed. A well-run and well-regulated infrastructure industry should not require these mechanisms to deliver cash flow sufficiency or affordability over 5-year time horizons.

As a matter of principle, remove the ability of regulators to incentivise agreement with their method and decisions.

3

Minimum term appointments for senior industry stakeholders.

Consider whether senior management appointments at the regulator / companies should be minimum term appointments that span more than once price control, with remuneration including strong long-term incentives.

CONSISTENCY AND PREDICTABILITY

The regulatory model has been continually reformed since privatisation. These reforms have occurred at both the overall design (e.g., shift to totex, introduction of ODIs and PCDs); and detailed method (e.g., efficiency benchmarking models) level. This is inherently damaging in a context whereby long-term investment is essential, which itself relies on investors being able to:

(i) assess the overall risk and return balance over multiple price control periods; and

(ii) trust the regulator not to make policy changes that revise the risk-reward balance after the event.

Whilst there are benefits to being able to reform regulation over time, the costs of constant revisions have been understated. Those costs take the form of both deterring investment and, concerningly, further encouraging short-termism (i.e., a lack of consistency and trust will logically induce investors to take cash out, when possible, and discourage responsible long-term investors from entering, or remaining in, the sector).

Furthermore, even when assessed on their own terms, it is questionable as to whether some of the implemented reforms have delivered meaningful benefits, but they have certainly been costly (e.g., retail competition for business customers, a reform akin to requiring all large companies outside of regulated sectors to outsource their billing and customer service functions).

SOLUTIONS

1

High hurdle for reforms of the regulatory framework, once the new model is established.

Once the new regulatory model is established, there should be a high hurdle for any fundamental reform in future. A standard consultation process, which affords regulators unfettered discretion to make any changes they wish, provides insufficient incentive to only propose high quality, considered, reforms that will be genuinely beneficial to customers over time.

2

Hard limits on regulatory discretion within the model.

In addition, regulatory discretion on method when implementing the framework at regulatory determinations should be materially reduced. For example, it should not be possible for regulators to continually revise efficiency benchmarks, nor the basis for setting outcomes target levels, at each price control. Indeed, the continual detailed revisions of benchmarks itself suggests the model is not fit for purpose at a more fundamental level.

A SIMPLER APPROACH

When the industry was privatised in 1989, the early price controls were transparent and easy to understand. The current model is opaque and complicated. This includes a proliferation of price controls, moving from a single end-to-end price control (at PR99 and PR04) to six separate price controls today. This complexity has contributed to a lack of focus on the underlying rationale for, and objectives of, regulation.

Over time, Ofwat has greatly increased in size and cost. This has likely contributed to the complexity, as the regulator's expansion has created capacity to create new incentives and methods, with existing ones rarely being retired.

There has also been an increase in the number of statutory duties placed upon Ofwat. This has made the regulator's job harder and has been misguided, conflating a belief that additional duties will help steer the sector to a better overall outcome with the actual problem: inappropriate interpretations of the existing duties, due to too much regulatory discretion. The debate around investability provides a good example of this: the original financing duty, correctly interpreted, always required efficient companies to be investable.

SOLUTIONS

1

Narrower focus on aggregate efficiency and outcomes.

The new model should focus on just two things: (a) ensuring appropriate long-term investment is allowed for, and occurs; and, subject to that: (b) incentivising performance around aggregate cost efficiency and overall outcomes performance. With this narrower focus, the number of individual incentive mechanisms should, logically, greatly reduce.

2

Rationalisation of regulatory duties.

The statutory duties placed on the regulator should be rationalised, being more in-line with those at privatisation and reflecting a more focused approach.

3

Smaller-scale, more efficient, regulator.

Ofwat, or its replacement, should be a considerably smaller organisation with a budget in line with that it originally had at privatisation (adjusted for inflation). Billpayers should get value for money from the regulator.