

A Response to the Interim Report of the Independent Review of Charging for Household Water and Sewerage Services (The Walker Review)

Incentives: Affordability: Public & Private Goods: Constructive Engagement & Choice for Customers: Metering & Tariffs and Debt & Disconnection

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Incentives and Market Instruments or command & control?

There are two threads running through the interim report. One talks about incentives and signals – a market for water resources (abstractions and discharges, not forgetting the latter), hence the value of water, metering as an incentive to economy, tariffs as balancing incentives to economy and incidence affects, the economic (including externalities) level of leakage. The other talks about command and control – e.g. the government tells us that we should not use > 140l/day and that abstraction rights should be removed irrespective of the wishes of the people, and suggests a distinction between outside and inside taps. There is a strong case for relying, to the greatest extent possible, on incentives and market signals. This would both allow for objectives, both customer and environmental, to be achieved more effectively and more economically, allow for choice and would take better account of the local and regional variations in the supply of these services.

Affordability

“Affordability” is not a precise word and could never be given precise operational significance/capability, as, e.g., 3% of income. Where the “affordability” issue is most acute, in the south-west, the bills are paid to a greater extent than in some areas; what is not affordable is afforded. (This would be worth illustrating.). Does “water- poverty arise when people can’t pay their water bills or when they can’t buy other things? “Water poverty, fuel poverty, ?food poverty, ?travel poverty, are unhelpful unless set in the wider context of poverty.

¹ This note is a purely personal contribution and no responsibility rests on the Water Industry Commission for Scotland, nor, of course, on the Water Services Authority (the present incarnation of Ofwat)

High water bills reduce the scope for spending on other goods and services that are thought to be so important that without them people fall towards or below some “poverty line”. So the effect of rising water (and for that matter, energy) bills is to reduce the income available for other necessary goods and services; the issue is pushing people into poverty or deeper poverty.

Poverty is more restricted than “affordability”. The social security system is the sharpest option for the relief/alleviation of poverty. Yet successive governments have been reluctant to use it in this area, preferring to create new ad hoc schemes such as WaterSure, especially when financed from water customers and not from general taxation. It would be better to recognize that there are two separate, if related issues, one that some people are pushed into/deeper into poverty by specific price increases and the other that a rising bills for an essential commodity/service leads to wide resistance from the consumers of that commodity/service.

If the problem is that rising water bills create poverty, the issue would be best addressed at source. It would be possible to introduce a regional differential in the scales for calculating social security benefits; that would be helpful for the relief of poverty. It would be a more efficient instrument than WaterSure. Any extension of WaterSure, should depend on the introduction of a regional differential in social security scale; to do otherwise would draw a non-elected regulator into decisions best made by politically accountable ministers.

But whatever is done in this area would, and, indeed, should, not be enough to deal with all the genuine concerns expressed around the notion of affordability.

Public & Private Goods & Services

The Interim Report makes an important distinction between public and private goods.² But while it sets out a useful series of arguments, it does not take them far enough. The discussion unfortunately begins with the statement that “In the main, water and sewerage services have the characteristics of normal goods and services – i.e. they are delivered to those who benefit and those who don’t pay can be physically excluded for consuming them.” Yet the majority of the expenditure since privatisation has been undertaken to improve treatment, with wide environmental benefits.³

² Foreword, page 1 “who should pay for environmental improvements from which all customers benefit.” : Executive Summary xxi : Chapter 3 paras 3.3.1 to 3.3.19. pp. 10 & 53-56

³ See, eg Water Industry Commission for Scotland *The Strategic Review of Charges 2010-14: The Draft Determination* Staff Paper 12 Update on value chain analysis, and calculations by Ofwat of the X and Q components of the K factor at successive price reviews

The conclusions⁴ set out in Chapter 3 are scarcely adequate. Incorporating the effects of new legislation on customers' bills into impact assessments of new legislation should be done, but is not sufficient. Many new obligations placed on water companies derive from existing legislation and it is necessary to ensure that there is specific costing of the effect of EU obligations before decisions are made about their application in the UK.⁵

In Chapter 11 the Interim Report does, however, draw attention to the use of Participatory Budgeting used by a range of public agencies round the world.⁶ The Interim Report⁷, recommends further exploration of this approach. This should be linked to the discussion in Chapter 3.

These issues are critical to the future of water regulation, and can play a crucial part in developing a more transparent and more participatory approach to water quality and environmental issues. Sufficient attention must be given to these issues in the final report, and, if necessary, it would be well worth delaying the final Report to deal with them adequately.

This note illustrates how participation could be taken forward, building on i) the cost of quality⁸ calculations undertaken for the guidance given, in the course of a price review, by UK ministers to Ofwat, on water and environmental quality obligations in England & Wales, ii) the analyses that underlie the ministerial directions set by Scottish ministers at a strategic review of charges, and iii) the steps taken by the CAA to develop constructive engagement in the regulation of airports and on the general experience of participative budgeting.⁹

Transparency/ Constructive Engagement/ Participatory Budgeting

Greater Participation & Engagement

This proposal, essentially, picks up initiatives of the past, such as the cost of quality debate and develops thoughts about how emerging techniques of

⁴ Executive Summary, para xxii, and Chapter 3, para 3.3.19

⁵ It is critical to lobby hard to ensure that the institutions of the European Union take proper account of compliance costs in framing Directives. Such costing should also form the basis of an empirical assessment of benefits. Such work has been neglected in Brussels, leading to the adoption of Directives that UK officials insist are mandatory and require no cost or benefit analysis before implementation. This imperfect process has been to the detriment of customers.

⁶ Para 11.10.3 p. 164

⁷ para 11.10.4, p. 164

⁸ See Ofwat, *The Cost of Quality 1992 & Paying for Quality: a Political Perspective 1993*

⁹ The logic of the public:private goods distinction also points to an approach whereby the provision of public goods was paid for by the taxpayer and that of private goods by the consumer. But in practice, both the present position on public finance and the practical problems associated with a precise and unambiguous allocation of obligation in to those with public and private purposes may rule out immediate implementation, without jettisoning the prospect of further consideration on a further occasion.

transparency, participation and social decision-making could be integrated into the regulatory system¹⁰, supporting rather than prejudicing the role of the economic regulator. At its heart lie two proposals – first an improved process for the presentation and discussion of information and secondly, the presentation of information in an easily comprehensible way, for example, by looking at the effect of proposals in a comparable numeraire, e.g. consequences for annual average household bills – for customers as a whole, or for designated groups.

Incorporation of objectives for prices

Any satisfactory price review process requires a view about levels of charges. Levels of prices are too important, for reasons of affordability, and for wider reasons, simply to emerge from a long process of taking account of all the “issues” where final price limits emerge from the process. Many of these “issues” are subject to uncertainty of one kind or another, especially in relation to timing and are, or should be, influenced by the preferences of the various stakeholders.

Various base, or par, positions are possible, but there is no need, as sometimes asserted, to begin with a rising price scenario. Water bills do not have to rise – they would have fallen in the 1994 price review had it not been for the need to finance large capital expenditure on enhancements to water and environmental quality. They fell at the 1999 Review, despite the allowances in price limits for the finance of the continuation of a large environmental programme. They are not rising, nor set to rise in Scotland even though Scottish Water has the largest per-capita capital programme in the kingdom and where a commercial rate of return on capital has been used to set price limits. They will not rise in England & Wales from 2010 to 2015. Both the privatisation and 2004 Reviews are outliers.

Pressures, costs & prices

There is no doubt that there are many pressures for higher costs, and for higher prices in the water industry. But there is considerable scope for greater efficiency in the water businesses and such pressures can, and should be managed with the consumer interest in mind. And comprehensive and objective analyses should be done before conclusions are reached.

Much emphasis is today put on climate change – whatever that may mean. Yet there is huge uncertainty in this area and the costs of sensible policies are well below those championed by some of the activists.¹¹ A recent paper, for example, by Gordon Hughes, Professor of Economics at Edinburgh University, indicates that the cost – in both the water and energy sectors – of adapting to climate

¹⁰ See Stephen Littlechild *Constructive Engagements & Negotiated Settlements* 2008

¹¹ See e.g., House of Lords Select Committee on Economic Affairs “*The Economics of Climate Change*” 2005-06: William Nordhaus *A Question of Balance* 2008 Nigel Lawson *An Appeal to Reason* 2008

change is relatively small.¹² This may reflect the general consensus that climate change is likely to be beneficial – at least in this half-century - in temperate zones.¹³

The desire to achieve new outcomes and increase outputs need not increase either costs or prices.¹⁴ The introduction of competition to the water services should reduce costs – as it has in Scotland. The introduction of market competition as recommended by the Cave Review¹⁵ would put much greater pressure on companies to reduce costs by undertaking their functions in more economical ways; currently there are perverse incentives on companies to seek solutions that are biased towards capital expenditure. This interacts with government's wish to avoid increasing public expenditure by imposing water and environmental quality obligations in ways that involve increased costs to customers; where this involves achieving public objectives these are forms of "stealth tax".

There is scope for going much further to emphasise the wider value of economic pricing to provide more incentives to enhance customer service and environmental quality. The Interim Report rightly draws attention to the discovery of the value of water, but does not draw all the implications that it should. Trading in water could save costs compared with the construction of new reservoirs, such as Thames Water's proposed Oxfordshire scheme.¹⁶ The development of retail competition, linked with reform of the special merger regime could lead to significant reductions in the costs of achieving environmental and customer benefits

The Interim Report also runs the risk of imposing new obligations expensively though command & control techniques rather than using incentives and market instruments to achieve the results more economically. Competition and economic pricing would also do much to improve customer choice in water services.¹⁷ Strengthening competition, pricing and choice would weaken the cost-plus

¹² Gordon Hughes et al. *Adapting to Climate Change: Results for Electricity and Water in OECD Countries*

¹³ Richard S. J. Tol "The Economic Effects of Climate Change" *Journal of Economic Perspectives* Spring 2009, Vol 23, No. 2

¹⁴ See Alan Sutherland *Improving the affordability of water charges* August 2009

¹⁵ *Independent Review of Competition & Innovation in Water markets* Professor Martin Cave April 2009

¹⁶ See, e.g. Tony Ballance in Balance, Byatt, Cave, Palmer & Sutherland *Innovation, Incentives and Competition; a new deal for the water industry* European Policy Forum February 2009.

¹⁷ It is vital to build on the work now being carried out by the Environment Agency and Ofwat to lay the foundations for trading regimes for water abstracted from and discharged to the environment. This will involve valuations for different volumes of abstractions and different volumes and strengths of discharge. Discussions on the value of water have sometimes neglected full discussion of the value of waste-water, the trading of discharge consents and the contribution that this could make to the management of rivers. It will also require changes to current charging mechanisms used by the Environment Agency and could have beneficial implications for public expenditure.

approach that leads to ever greater capital expenditure and for evermore onerous interventions.

The neutral base, starting or par, position in any price review should be that the K factor should not exceed zero, i.e. that before considerations of quality enhancement, tariff balance and greater efficiency are addressed, household bills should rise by no more than the rate of inflation. To address the arguments that point to rising or falling real/inflation household bills requires the expertise of expert bodies, such as the quality regulators¹⁸, the economic regulator,¹⁹ the consumer representative bodies,²⁰ and, in some cases, ministers. Each group could put forward proposals for enhancement of water and environmental quality, standards of service, tariff rebalancing, greater efficiency and the appropriate return on capital²¹. Such proposals should be framed within proposals for promoting competition where it is to the benefit of customers.²²

Enhancement of water and environmental quality

The quality regulators should take the lead here, drawing, as appropriate on ministerial policy at both national level and that of the European Union. As they typically do not have the resources to cost their proposals they must look to the water companies and, where they wish to, seek advice from the economic regulator.

Policy proposals must be costed and the arguments to support their adoption clearly set out, whether in the form of a cost benefit analysis, or in a less structured way.²³ The key, however, is that all proposals should be treated fairly on a level playing field. If this is to be done properly, open-ended commitments, not properly costed, must be avoided, whatever their superficial attractiveness.²⁴ Such costing must also include any wider effects after consideration of possible unexpected consequences.²⁵

¹⁸ The Drinking Water Inspector and the Environment Agency in England & Wales and the Drinking Water Quality Regulator and the Scottish Environment Protection Agency in Scotland.

¹⁹ The Water Services Authority (Ofwat) in England & Wales and the Water Industry Commission for Scotland (WICS)

²⁰ The Consumer Council for Water (CCW) in England & Wales and WaterWatch in Scotland.

²¹ Traditionally, the cost of capital relevant to the Regulatory Capital Value or Regulatory Asset Base (RCV or RAB)

²² In doing this a long-term view is essential; it could be sensible to link such consideration to the 25 year resource plans now undertaken by companies.

²³ There must be limits on the detail with which this is pursued. The guide should be the approach of Blastland & Dilnot, namely, "Size: Make it Personal". *The Tiger That Isn't* Michael Blastland & Andrew Dilnot, 2007

²⁴ See footnote 9 on page 3 above

²⁵ The 2005 Strategic Review of Charges in Scotland provides an apt example. In its 2nd draft business plan, Scottish Water set out a set of capital cost estimates that were some 50% above the costs incurred in practice.

Efficiency

It is to be expected that water companies would improve their efficiency over the period of a price review. So far, a combination of privatisation, better quantification and systematic comparisons of the costs of existing vertically integrated activities and their performance has led to considerable reductions in costs. There may be limited returns from continued pursuit of these techniques. The introduction of market competition, however, linked to vertical dis-aggregation of activities, would open up further scope for considerable economies in operation.²⁶

A neutral base, starting or par, expectation at the beginning of a price review could be that water companies would improve their efficiency in line with the trend improvement of efficiency in the economy as a whole.²⁷ During the course of a price review, this position would be modified as Ofwat undertook its efficiency studies.

Participation & Process

Price Review might, to an increasing extent, revolve round a dialogue focussed on the options for pursuing policies (additional obligations and standards of service) that might raise prices above inflation to customers and those (increased competition, greater reliance on economic incentives, technological and/or commercial innovation) that might reduce prices relative to inflation.

It would be worthwhile to spend more time on orchestrating such a dialogue, possibly at the expense of some of the details of regulatory analyses, for example reducing the scale of effort in the use of a battery of heavy econometrics. Such comparisons have been of great value in developing regulation, but may now have achieved their key objectives. It is also worth noting that as competition develops, accompanied by greater vertical dis-aggregation, the nature of such comparisons should change, shifting to a rather different kind of benchmarking.²⁸

The key stage of such dialogue could be the period between the first and second business plans. It may be appropriate to conduct some specific market research alongside such a dialogue. Such dialogue would be conducted on the basis of

²⁶ There was a significant increase in efficiency in the energy industries following the strengthening of competitive forces.

²⁷ One measure could be the trend increase in productive potential per capita as estimated by the Treasury and set out in Budget documents.

²⁸ See Ofwat letters to water companies, MD 142 *Benchmarking and Efficiency*, 17 November 1998 and RD 35/98, 28th October 1998, which distinguish between benchmarking of best practice by activity across all industries world-wide and econometric comparisons of costs of vertically integrated water services provided in the UK. Unfortunately little progress seems subsequently to have been made on this work.

the initial costings described above. In the final stages of the Review they would be adjusted when all necessary studies had been completed.²⁹

This note is based on the assumption (footnote 3, page 2) that customers will continue to pay the bills emerging from pursuit of public as well as private goods. The framework suggested in this note would also enable other forms of funding, such as direct government payment for the provision of public goods.

Metering - universal or selective?

The imposition of universal compulsory metering could be a political disaster – as could a compulsory switch to charging for surface water drainage by area. The situation in the water industry is more variable, by region, by area, by circumstances than in energy. Attempts to impose what seem to be sensible – and are sensible – policies in a blanket solution risks hiding problems that fester – and even multiply - under the blanket.

So metering should be encouraged. The differential between companies shows that different approaches are used; some have encouraged metering and achieved a high rate of household meter penetration; some have dragged their feet. Many companies do not like metering because of the revenue uncertainty – and some have deep cultural antipathy to it – and to the use of pricing signals more generally. It would be good to put a duty on Ofwat to encourage metering: but universal metering would cause problems. The idea of a “tipping point” strikes me as an attempt to impose bureaucratic tidiness rather than pragmatic common sense.

Government has to play its part. Michael Meacher’s decision to attenuate the power of water companies to insist on meters was damaging, partly because it removed the pressure from companies and partly because the government was dilatory in using its powers to “allow” compulsory metering in designated water scarce areas. Action may need to be taken to ensure that companies could insist on metering at a change of occupancy (meters for new properties, change of occupancy and optional metering would shift the average quite quickly).

Innovations may be required to deal with metering in apartment blocks and other multi-occupied buildings. The use of a common meter, giving occupiers and landlords the opportunity for subsidiary meters should be explored. The use of “assessed charges” by water companies, where it is alleged that metering would be difficult or expensive because of the construction of the building or the existing pipe network, should be checked, both by sampling and investigation of complaints.

²⁹ Ofwat should provide ready reckoners for the relative effects of current and capital expenditure on bills. For the “pre-efficiency” debate these ready reckoners would use the cost of capital used at the previous price review.

Meters must be visible to customers. Installation at the boundary of the property is often unsatisfactory. Moreover, internal installation would give householders an incentive to address any leakage on their properties. It also increases the scope for the use of smart meters when they become appropriate.

Tariffs are crucial; meters are necessary but not sufficient. Water companies like to have large standing charges and low volumetric rates – this contains revenue uncertainty. They argue for them on the dubious grounds that “costs are fixed”. But they are neither liked by customers nor environmentally friendly. Tariffs can, however, get quite complicated and if you recommend something specific, some one will dislike it - and claim to be disadvantaged by it. And with retail separation, the picture can change. So I suggest i) arguments against high standing charges and ii) recommendation for properly cost reflective (i.e. balance of fixed and variable elements such as are in place in Scotland, for standard wholesale charges to all retailers, with retailers free to do deals with customers – as in telecom & energy.³⁰

Debt, Disconnection & Pre-payment

Action needs to be taken on pre-payment devices. I do not believe that it would be politically feasible to restore to companies the ability to cut off non-paying customers. Conservative Ministers were not happy with the rise in disconnections in the early 1990s – although it proved possible to reduce the number significantly by regulatory action. Ofwat was subject to Judicial Review on pre-payment devices and lost, thanks to the drafting of the Disconnections Code.

It would be straightforward to permit prepayment devices that should work on time or quantity – to give choice for customers and protect those on RV charging. These devices might/should have a trickle device fitted to them so essential (public health) supply remained available even if the device was not charged.

³⁰ The structure of wholesale charges is designed to combine cost reflectivity with simple price signals that should reduce costs over the short to medium term. The structure takes account of Scottish Water’s evidence on the main drivers of the costs that it incurs in providing the various water and sewerage services that customers receive. Importantly, we have grouped these drivers according to those that can be influenced by customers through their annual use or their peak use, and those that cannot. This grouping is reflected in the volume charge, the capacity volume charge and the fixed charge, respectively. The first two charges provide simple signals to retailers and their customers to reduce their annual use or their capacity requirements. For large users, we have examined whether (and to what extent) Scottish Water gains from economies of scale. Water charges reflect economies of scale for large users, but there is no evidence of this for sewerage services. For numbers see Water Commission for Scotland website:- www.scotlandontap.gov.uk

These devices, which in the early 1990's were related to time not quantity, were voluntary and liked by customers.³¹

Regional & local variations: Whitehall size does not fit all

The regional and local elements are very important in water services; this militates against over-prescriptive “solutions”, and attempts to get into detail such as the distinction between inside and outside taps. The life of a DIY water plumber is less hazardous than that of a DIY electrician or gas plumber. “Smart” meters are all the rage at the moment, but water meters are often in damp chambers at the boundary of the property – in an unfriendly environment and not easy to read. They are more suited to a world of retail separation and internal metering than the world of the vertically integrated supplier disclaiming responsibility beyond the customer's boundary.

Generally, the industry needs a greater emphasis on the measurement of water flows and many more simple measuring devices/ meters, in all kinds of places – at sources of abstraction and discharge, and at various points in the network (leakage, optimal management of the network, etc.). This is all going slowly and a drive for smart metering in today's circumstances could allow companies to take their eyes off the ball.

Conclusions

Incentives and the use of economic incentives work much better than centralized command and control, both because their application is tailored to the situation and because they can achieve goals (water & environmental quality and customer service) more efficiently and economically.

The discussions of private and public benefits in Chapter 3 and of participative budgeting in Chapter 11 of the report should be linked to provide a useful point of departure for developing a much more transparent and participative review process which can lead to a full and frank dialogue before price limits are set. Objectives for customer prices should be introduced into these arrangements.

This would alleviate, but may not solve the affordability problem. It could be further enhanced by providing a platform for specific government contributions to the cost of pursuing social and environmental goals. It would also be wise to adapt the water element of social security payments to regional differences in household charges.

³¹ It could be sensible to give customers a right to such devices, linking them to the meter option. Such devices should not increase the tariffs payable by customers compared with customers paying on standard tariffs. The water devices of the 1990s did not involve this – unlike the regressive arrangements used in energy.

This more participative approach should be linked with the introduction of trading in water abstractions and discharge consents and with market competition and vertical dis-aggregation of the activities of water companies - as envisaged in the Cave Review.

The work being undertaken by the Environment Agency and Ofwat on the value of water – and waste water - should be vigorously pursued. It is the key to the better use of scarce water, the better operation of networks and the economics of leakage, and a good way to take account of regional variations.

Finally, throughout the process of a price review: companies should be encouraged to put more emphasis on their customers, by moderating their dividends and taking more account of customer's views and of the affordability of their water bills: and ministers and the quality regulators should be encouraged to ensure proper costing of their proposals for enhancing water and environmental quality and systematic analysis of their benefits. While a full cost-benefit analysis may not always be appropriate, it would be quite wrong to ignore objective analysis of costs and benefits. Price limits with adverse implications for affordability would not then simply emerge at the end of a long and apparently technical set of analyses.

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