Social Market Foundation: Lessons from regulation and future changes

London 10/03/10

Regulation of the water industry in Great Britain has greatly benefitted customers. But that does not mean that we can rest on our laurels. In the next few minutes I want to outline some lessons that I think can be learned from our experience and of future changes to regulation that we plan to implement in Scotland. It is for others to decide whether these lessons have broader application.

In England and Wales, where the industry was privatised in 1989, some £85 billion has been invested, customer service levels have improved markedly and thanks to the dramatic improvement in the industry's efficiency, bills are some £100 lower than they would otherwise have been.

In Scotland, where the industry remains in the public sector, we drew heavily on the performance of the privatised industry to set Scottish Water challenging targets. No-one would have believed the extent of efficiency that could be achieved by the water industry in Scotland – had it not been for the hard evidence provided by these benchmarks.

Over the past ten years, the Scottish industry has invested £5.5 billion in current prices, customer service is now broadly in line with that provided in England and in Scotland too we have seen a marked improvement in efficiency resulting in bills that are over £100 lower than they would otherwise have been. Bills will not increase this, and probably next, year and will increase at 5% less than the rate of inflation over the next five years.

These benefits are material and it is thanks to effective economic and public health/ environmental regulation, to which the companies have responded, that Great Britain has lost its tag as "the dirty man of Europe".

Just as we adapted RPI-X regulation to price setting for a public sector utility, could this not be further adapted to improve the efficiency of other public services. There are, after all, private sector comparators available in education, health, waste management and many other important areas of Government spending.

The water industry faces new challenges – carbon reduction targets, affordability of bills and customer demands for more tailored services – have replaced those (such as delivering a backlog of investment and improving efficiency) that faced the industry when economic regulation was introduced. There is a clear need for reform.

Why? Let me start with a practical example. Thames Water refused to buy water from a new entrant to the industry, Envirologic, ultimately preferring to opt for a desalination plant, which has a substantially higher unit cost. Unfortunately, this is not an isolated example. There is little movement of water over the boundaries between companies – even when there are substantial differences in marginal, average and long run marginal costs.

Surely commercial companies should want to maximise their profits? They do! Simply put, companies have an incentive to favour capital expenditure. They earn a guaranteed return on any asset that they build – even if this asset were later to prove to have been unnecessary. In contrast they earn no return on devising a solution, which involves committing operating as opposed to capital expenditure. Indeed, it gets worse. A company that buys water from a neighbour could find that the water on which they had counted may not be supplied – because the seller has a primary duty to the customers of their own area. And as if this were not bad enough, a company that buys water will incur higher operating costs which will make it look less efficient and lead directly to it receiving a higher efficiency target at the next price review.

Oh, and the seller is not too keen either. Any benefit earned would be transferred to customers after five years – so it is hardly worth the trouble of negotiating the deal.

Regulation does not just adversely impact the trading of water. Even if a company could identify a cheaper way to deliver a required outcome – perhaps a formal agreement with a farmer to allow for natural flooding or to restrict the amount of pesticides that make it into a watercourse- this would be likely to increase operating costs and would earn no return. Instead of a higher return for developing an innovative solution, the water company could actually end up being worse off! The same applies even if a company could save operating costs. Any benefit in terms of reduced operating costs is again transferred to customers at the end of the regulatory period and any additional capacity created means less need for investment in future which also means lower profits! In short there is a misalignment between the interests of customers and the interests of the companies.

Why then are we surprised that there is a lack of innovation in the water and sewerage industry? Interestingly, now that, in Scotland, we have separated retail, customer facing activities from the wholesale business, more innovation and more tailored services are becoming the norm – precisely because there is much greater alignment of interest between the retailer and the customer who can now, of course, take his business elsewhere. It seems to me that this is an important lesson. We should seek out areas that can be made competitive – if necessary within a specific policy framework.

Unintended consequences of economic regulation are not restricted to the delivery of better outcomes for customers. The setting of a single weighted average cost of capital results in companies feeling as pressure to improve returns to shareholders or to fend off an unwanted takeover to increase their leverage. These increases in leverage can lead to windfall gains for shareholders. But such gains must increase the future cost of finance and result in higher bills for customers. For example, Welsh Water is allowed the same rate of return as the other water and sewerage companies, yet it does not have to make payments for the use of retained surpluses.

Even if this can be justified in terms of financial theory, it has to result in the company facing a less hard budget constraint than its peers. Any reduced pressure to improve efficiency is, surely, not in the interests of customers.

This is why the Water Industry Commission for Scotland has launched its Incentives and Regulatory Accounting Project – IRAP for short. Copies of a draft discussion paper are available to anyone who is interested. I understand that Ofwat is also reviewing its approach. The essence of IRAP is to align the interests of customers and Scottish Water, to encourage a substantial simplifying of the regulatory process (both in approach and information collected) and to encourage innovation.

In our view there is much greater scope for allowing flexibility within a price review period. Why allocate all investment ex ante, when priorities may and perhaps should change? This is the third lesson that I would draw. Regulation is not and should never be allowed to become static and frozen in time. It has to focus on ensuring that customers get value for money.

IRAP responds to the new challenges facing the water industry, it is about evolution not revolution- much of what we do today (for example reporting on progress) still works and works well. We are targeting our reform at those things which have the potential to impact the customer adversely. The Commission believes companies should be able to respond to what their customers want – otherwise how can we hold them accountable? And, if the companies are not accountable, just who is managing the industry?