Memorandum by the Water Services Regulation Authority (Ofwat)

Summary of Ofwat’s views

1. Water and sewerage services have many characteristics of natural monopoly. Ofwat has applied its powers to ensure that consumers benefit through the application of regulatory incentives designed to mimic the effects of market competition. This has produced widespread benefits for consumers and the environment.

2. A new statutory regime took effect from December 2005 to enable competition to be introduced in a small part of the market (limited to very large users). So far the results have been disappointing. Ofwat is reviewing its implementation. There may be implications also for the statutory framework.

3. Ofwat believes that its independence from Government has been an important factor in protecting consumer interests in a sector which is wholly privately financed. Nonetheless, it is important to work effectively with other stakeholders including fellow regulators, the Government and consumer representatives, notably the Consumer Council for Water.

4. The ‘consumer interest’ and ‘public interest’ in our view overlap extensively in this sector. It is important for the regulator to apply a disciplined value based approach to services essential to life which are used by and benefit all citizens and which have important long-term environmental effects.

5. Ofwat is concerned to ensure that the burden of regulation is proportionate to the benefits for consumers and that it behaves in an open and transparent way, following the developing principles of better regulation.
Introduction

1. Ofwat (The Water Services Regulation Authority) is the economic regulator of the water and sewerage companies in England and Wales. The industry comprises 23 regional and local monopoly firms that were privatised in 1989. Ofwat has been in existence since 1989 and became a corporate body with a board structure from 1 April 2006.

2. Our main duties are (in summary) to protect the interests of consumers (including vulnerable groups), wherever appropriate by promoting effective competition, to enable efficient water and sewerage companies to carry out and finance their functions and secure that companies with water supply licences (i.e. those just selling water to large business customers) properly carry out their functions. We have a number of secondary duties, which include contributing to the achievement of sustainable development. We interpret the statute and make judgements in order to strike a balance between our various duties.

3. To deliver an effective service we work with all our stakeholders, including the Environment Agency and the Drinking Water Inspectorate (the quality regulators), fellow economic regulators, Government and the Consumer Council for Water (CCWater). Our aim is to protect consumers, promote value and safeguard the future. Our independence has enabled us to take a longer-term view both in the interests of consumers and our environmental and social duties.

4. Market competition in the provision of water and sewerage services is very limited. We use comparisons between the monopoly companies (comparative competition) to drive future efficiencies when we set price limits every five years. Average bills will be around £100 less than they might have been in 2009-10 had there not been an economic regulator due to efficiency savings included in price limits. Customers’ bills have increased since privatisation by 40% in real terms, but at the same time companies will have invested some £70 billion between 1990 and 2010 in maintaining and enhancing services to customers and environmental and drinking water improvements. The level of capital investment each year since 1989 has been almost double the rate before privatisation. The benefits are seen in improved customer services, even safer drinking water, and a huge environmental improvement in rivers, bathing and coastal waters. Over the period 2000-10 the increase will be 7% in real terms nationally.

5. Ofwat sees the development of competition in the sector, climate change, and the need to ensure sustainable development across all sectors of the economy as big challenges in the future. For the 2009 price review (when we will set price limits for 2010-15) we will ask each company to set out its long-term strategy for delivering its service to consumers, taking account of these challenges.

Independence and funding

6. Ofwat is a non-ministerial government department. We are independent of the industry, Government and other stakeholders, while working within the framework of national policy. The Secretary of State for the Environment, Food and Rural Affairs and the Welsh Assembly Government are responsible for the development of policy for the water and sewerage sectors in England and Wales respectively. We are financed by water and sewerage customers through an annual licence fee, which is recovered from the companies.

7. The Secretary of State and the Welsh Assembly Government also have specific roles in relation to some of our functions. In particular, they provide social and environmental guidance. This includes guidance on matters relating to the approval of companies’ charges schemes and the environmental and drinking water quality programme needed to deliver the United Kingdom’s obligations.

8. We are accountable to Parliament and we produce an annual report, which is laid before Parliament each year. The National Audit Office audits our accounts and provides regular reports on value for money. Our expenditure is subject to parliamentary scrutiny. Our total budget is around £12.5 million each year which works out as approximately 50 pence per connected customer per year, or 0.15% of the industry’s £8 billion turnover.
Value for money and effective regulation

9. We publish our forward programme each year for consultation with stakeholders. This sets out what we consider are the key strategic issues facing the water industry, identifies our role in addressing those issues and sets out the work we intend to do over the next three years and beyond.

10. We are committed to continuing to develop our regulatory approach along the principles of better regulation. The regulatory burden is scrutinised to ensure that it is appropriate for monopolistic companies and integrated where possible with the work of fellow regulators. Our new Board structure effective from 1 April 2006 contributes to internal scrutiny and challenge.

13. Our regulatory decisions are subject to review. Companies’ objections to the price limits we set or proposed amendments to their licences are referred to the Competition Commission, as are any proposed mergers. It is currently assessing a merger between two water only companies: Mid Kent Water and South East Water. Other decisions are subject to judicial review.

Working with other Stakeholders

14. Ofwat contributes to the development of policy for the water and sewerage sector while maintaining its independence. We do this by contributing openly to policy debate, using our expertise in advising stakeholders and engaging in joint research work. For example, through our participation in the Defra-led Water Saving Group, we have contributed to the recent Government consultation paper on the extension of compulsory metering to households in water stressed areas. We are also reviewing our approach to the establishment of leakage targets for companies, partly to ensure that the dynamic approach which underlies the present “economic level of leakage” does, as intended, take full account of environmental and social issues.

15. We make sure that regulation remains effective and targeted, ensuring the regulatory burden is minimal. For example, Ofwat collects information from companies on health and safety issues which we share with the Health and Safety Executive. We publish joint reports with the Environment Agency and Drinking Water Inspectorate where appropriate, for example our annual report on the levels of service provided by the water industry.

16. We work jointly with other economic regulators on issues of common interest. We are a member of the Joint Regulators Group of economic regulators. We published in 2006 a joint discussion paper with Ofgem on ‘Financing Networks’ which covered issues of concern in both sectors.

17. We shall develop our approach to the coming price review in close consultation with other stakeholders and expect, as for the last periodic review, to conduct joint stakeholder research into consumers’ views on issues affecting price limits.

18. Given the monopoly nature of the industry we need a minimum level of information to fulfil our duties and to protect customers. We have reviewed with Defra and others, including representatives of the water industry, the scope for reducing the regulatory burden by reviewing annual reporting requirements and improving data sharing with other regulators. The main obligation on the incumbent companies takes the form of two annual returns, first on each company’s charges for the forthcoming year, which require our approval to ensure consistency with price limits and other guidance. Second each company reports in June on its performance and expenditure. Our requirements are scrutinised both through an internal group and a forum of industry, regulatory and consumer representatives designed to challenge our requirements and ensure a balance.

Communications and transparency

19. We seek to communicate effectively and operate transparently. We consult on our forward programme and on all our main proposed policy changes. We place all our publications on our website. We publish responses to our consultations and explain our decisions. We make available the financial model that underpins our price setting decisions.

20. Each year we analyse and report on the performance of the companies in five main reports.

These are:

- Financial performance and expenditure of the water companies in England and Wales;
• Security of supply, leakage and water efficiency;
• Levels of service for the water industry in England and Wales;
• Water and sewerage service unit costs and relative efficiency; and
• Water and sewerage charges.

21. We also publish an annual report and other documents including an International comparisons report, a range of public leaflets, information notes, and ‘H2Oftwat’, our quarterly newsletter, and detailed performance data which are available on our website for all stakeholders.

22. We regularly conduct research across England and Wales in order to understand customers’ satisfaction with the services they receive. We also ask our other stakeholders for their views on the way in which we carry out our duties and following price reviews. In reaching our decisions we are also open to the views and challenge of all stakeholders.

Enforcement powers

23. Our approach to enforcement broadly matches the Macrory\(^1\) principles of regulatory justice. Where we do take regulatory action we explain to all stakeholders what action we are taking and why, and where appropriate how this action fits with the need for consistent and proportionate regulation.

24. In addition to the enforcement powers given to us at privatisation, the Water Act 2003 gave us powers to fine companies for failures in performance after April 2005. This power may only apply to the performance of a company during the 12 months preceding a notice of intention to fine. Any fine is payable to the Exchequer.

25. One outcome of our new powers, so far, has been to allow us leverage to pursue a range of other types of enforcement actions which we believe provide us with greater flexibility in getting the best outcome for customers. For example, rather than fining Thames Water for a service failure on leakage control, we obtained a legally binding undertaking from Thames Water to replace an extra 368km of water pipes at its own expense, an extra £150 million of its shareholders money, as well as requiring it to meet future leakage targets. The maximum fine we could have made imposed on Thames would have been 10% of its turnover on its water service or around £66 million. In practice any fine must be proportionate to the offence, in accordance with our statement of principles on this issue. Subsequent failures could lead to further enforcement action, including fines if appropriate, from 2007.

26. We have given notice of our intention to fine Severn Trent, Southern Water and Thames Water for failing to meet statutory performance standards for certain aspects of customer service. We are also considering whether these companies have misreported regulatory information to us. This may lead to further action and additional penalties. United Utilities Water may be subject to enforcement action due to concerns over transactions with its associates.

Economic regulators and the public interest

27. Our duty is to protect the interests of consumers, but given that water and sewerage services are essential to all, we consider the public interest and our duties are closely aligned. We agree with the House of Lords Science and Technology Committee\(^2\) that water is a resource essential for life, environmental health and a successful economy.

28. We are committed to the Government’s five guiding principles on sustainable development. At the 2004 price review we accepted that prices should rise significantly, in spite of continued improvements in efficiency by water companies, to meet the investment needs of the industry. We took due account of Ministers’ environmental guidance in reaching our decisions. But as the economic regulator we also had a key role in securing value for consumers by challenging the cost, scale and pace of environmental improvements. We must balance our decisions to meet the needs of current consumers as well as those in future generations.

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1 Regulatory Justice: Making Sanctions Effective, Professor Richard B. Macrory, Better Regulation Executive, November 2006
2 House of Lords Science and Technology Committee 8th Report 2005-06 ‘Water Management’.
Competition within domestic industries

29. Water supply and sewerage service provision remains a regulated sector in which market competition is not available to the vast majority of customers. In part, this reflects the nature of water supply: water is heavy and costly to distribute. It would not be cost effective or environmentally acceptable to develop a full national grid.

30. However, the statutory framework reflects the Government’s policy choice. Sector-specific legislation to introduce limited opportunities for market competition in the water industry through a water supply licensing (WSL) regime was contained in the Water Act 2003 (WA03). The legislation was enacted partly with the aim of removing the uncertainties arising from the Competition Act 1998 (CA98) about how appointed water companies should allow access to their distribution networks. The opportunity for customers to switch suppliers is currently limited to very large users of water. The Government chose to prohibit market competition for “non-eligible” customers; this was designed to minimise the impact on consumers who would not benefit, including domestic consumers.

31. We are dissatisfied with the lack of progress. We have initiated a wider internal review of market competition and our approach to implementation. We shall consult on this later in the year. Our Chief Executive wrote to the Minister for Climate Change and the Environment at Defra on 28 November 2006 expressing our concern about the lack of progress in the development of competition in the water industry since the WSL regime started. The key characteristics of the WSL regime that are set out in primary and secondary legislation (the ‘costs principle’ and the threshold for contestability) may need to change. Our review will take account of experience elsewhere, including the different approach taken in Scotland.

32. The regulated nature of the industry limits the scope for water companies to, for example, abuse their dominant positions. We use our competition law powers when we deem them to be the most appropriate way to address the issues raised by an allegation or complaint. In addition, while competition within the market has been limited, our downward pressure on water industry costs through comparative competition and by setting price limits has helped expand the market for contracting out of water companies’ activities and generated more competition in provision of these activities.

International competitiveness

33. We have no specific duty to consider the UK economy or its competitiveness. However, a key contribution is to ensure an efficient water industry that delivers for the environment and for business and domestic consumers both now and in the future.

34. Where international comparisons are possible the water industry in England and Wales compares favourably on the level of services offered and on bills. Comparisons are limited and complicated by the fact that in England and Wales investment is entirely funded by customers, whereas elsewhere water and sewerage services can be supported by explicit or implicit national and local subsidies.

Levels of investment and incentives

35. In the English and Welsh water industry investment is not driven by market demand. One of the key drivers is environmental legislation from the EU and nationally. Each piece of legislation has its own timetable, which will not necessarily be linked to market or economic cycles. For this reason market signals to incentivise investment in the water industry are not always needed. Other key drivers are the need to ensure security of supply and that the assets are maintained as fit for purpose (‘serviceable’).

36. To attract efficient investment to the industry we have sought to balance stability and flexibility in the regulatory approach. Thus, at each price review we set the cost of capital to ensure that efficient companies are able to access the financial markets on reasonable terms. Maximising transparency and consistency and minimising those risks which are outside the control of efficient management in turn has a beneficial effect in lowering the cost of capital. As companies outperform our assumptions to reward shareholders, so consumers benefit from the new performance benchmarks which enables Ofwat to set lower price limits for the future.
Foreign ownership

37. Foreign investors have been attracted to the water industry in England and Wales. Competition for ownership of water companies can stimulate existing owners to become more efficient in the provision of water and sewerage services as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership. Our role is to encourage through regulation the development of efficient companies that can deliver good value to their customers. Owners should be fit and proper persons. Whilst we have no power to block changes of ownership we must be satisfied, when a change occurs, that the prospective owner has the probity and the operational and financial capacity to assume that role.

38. When a change of ownership occurs in the water industry we consult on the capacity of the new owners. We are able to propose modifications to the company's instrument of appointment (licence) to ensure that the regulated company has sufficient financial and managerial resources to carry out its functions and is appropriately ring-fenced within its new group. Our approach is the same regardless of the nationality of the new owners.

Economic regulators' use of regulatory impact assessments.

39. We use regulatory impact assessments (RIAs) when we have a new policy proposal to implement or to change one of our existing policies. We have established criteria for considering where an RIA might be appropriate.

40. Our main use of RIAs in the past two years has been for implementation of policies around the Water Act 2003. However, responses to RIA’s, notably on quantification of costs and benefits, have been limited. For example, in our consultation on strategic supplies only two of 33 responses commented on the draft RIA. We have also contributed to RIAs undertaken by Defra, including the proposed transfer of private sewers into ownership by the sewerage companies.

41. We are revising our RIA process to become an impact assessment (IA) process in line with the Better Regulation Executive’s (BRE) consultation, ‘The Tools to Deliver Better Regulation – Revising the Regulatory Impact Assessment: A Consultation’. We are seeking to incorporate changes that will allow us to assess whether we have met our duties including those on sustainable development and our wider consumer duties under the Water Act 2003. We will consult on the changes to our process once the BRE has confirmed its revised guidance.

42. We have also undertaken some wider impact assessment work of our own. In 2006 we published ‘Water industry forward look 2010-30 Some possible views of the future’ where we examined the possible future implications for financing and household customers’ bills of four scenarios over the next 25 years. We have considered the potential range of operating and capital costs and the revenues associated with a number of known potential drivers of change for the industry under each scenario.

9 February 2007