

Competition, Conservatives & Climate Change; what will the Water Industry look like in 10 years time?

Address at dinner held at College Hill, the Registry, Royal Mint Court, London

A Time for change?

Forecasting is not my speciality, but I sense a powerful sense for change. The direction of change is more uncertain.

Regulation is getting both too complicated and too entwined with government – a matter for experts and a matter for politics. Customers are not being properly consulted; centralised target setting is booming.

A new administration may do things differently. The Conservatives have said that they want to take “policy” back into Whitehall. They also seem committed to a retreat from detailed centralised targets and a re-establishment of incentives.

And for us, the ownership of Scottish Water is on the political radar and public expenditure pressures will keep it that way. So its financial strength is important to us.

Currently, incentives are in danger of going out of the window. And two key groups seem to be missing out – customers and shareholders. Customers are/should be crucial for what is delivered and shareholders for enabling its delivery.

Where are we pointing?

We must remember that good regulation is focussed on outcomes/outputs rather than inputs.

- We must ensure that they are the outcomes that customers want. Customer participation could be increased by disentangling the continuation of current outputs from the enhancement of water and environmental quality and of standards of service.
- We must ensure that outcomes are delivered efficiently. Efficiency could be improved by the greater competition and better benchmarking that can arise from progressive dis-aggregation of both water and wastewater activities – as has happened in the other utilities.

Shareholders will only continue to support the industry if they can expect a competitive return. To date, returns have been good because company profits have been related to enhancement Capex through the RCV and because the development of debt finance has enabled leverage/gearing to increase significantly.

We need to consider how the role of the shareholder may be changing, as capital markets recover from recent shocks and the role of regulation adapts to change.

To take one issue, the bias to capex needs to be eliminated, both to protect customers and to achieve more efficient ways of delivering outcomes/outputs. One way to progress this could be to change the way that benchmarking is done – away from heavy econometrics, towards more selective methods, looking at capex and opex together and looking outside the water industry as well as within it.

Vertical Dis-aggregation

In Scotland we have already achieved some vertical dis-aggregation by splitting-off non-household (business & public services) retail. This is working – we now have 6 retail suppliers and a third of customers are already getting a better deal. We do not anticipate early extension to household customers; this will depend on political pressures and political attitudes. But we are financing a trial of household metering.

It seems likely that England, but not Wales, will follow the Scottish example.

The next stage would be to separate networks (maintenance, expansion and operation) from treatment and resources (again enhancement and operation). Capex & opex would be treated symmetrically. In due course, it could be useful to separate resources and treatment – although the pressures for this seem rather greater in England than in Scotland, because of the supply “shortages” in the South East.

With respect to shortages in the South East, I agree with Nick Herbert that a “virtual” water grid is needed – but I would put it as the need for regulation to provide a network “connection facility” by using – or possibly extending – the existing powers for determination of bulk supplies.¹

How can we achieve greater participation?

Regulation risks getting too complicated – a game for experts rather than customers. We will be exploring ways in which this could be remedied. One possibility would be to establish a base or “par” position, say that prices would rise in line with

¹ An alternative could be to use the “single buyer” or “procurement operator”, raised in discussions on the directions to take on the journey towards greater competition. See Cave review.

inflation, early in the price review process, and then construct options around this, showing the hypothetical consequences for customers' bills. These options would include water quality and environmental objectives, improvements in customer service and options for greater efficiency, deriving, e.g., from the benchmarking mentioned above.

These options should include ways of dealing with climate change, where the issues are a good deal more uncertain and a good deal more complex than the political establishment currently acknowledges.

The regulator would then manage a quantified process of consultation involving all stakeholders, including quality regulators and government. The results would be gathered together for the draft and final determinations of prices.

What might be the implications for shareholders?

Will these changes, vertical dis-aggregation, increased competition, changes in benchmarking, and greater participation pose challenges to shareholders? Will they increase risk and so the cost of capital? This issue was raised in Martin Cave's Interim Report in relation to competition, but it goes much wider.

This is where we need your help. The continuing confidence of investors is crucial to progress and must be at the forefront of our discussions.

Our own view is that, while there will be issues involving the allocation of risk to different activities and hence for the cost of capital in different areas, the key issue is the degree of clarity – for customers and environmental interests – as well as for

shareholders that will be achieved. We think that the reforms I have discussed should add to clarity – but this will only happen if the debate is a transparent one where all parties are prepared to be open about their objectives and ready to defend their preferred solutions by objective analysis.

Thank you for listening to me. I now look forward to listening to you.

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Ian Byatt