

Waterwise Response to BIS Call for Evidence on

Principles for Economic Regulation

February 2011

Overview

Waterwise is very supportive of the Coalition Government's commitment to setting out principles for economic regulation across sectors. Many of the challenges – for example of climate change and population growth – are common across sectors, but because the regulatory framework for each sector has developed independently, these regulatory frameworks do not currently work together and on occasion work in conflict. This consultation and the resulting policy offers the opportunity to address such issues more strategically and deliver multiple outcomes more cost-effectively.

Questions

The principles themselves

1. Do these principles sufficiently encapsulate the characteristics of a successful framework for economic regulation? If not, how could they be improved?

The principles are a welcome and long-overdue strategic approach to ensuring future challenges are met most effectively across the UK.

Waterwise particularly welcomes the principles of vertical and horizontal coherence, and suggests some improvements below under the "Focus" section.

Vertical and horizontal coherence

At present, the fact that the regulatory frameworks for water and energy have developed independently of one another leads to barriers between joint working between the sectors, where such working would specifically address the challenges of climate change and effective competition and consumer outcomes outlined in the consultation. For example, the water and energy companies have developed plans to work together under the Water Efficiency Targets set by Ofwat and CERT which is administered by Ofgem, delivering whole-house water and energy efficiency retrofits to customers through a single, more cost-effective approach, but over-application of the "additionality" principle within CERT (where it is deemed that such work would have happened anyway) has led to much of this work being shelved. (For further detail, see the [Waterwise-co-ordinated cross-sectoral response to the recent DECC consultation on CERT](#)).

As both regulatory frameworks (water and energy) are currently being reviewed by government, there is a significant opportunity now to ensure that the sectors are working

together to deliver Coalition Government priorities such as climate change mitigation and adaptation, as well as growth of the low-carbon economy and nudging sustainable behaviour. “Vertical coherence” would help ensure this, as would “horizontal coherence”, which might even mean some joint mechanisms across sectors – for example on approaches to retrofitting customers’ homes. Links with other sectors not covered by the Principles of Economic Regulation, such as housing, would also help deliver the more sustainable approach set out as an aim in the consultation – for example including water efficiency measures and showers in the Decent Homes standard for social housing, in the Green Deal (a welcome announcement to this end was contained in the National Infrastructure Plan) and in Energy Performance Certificates for homes. Energy and water customers are currently treated in regulatory terms as entirely separate groups, while in practice they tend to be exactly the same people.

Vertical and horizontal coherence in economic regulation would also help ensure the considerable economic, environmental and social opportunity of mainstreamed water efficiency is fulfilled. Water efficiency – wasting less water – is an essential part both of adapting to climate change and building resilience into our systems, and tackling climate change. Water efficiency has an important role to play in the green economy, the big society and safeguarding the environment. It can also help reduce the deficit (through reduced water and energy bills in the public sector). And water efficiency is vital in adapting to the climate change the UK is already seeing and cannot avoid, despite action now – underpinning the statutory National Adaptation Programme for England. Both hot and cold water efficiency measures are important even once the electricity grid is fully decarbonised, because there can be no such thing as a zero water house, and because gas, on which there is a huge reliance for water heating, cannot be fully decarbonised.

“Focus”

Waterwise proposes a change to the section under “Focus” which states that “economic regulators’ duties should be concentrated on economic considerations”, to reflect the need for sustainability.

Ofwat’s primary duty to protect the interests of customers is currently (rightly, Waterwise believes) interpreted by Ofwat as including the needs of future customers, and this is reflected in the parentheses set out in this section of the consultation. This means in theory that the costs and benefits of measures taken now both to increase supply and to manage demand both in the next five years and the longer term should be evenly balanced. In practice, because it is not specified in the primary duty, companies tell us time and again that the costs and benefits of measures are biased towards short-term gain (focussed on the five-year price review period), and in particular to those measures which contribute to their regulatory asset value, which tends to mean new, often carbon-intensive supply-side measures such as reservoirs, rather than demand management measures such as a retrofit of tens of thousands of homes.

With no mention in the principles of the need for sustainable development, which is at the core of Coalition Government strategy and policy on the economy and more widely (as well as the necessary reform of the regulatory framework for water itself, to which the Coalition Government is also committed), there is a danger that short-term “price” will continue to

triumph over longer-term “value” in the water sector. In water, this would mean in practice that the scarcity and over-abstraction of water both now and in the future would not be reflected in decisions on supply and demand options, with potentially disastrous results for supply to both domestic and non-domestic customers (in turn impacting the economy) and the environment. This also sits at the heart of the economics of water regulation, as it has a direct impact on the costs and benefits of water company processes.

Waterwise would like to see the need for sustainability more explicit in the principles, and proposes the following wording: *“economic regulators’ duties should be concentrated on economic considerations, in the context of sustainability, including ensuring an appropriate balance between the needs of future and existing customers and the impact on the environment”*.

This is particularly important in the water sector not only because of the impact the current bias towards capital expenditure (see below) has on water availability and the environment in the future, but also because there is currently a lack of coherence of application between economic and environmental regulation of that sector. For example, the Water Resource Management Plans and Ofwat’s Price Review are the key strategic drivers on the water companies in England and Wales, but the former does not bear sufficient weight in the latter to justify spend, as implemented by Ofwat. This is despite the fact that Water Resource Management Plans are extensively consulted on with stakeholders and as a result contribute to the stated aim of both the Coalition Government and Ofwat to include a greater role for the consumer in the water sector. Greater coherence between economic regulation and other types of regulation on the water sector is important, and should be inherent in the principles as it undoubtedly also applies to other sectors with important health and safety and environmental considerations, such as energy and aviation.

The regulatory framework for water currently incentivises the water industry in England and Wales towards supply-side measures. As such, the full long-term value of water, in economic, social and environmental terms - for example its value in different places at different times - is not reflected, as noted by Cave and Walker. There is a strong bias towards capital expenditure because this contributes to the regulatory asset base. This bias acts as a barrier to large-scale water efficiency – this is despite the Revenue Correction Mechanism which Ofwat has introduced, which is welcome, but will only bite every five years, so does not drive year-on-year supply-demand investment decisions. The water companies are undertaking excellent work, retrofitting tens of thousands of homes at no extra cost to the customer, including in conjunction with large-scale metering programmes, and encouraging customers, schools and businesses to waste less water. But this is a very small proportion of the amount they spend on supply-side measures. As Severn Trent Water set out in their Changing Course document in April 2010, “In order to equalise incentives, there needs to be scope for initiatives involving operating expenditure to earn a return”. A bias towards capex also acts as a barrier to sustainability in other sectors, such as transport, energy and communications - and in the public sector - where investment in new capital projects is easier to fund than alterations.

The capex bias identified above as a limiting factor on sustainability in the water sector is also an issue for other sectors. In water it was initially identified through Waterwise’s

Evidence Base for Large-scale Water Efficiency Steering Group but is now widely recognised by water companies, regulators and government as a barrier to a more sustainable water sector in terms of increased catchment management and demand management schemes, rather than new supply-side measures.

2. Would their application deliver greater clarity about the respective roles of Government, regulators and producers, and greater policy coherence, and hence reduce uncertainty generated by the lack of clarity?

Waterwise believes this would definitely be the case, subject to the points on content of the principles set out above.

As the consultation states, the utilities provide services on which every business and every citizen relies. It is already clear that the market alone will not deliver wider considerations such as tackling and adapting to climate change – this is why measures such as the EU Emissions Trading Scheme and the Climate Change Levy were designed. In a sector such as water, which delivers a public good on which the entire economy as well as human life depends, the principles of regulation, alongside the reform of the sector which the Coalition Government will set out in the forthcoming Water White Paper, are therefore essential.

Every sector of the UK economy is dependent on water. In a 2005 report, the National Audit Office pointed out that “Many of these industries would not be possible without the use of water. To replace a supply of one million litres of water a day would typically cost about £2 million. The Agency’s regulation of abstraction, therefore, protects resources worth some £72 billion to licence holders. Clearly, water use is of such importance that its value to the economy as a whole is incalculable.” The Cave Review also points out that, although the cost of the abstraction licensing regime is relatively low (around £124 million in 2007), the value of water in the economy is significantly greater. And, as both the Cave and Walker Reviews clearly identified, the full long-term value of water is not reflected in the current regulatory framework in England and Wales - and tightening up of the abstraction framework may be necessary. Most stakeholders agree.

Waterwise would also welcome increased transparency, as set out in the principles. For example, company business plans for the price review in England Wales are public, but there is a vast amount of detail behind them which is not. Such detail would not only increase transparency in its own right, but could also help identify opportunities for some plans such as demand management with domestic customers to be undertaken with partners at reduced cost, even if they weren’t approved in the final determination.

Waterwise agrees with the statement in paragraph 40 of the consultation that “By insulating regulators from short-term political factors, independence ensures that the rules are applied in a transparent and consistent manner and that commitments in terms of risk allocations are met.” However, as detailed above, this also acts to the detriment of longer-term government commitments of a non-political nature, such as the need to tackle and adapt to climate change.

In paragraph 50 the consultation states that “Where [competition] is not possible, regulation needs to be a cost-effective alternative.” In the water sector there is a clear distinction between competition for non-domestic customers and those for domestic, with most stakeholders supporting the former but not the latter. This is particular to the water industry and is to a large extent because of the regional nature of water and the actual weight of the product (compared with, say, electricity). In addition, Waterwise considers it essential that, for these vital sectors to be able to deliver the wider policy aims (and at the very least not to act against wider policy aims) of government, there is an essential role for regulation alongside competition, not only as an alternative.

Waterwise fully supports a move to increased efficiency of regulation. Ofwat is carrying out its own comprehensive review of how it regulates, in the context of providing “Sustainable Water”, and is moving to a more risk-based approach. This will help address the focus and strategic delivery of the economic regulation of water which has developed piecemeal over the two decades since privatisation, layer on layer. Ofwat itself points out that in 1990 the guidance for the annual June Return required of the water companies was 64 pages long with 16 tables, while for 2010 it ran to more than 800 pages and 77 tables.

Applying the principles in practice

3. Is the division of responsibilities, currently divided between regulator and Government, sufficiently clear?

- *Does the regulatory framework allocate responsibilities to regulators that are inherently political in nature and which should be taken by Government?*

There is currently a gap between what the Coalition Government is committed to in terms of policy, for example on climate change mitigation and adaptation, and being the greenest government ever, and what Ofwat is able to deliver through the water sector under its existing primary duties. As a result the water sector – representing almost as significant a proportion of total UK greenhouse gas emissions as aviation (with 1% from its own processes and 5% from heating water in homes), and at the forefront of necessary adaptation to increased floods and droughts – does not currently help deliver these priorities (and in the case of the capex bias in some cases actively acts against them). A return to statutory guidance is one option discussed in the consultation, and this certainly has appeal.

Timing difficulties are often a practical barrier to such coherence. For example, during the 2004 Price Review internal government discussions delayed the process of statutory guidance and, as a result, the final determination, to the consternation of the markets. Similarly, the delay in the 2009 UK Climate Impact Programmes scenarios meant that water company investment for the next five years justified on the basis of water availability patterns set out in those scenarios was not included in the final price limits for companies.

- *Are there areas where the Government should step back, having set out its objectives, and leave the regulator to take decisions?*

4. *How clearly is the division of responsibilities articulated, for example through statutory duties, in a way that provides the necessary focus?*

- *Are regulators' duties easy to understand and clearly prioritised?*

See the response to 1 above.

- *Is the range of issues regulators are required to consider too broad?*

See the response to 1 above.

- *To what extent should regulators' duties be more outcomes-focused and avoid specifying means, tools or inputs to achieve policy goals?*

Waterwise would welcome a focus on outcomes. This would enable regulators to deliver wider government priorities such as climate change mitigation and adaptation alongside their primary duties. Tying in with a more risk-based approach, it would also offer an opportunity for the increased involvement of independent experts (including NGOs) – a point also made in the consultation – such as on the horizontal auditing of performance on certain issues across and between sectors.

5. *To what extent is the decision making of the regulators sufficiently transparent (for example in consultation practice, publication of the reasons for decisions and accessibility of tools and models) to enable sectors to predict likely outcomes and scrutinise decisions?*

6. *Are the existing appeal mechanisms appropriate, in terms of the:*

- *bodies with the right to appeal/object*
- *appeal-hearing body*
- *basis of appeal*
- *role of government?*

7. *How effective are mechanisms to review the operation and delivery of economic regulation?*

- *Should periodic reviews of sector regulation and the role of the regulators be undertaken, to identify possible areas for improvement and provide greater confidence in the framework?*

This would be one way to ensure UK-wide priorities are not being compromised by economic regulation. However, it would be important to avoid too-frequent detailed change for sectors.

- *Who should undertake such reviews? Should they be by an independent third party, for example, to provide an external challenge and how frequently should they be undertaken?*

The Walker and Cave Reviews have been very effective in the water sector in reviewing the impact of regulation in specific contexts – namely, charging, and competition and

innovation. Multi-stakeholder engagement during the process and support for conclusions has given their reports added weight. This is certainly a useful mechanism to consider for the future.

8. What is the optimum way of balancing the need to make the frameworks stable and predictable, coherent with broader public policy and able to adapt to changes in sectors and technologies?

- *What effect has the evolution of regulators' responsibilities had on the predictability of the framework and the attractiveness of the sectors to investors?*
- *How effectively does Government articulate the broader policy priorities under which regulators carry out their statutory functions? What is the impact on regulatory decision making and does this deliver a coherent overall regime?*
- *How effective have changes to statutory duties been in adapting the focus of regulators to emerging priorities?*

Waterwise supports in principle the sustainability duty which Ofwat received in the 2003 Water Act. However, in practice sustainability has been biased towards the economic strand, because of the focus in the primary duties on price. A shift towards the importance of "value" would be a more effective approach, in the primary duties. The balance between duties and wider government priorities is a difficult one which is not currently, in water at least, being effectively achieved.

- *What restraint should Government impose on itself in the frequency of changes to the framework and policy priorities?*
- *Would a more formalised, pre-announced process (such as a Government strategy statement) for articulating policy priorities, reviewing the effectiveness of regulation and implementing changes on a cyclical but infrequent basis be beneficial in balancing these three principles in particular?*

This is one way of addressing the dichotomy outlined above and in the response to question 2, and Waterwise would welcome it.

9. Are there sufficient and efficient mechanisms in place to facilitate cross-sector work by regulators?

No. See response to Question 1 above.

- *Should regulators' approach to similar issues (e.g. aspects of the price control, promoting competition and addressing consumer impacts including affordability) be more coordinated?*

Yes. See response to question 1 above. The sectors are addressing common challenges in many cases and so the regulatory frameworks should act alongside and with each other, rather than operating in isolation as they do currently. Some joint regulatory mechanisms might even be necessary.

- *Would shared non-executive board members across regulators helpfully reinforce collaboration, learning and coherence in approach?*

10. How cost-effective are the regulatory frameworks overall in terms of regulatory burdens, benefits delivered and efficiency of regulatory institutions?

In terms of links between sectors, not at all cost-effective currently, with for example approaches to consumers from both the energy and water sectors with retrofitting offers and behaviour change advice being delivered through separate programmes, resulting in multiple visits to customers, and higher cost (because the primary cost of a water retrofit is the home visit itself). This is starting to be addressed through the Green Deal but the remainder of CERT and its replacement, ECO, need to be designed so that they work specifically with the regulatory framework for water. In addition, existing visits to social housing under the Decent Homes standard and other local authority schemes such as gas checks could usefully be linked in regulatory terms to the water sector, as well as the energy sector.

Finally, clarification would be useful on any discussions BIS has held with the Water Industry Commission for Scotland and the Utility Regulator in Northern Ireland – the consultation makes it clear that the water sector in England and Wales is the primary focus in terms of water, but there will be implications for the remaining regulatory frameworks in the UK.

*Nicci Russell
Waterwise Policy Director*

Waterwise is an independent, not-for-profit, non-governmental organisation focused on decreasing water consumption in the UK and building the evidence base for large scale water efficiency. We are the leading authority on water efficiency in the UK. Our aim is to reverse the upward trend in how much water we all use at home and at work. For more information please visit www.waterwise.org.uk