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25 years of Regulation of Water Services; looking backwards & forwards[1, 2]

Ian Byatt

Frontier Economics, 71 High Holborn, London WC1V 6DA, United Kingdom

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ABSTRACT

Sir Ian Byatt was the first regulator of the water and wastewater industry in England and Wales (Director General of Water Service) from privatisation in 1989–2000. He examines the experience of a quarter of a century of the regulation of water companies, concentrating on what worked well and where further developments are needed to deal with changing circumstances. He concludes that while RPI-X regulation, combined with comparative competition, worked well with respect to operating expenditure, the regulation of capital expenditure needs enhancement to avoid overcharging of customers. He advocates the development of performance regulation, backed by project competition, where customers pay for quality enhancement only when they receive it.

Observing the progress of the revolution in Paris in the 1790s, Mme de Stael wrote:

> Theory without experience, is only a phrase; experience without theory, is just prejudice.[3]

1. Early-stage liberalisation and market opening

The privatisation of Water Services (both water supply and wastewater disposal) in England & Wales[4] in the year 1989 was very unpopular, despite providing incentives for a large improvement in water quality. Ofwat, the newly created economic water regulator, helped to make it work by publicity and explanation. Explanation (transparency) was critically important, in simple ways that could be understood by a wide range of interested parties, not in the form of long and complex papers. The key audience was the paying customer.

This involved using the media. Not easy, but you can learn. A media presence is essential for an independent regulator. Regulators must manage the public agenda and deliver public signals to all stakeholders.

Did privatisation work well? Replies should be more nuanced: nothing stands still - nor should. Some things went well, and policy still needs to move on.

The politics is as important as the economics. It was not wise, at the privatisation settlement in 1989, to allow water companies to use their ungeared balance sheets to undertake often unwise diversification.[5] The more recent take-over of many companies by private equity infrastructure funds has also led to problems of perception, and so public acceptability. Institutions, along with personal and institutional networks, are crucial. So are personal and institutional incentives, often pulling in different directions.

At a periodic price review, the major issues need to come together and be considered in the round. Too much detailed modelling can inhibit wider customer involvement.

E-mail address: ianbyatt@blueyonder.co.uk.

[1] This paper is an extension of the notes I delivered at the annual conference of the Regulatory policy Institute held at Merton College Oxford on 12/13 September 2016 I amended the notes in the light of the discussion at Oxford and further helpful comments on an earlier draft. An important contribution could be made by adoption, or adaptation, of a new procedure devised for the Australian electricity market, made in a lecture by John Pearce, Chair, Australian Energy Market Commission, and an insight by Stephen Smith in his presentation on the Evolution of Network Price Determination Processes. Further points emerged at a subsequent presentation by Thames Water at a European Policy Forum Roundtable on the financing of the Thames Tideway Tunnel. I am particularly grateful to Alan Sutherland, John Smith, Colin Skellett, John Banyard, Remy Prud'homme, Rupert Darwall, Martin Cave, Stephen Littlechild, Sonia Brown and Jonson Cox and to three anonymous referees for help in the drafting of this paper and to Julia Havard in editing the text.

[2] See my article on the Regulation of Water Services in the UK in *Utilities Policy* 24 (2013) for my account of my term of office from 1989 to 2000.

[3] *Of Present Circumstances*.

[4] Water services were not privatised either in Scotland or in Northern Ireland. They remain publicly owned but in both cases are regulated independently of Ministers.

[5] Much money was lost in ill-conceived overseas ventures e.g. by Thames Water and North West Water. Welsh Water made politically unwise diversification into hotels.

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1.1. The regulatory office

The quality of the regulatory office is key; I was fortunate to have skilled and creative senior staff. Focus on the straightforward regulatory objectives was vital; mission creep was to be avoided. The regulator only does a good job when the companies do a good job.

We devised systems for collecting information, which stood us in good stead when making decisions. We appointed independent Reporters to challenge company information.[6]

We addressed four major issues in the early days; publishing consultation papers, with clear proposals for action:

- Paying for Water; Video, Analytic Papers and Director's conclusions (1991):
- Cost of Capital (1991) & Assessing Capital Values (1992):
- Cost of Quality (1991, 1993):
- Paying for Growth (1993).

Taking due account of the main responses, set the scene for our future work.

1.2. Working with companies

I declined to work with the Trade Associations normally used by Government, preferring direct personal touch with the companies, visiting them regularly and always being open to their visits. I established working groups to test regulatory strategies. Things need to be talked through; regulators and companies need to listen to each other.

I visited the European Investment Bank to encourage it to finance privatised as well as state-owned utilities. We regularly briefed the financial analysts in the City of London, including Rating Agencies, on regulatory intentions.

Utility companies seem to respond better to challenges than to opportunities; the prospect of loss seems a more powerful incentive than the possibility of gain. Managements deal with difficulties, but hesitate to innovate.[7] Regulators need to consider how best they can present challenges to drive better performances.

1.3. Working with regulators, ministers and parliament

The key networks relate to customer representation, water and environmental quality as well as to Ministerial policy. Good relations with, not subservience to, Government Departments (not only the Department of the Environment), were the key to accountability; remembering that there are different emphases between different Departments. The emergence of formal interactions between regulators and Parliament, which has its own, often conflicting, priorities, was a significant step in the public governance of utilities.[8]

Ofwat cooperated with the Environment Agency[9] to check that big investment projects were on course. In Scotland, the Water Industry Commission for Scotland (WICS) developed an output-monitoring group to track capital expenditure. But recent events (see below) show that monitoring of environmental performance should be strengthened.

1.4. Working with customers

Initially customer representation was closely linked to regulation. The Chairmen of the Customer Service Committees (CSCs), appointed from across the political spectrum, came together in an Ofwat National Customer Council, which played a major part in the Ofwat consultations on metering, and attended the meetings where companies made representations on the 1994 draft price determinations. In contrast, the independent Consumer Council for Water has progressively lost authority, and influence, since its creation in the early years of the new century.

1.5. Paying for Water

At privatisation in 1989, household customers, with rare exceptions, were charged in relation to the domestic property tax, the rateable value (RV)[10] of their houses, irrespective of consumption. For many people, this was a matter of principle[11]; but the privatisation legislation forbad the use of RV after the end of the century.

Our consultation revealed different preferences, particularly between different regions and different tenure groups.[12] We advocated customer choice,[13] but found the metered tariffs in use were loaded against metering. Acting under our non-discrimination powers, we required companies to reduce their volumetric charges so that the metered bill for average households was not significantly higher than the average RV bill. This led to significant reductions in metered bills and to an increased take-up of metering.[14]

The gradual switch to metering (still not complete) had a major impact on the demand for water, considerably reducing the scale of investment needed for enhancement of capacity, and so moderating general increases in customers' bills.[15]

1.6. Governance?

I believe that the single regulator, involving personal responsibility, is to be preferred to the Board. Regulators need advisers; I appointed a group of business advisers when Ministers decided to separate CSCs from Ofwat. But politics is personal, and wide visibility is essential to independence from Ministers.

People are crucially important. An interesting change in governance followed the break-up of the Welsh multi-utility Hyder. A public interest company was created that is much more customer-focussed than the impersonal, finance dominated infrastructure companies that have now taken over most of the industry.

[6] These Reporters were independent consulting engineers appointed in consultation with Ofwat, with a duty of care to the regulator. I would have preferred to pay them from Ofwat funds, but we had to make the best use of our budget.

[7] Sir John Hicks famously said that the profits of monopoly were a quiet life.

[8] Starting with *The work of the Directors General of Telecommunications, Gas Supply, Water Services and Electricity Supply Report by the Comptroller and Auditor General HMSO 1996*. An all-party Group was a useful pre-curser.

[9] The regulatory functions of the nationalised Water Authorities (created from the water supply and sewerage functions of the Local Authorities in 1974) were removed at privatisation in 1989 and put in the hands of a newly created National Rivers Authority. (NRA). Five years later the NRA was incorporated into the newly created Environment Agency (EA). Neither the NRA nor the EA was formally independent; unlike Ofwat they reported to Ministers.

[10] Last assessed in the early 1970s based on the rental value of property in a situation where government policy had destroyed the rental housing market.

[11] A long-standing debate is whether water supply and wastewater disposal are economic or social services. Privatisation stressed the economic and business aspects.

[12] Fixed charges were favoured in the North, and among local authority tenants, while the South and owner-occupiers preferred volumetric charges.

[13] Under nationalisation, customer already had a legal right to have a meter, but tariffs were in the hands of companies.

[14] This also depended on the policies of individual companies. While, Anglian Water moved quickly to encourage metering; Thames Water waited for customers to take the lead and Severn Trent Water made a policy change at the time of the 1995 drought.

[15] A study by Wessex Water showed reductions in demand of around 17%, irrespective of tariffs. See Wessex Water website.