Leaner, meaner and greener too?

frontier economics

WATER BULLETIN

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Challenges for water companies in the next review

As the privatised water industry has matured in England and Wales, the regulatory regime has become tougher. The next periodic review in 2004 may well pose even greater challenges to the water companies, as the Office of Water Services (Ofwat) struggles to reconcile the investment requirements flowing from new environmental obligations with political pressures for low prices. 2002 offers a window of opportunity for strategic pre-planning by both companies and regulators.

The water industry in England and Wales was privatised with substantial investment requirements, flowing from its history of insufficient funding for maintenance and increased by EC water quality and environmental legislation. This investment programme was funded by a combination of price increases and efficiency gains achieved by the water companies. But the regulatory regime gradually tightened the screw on them and excess returns have been ratcheted down. The "pass-through" mechanism was redrawn, from the original 10-year glide-path to the rolling five-year approach adopted in 1999 leading to one-off price cuts following the last review.

While the headline price cuts looked tough on the companies, the 1999 review was in some ways a straightforward process for the regulator. By removing past out-performance and squeezing the companies harder the determination was able to deliver significant price cuts while allowing funding for further environmental investments. As a result, expectations have been raised that this feat can be repeated. This will not be so easy the second time around.

The challenges presented by the review due in 2004 follow from the fact that 1999 left the companies with much less headroom, and that meanwhile the momentum of environmental pressure has increased rather than abated. This has led companies to explore new forms of financing and operating structures, which in turn will further complicate the regulatory review.

Even more bangs, even fewer bucks

Contrary to expectations at privatisation, environmental cost pressures continue to mount. The investment programmes envisaged at the time are by now largely complete. But the industry faces the prospect of further environmental and quality obligations. The new European Water Framework Directive can be expected to have an impact, while significant uncertainty still surrounds the costs of dealing with climate change. The role of the Environment Agency in the coming review will be extremely important.

There is, however, little evidence that the political climate has warmed towards water price increases. With the Government exerting pressure on prices across the economy through a toughening-up of the competition regime, ministers are unlikely to react kindly to the prospect of an acceleration in water charges.

Although the upward trend was halted in 1999, some companies' prices will start to rise again in the lead up to the 2004 review. There will be some popular expectation that another review should again lead to price cuts, fed by the last review and the downward trend in regulated gas and electricity prices (sectors in which investment requirements are far closer to "steady state"). Moreover, 2005 is likely to be a general election year, in which ministers will not want to face the backlash from increases in water charges.

Priorities, priorities

The 1999 review was made more difficult by the clash of conflicting objectives amongst policy-makers with respect to social, economic and environmental factors. While separating increases environmental regulation (by the Environment Agency) from economic regulation (by Ofwat) increasing transparency, this does not obviate the need for agreement, if not on objectives, at least on the costs and benefits of achieving them.

In practice, the reliance on ex-post adjustments to prices, either through interim determinations or at the next review, decreases the transparency of regulation and imposes additional risks on companies. For the determination and funding of new obligations to be economically efficient, the process must be improved. A good starting-point would be a more rigorous analytical framework for assessing environmental obligations and priorities that was accepted by all the major stakeholders. This, in turn, should be accompanied by greater consistency in the determination of obligations and funding.

Mind the gap

To reconcile stable or falling prices with mounting investment obligations Ofwat will need to identify additional sources of funding from within the companies. In the wake of the 1999 review, the extent of such sources is limited. Ofwat will need to look hard to find ways of squeezing more out of companies from 2005.

Further, the last review has encouraged companies to explore such alternative structures – both financial and operating – in pursuit of further efficiency gains. These include the Glas Cymru not-for-profit model, the "thin equity" approaches adopted by a number of other companies, as well as a more general move towards greater use of outsourcing. These changes in company structure will only complicate Ofwat's task at the 2004 review as it seeks to compare companies that are structured in a variety of different ways.

Ofwat's search for further sources of investment funding within the industry will inevitably focus on the three factors that have been central to past reviews:

- efficiency targets;
- the allowed rate of return; and
- expenditure on asset maintenance.

Reduced fat

At the next review the scope for efficiency savings over the coming period may look significantly more limited than it appeared in 1999.

Allowances for capital expenditure have become tighter with successive reviews. As a result, management's ability to extract savings by outperforming on their investment programmes has become much more limited. At the same time, there is evidence that suggests the "easy" savings on operating costs may be close to exhaustion: for example, the scope for further reductions in labour seems pretty limited. While this argument has been played out before, its validity increases with each subsequent review.

While many of the gains in operating efficiency available to companies in their present form may already have been made, there may be significant scope for further savings through more radical organisation changes. Some answers may be provided by innovative restructuring options such as the "24-7" joint venture between London Electricity and Eastern Electricity. But the question remains as to whether the regulator will permit companies to tap the significant potential source of efficiency improvements offered by mergers, joint ventures and out-sourcing.

Historically, the regulator has placed great weight on the value of comparators, arguing more than once that maintaining a sufficient number of these outweighs the potential efficiency gains from a merger. But already the growth in outsourcing of core functions raises questions about the value of some comparators. Given, for example, that Glas Cymru outsources its operational activities to United Utilities, its value as a separate comparator in Ofwat's analysis of operating efficiency is far from clear. The paradox is that protecting a system of comparative competition designed to encourage efficiency may in fact be limiting the scope for future efficiency gains. The answer is for the regulator to take a more innovative approach to comparative competition, which would allow more of the potential benefits of industry restructuring to be realised.

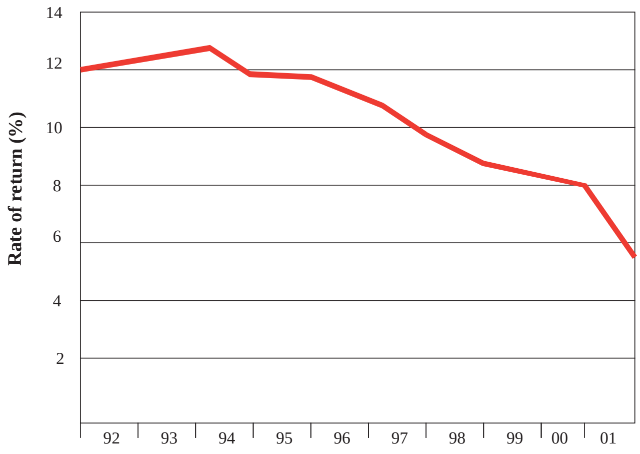
Diminishing returns

In the 1999 review, much of the gap between increasing investment and falling prices was filled by a reduction in the rates of return earned by companies. The extent to which this approach can be repeated at the next review will be limited.

As the chart shows, excess returns in the sector have been ratcheted down over successive reviews. Average rates of return now lie close to the cost of capital, and are unlikely to rise significantly over the current period.

In addition to the challenge imposed by the limited availability of excess returns to fund investment and price cuts, Ofwat's determination of allowed returns post-2005 will also need to address the different financial structures that have been adopted by companies. While the regulator has indicated that the same basic periodic review methodology will be applied to all companies, it is not clear how this can work in practice. For example, Ofwat will need to re-consider its approach to the treatment of gearing and the embedded debt premium.

Figure 1: Post-tax rates of return 1990-91/2000-01



Essential maintenance

The level of expenditure on asset maintenance has long represented a soft target for a regulator looking to squeeze "base" expenditures to support enhancement schemes. The long lives of many water industry assets and the lags that can occur between deterioration in asset condition and deterioration in service quality ensure that the results of under-expenditure may not manifest themselves for a number of years. However, the condition of many assets of privatisation and the outstanding backlog of maintenance work demonstrate the myopia of this approach.

Much effort has been devoted to developing new measures of the serviceability of assets. Nevertheless, it is too soon to say whether these will represent a reliable, forward-looking measure of the required level of maintenance expenditure. In any event the temptation to squeeze allowances at the next review may be great.

Opportunity knocks

The pre-review period offers a window of opportunity for the "stakeholders" to review the ground rules of regulation, and also to try to agree a cost-benefit approach to future obligations.

Frontier's economists, who have worked closely with many of the water companies through the last review, are finding that the industry understands the need to be better-prepared this time. Reaching agreement on changes to the regime takes time. In the case of efficiency targets and the assessment of maintenance expenditure, information requirements can in themselves imply significant lead times.

The opportunity for quiet preparation is enhanced by the fact that – for the moment at least – the water industry is further down the politicians' anxiety list that certain other parts of the national infrastructure. And the Environment Agency is at least aware of the greater constraints under which the industry is operating.

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