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Agenda

Advancing economics in business

Planning the business in light of Ofwat's Future Price Limits proposals

Keith Harris, Oxera Associate, and Luis Correia da Silva, Oxera Managing Director, discuss how regulation of the England and Wales water industry looks set to change following the publication by Ofwat of its consultation on a framework for setting future price limits. Their particular focus is on how Ofwat's proposals may affect incentives and the business planning process

When the UK water industry was privatised 22 years ago, the Conservative government was in the midst of its popular capitalism programme which exposed state-owned corporations to market disciplines. The plan worked well. Equity pressures, along with comparative performance league tables produced by regulators, caused operating costs to fall and service to improve. This, combined with largely debt-free balance sheets and quite substantial price increases, allowed capital investment to be readily financed and profits to be healthy. Such were the profits that the regulator chose to intervene, eventually causing prices and investor returns to fall.

As might be expected, companies responded, returning money to shareholders by gearing up balance sheets. Moreover, as companies bunched towards the efficiency frontier and gains from efficiency investments declined, the focus changed to delivering value by generating long-term growth in the regulatory capital value (RCV) and exploiting the arbitrage between the allowed return and the marginal cost of capital.

Despite predications to the contrary, the need to invest in capital has continued. Moreover, new pressures have emerged, in particular the following.

- The industry is expected to deliver outcomes in an ever more sustainable fashion.
- Customers' willingness to pay higher bills seems to be diminishing, following a period of price increases and falling real incomes.
- Affordability among certain groups is a growing issue.
- Customers want to have a greater say in prices and services, and non-household customers are increasingly looking to a liberalised retail market to deliver that.

Through all of this runs a theme: through time, the regulator has taken increasingly greater control over the outcomes that the industry delivers. The consequence, it might be argued, is that companies have lost ownership of their business plans and consumers feel increasingly like taxpayers rather than customers.

Regulators may be forgiven for having acted in this way. The water industry has a high media profile and there is a politically acceptable ceiling on price increases, below which new investment obligations must be accommodated. If efficiency is increasingly stifled, and balance sheets largely exhausted, it is only to be expected that regulators will look to other ways to keep bills down—including squeezing returns. As the 'levers' open to regulators rely more on judgement than science, they can be readily exploited to the detriment of companies and their investors.

Regulators do, of course, have statutory duties and their decisions can be challenged. They therefore need to be careful with their decisions and, rather than confront companies, would be wise to identify a package which companies and their investors can live with. In return, companies would be wise to develop business plans that customers support.

The implications of current regulatory proposals

There are differences of opinion as to what these regulatory packages should comprise. In Scotland, the Water Industry Commission for Scotland (WICS) has sought to give ownership of business plans back to the company by looking to new incentives and by getting the company to agree, as far as is possible, with a new

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Customer Forum about what services are required and at what prices. If agreement is reached then the regulator will enact the proposals.

By contrast, Ofwat, the regulator of the water sector in England and Wales, seems to be proposing a more prescriptive model where:

- companies seek to agree outcomes, and the associated solutions, with a local customer forum. The more that the forum supports the proposals, and the more that the plan uses 'sensible' input assumptions, the less regulatory challenge is likely to be expected;
- the regulator's role is to consider whether outcomes are being delivered at best possible value;
- companies will be incentivised through separate retail and wholesale price limits (and within the wholesale limit a further sub-limit covering network and treatment activities), as well as new ways of remunerating capital and operating expenditure (CAPEX and OPEX).

Each proposal will have an impact on how companies prepare their business plans.

A retail price control

Arguably, a separate retail price control is simply the next logical step in the way in which price controls have always been set. If costs are transparent and ring-fenced, and there are no trade-offs between activities, then why should a regulator not seek to determine the comparative performance of each company in a sub-set of business activities, and set prices accordingly?

Ofwat proposes setting the price control for non-contestable customers equal to the industry's average cost to serve. In the contestable sector there will be a maximum default tariff. There are two significant issues. First, cost allocation. Ofwat proposes to use, as a starting point, the definition of retail services identified in its accounting separation work. If, however, mandatory legal separation became part of government policy, Ofwat notes that it would change its definition of retail to suit. It notes, however, that its proposals do not rely on legal separation being introduced by government.[1]

A lesson from Scotland is that the definition of what customers expect from 'retailers' is not necessarily what either regulators or companies initially presume. While it would be easy to assume that retail is largely about price, billing, debt collection and contact management, experience tells us that 'retail' can readily evolve into areas such as operational customer service and 'added-value' services including water efficiency and waste management. The boundary can change and regulated activities can become contestable. Understanding the cost structure, and how it may evolve, should be central to effective business planning.

Second, should the regulator's duty to finance functions of retail activities continue? Where a competitive market has developed, it would seem odd not to allow retailers to fail, particularly if there are obligations on other players to continue to supply the customers of the failed company. The position in the non-contestable sector, however, seems different. Water and sewerage services are essential to customers, and they must be supplied. This is not to suggest that the water might stop flowing, but customers must continue to pay and to have high-quality customer service. That requires retail functions to continue.

A wholesale price control

Ofwat proposes that there will be one price cap to recover the cost of all wholesale activities. This will largely be set by using the existing building blocks of OPEX inflated by the retail prices index, capital maintenance charges, tax, and return on capital employed, but there are to be some significant new aspects:

- Ofwat proposes to remove the CAPEX/OPEX bias, potentially by moving to a total operating expenditure (TOTEX) approach;
- there will be an indicative non-binding price cap for 'network plus', which allows Ofwat to apply new incentives and determine access prices while keeping the cash flows within the regulatory ring-fence.

The attempt to remove the CAPEX/OPEX bias should be welcomed. But whether it is good for companies will depend on the detail of the TOTEX methodology. As it stands, the potential exists for there to be movements in revenues resulting in changes to bills, profits and cash flows. Whether it results in a rebalancing towards OPEX-based outcomes will also depend on the detailed workings of the proposals and a company's risk appetite.

The purpose and implication of the indicative non-binding sub-price cap seems less clear. Indicative price caps are just that. Indeed, they have existed between water and sewerage since 1995 but have not really changed how companies think. Moreover, the incentives in relation to activities such as the system operator that goes with the sub-price cap seem unlikely in themselves to change behaviours. All companies already carry out system operator activities in one form or another. The 'new' system operator activities that Ofwat envisages—fair access prices and facilitation of interconnection—rely more on corporate incentives to trade. Interestingly, the Future Price Limits proposals do propose new trading incentives, potentially including deregulation, which may reduce some of the more obvious barriers to bulk supplies which have grown up since privatisation.

Customer engagement is central to a legitimate business plan

Choice in the water sector is limited. It is not surprising, therefore, that some see consumers as taxpayers rather than customers. But to do so is a short-term, and ultimately self-defeating, strategy. Customers expect companies to understand and deliver the services they want, and to do so both efficiently and sustainably. Absent that, and as evidenced from periods of service failure, customers become cynical and ultimately hostile towards their service provider, the prices it charges and the profits it earns. By contrast, understanding and subsequently meeting customer expectations creates the feeling of value for money and a willingness to pay more for better services and growth. Engagement and delivery are the keys to long-term profitable growth.

It is impossible to engage on an individual basis, save for the largest or most vocal customers, particularly in the absence of a liberalised retail market. Evidence from Scotland suggests that a liberalised market for non-household customers does result in improved efficiency, lower bills and new and better services. However, there is no appetite, and no case, for a liberalised market for households. It follows that companies must seek to understand and fulfil customer expectations on a group basis.[2] This implies the need to create and engage with a representative, legitimate and knowledgeable customer forum.

Again, the Scottish model could prove instructive in developing customer-focused business plans. Here the regulator and company have agreed that Scottish Water can negotiate directly with a Customer Forum over discretionary improvements to service. The negotiation, which will be undertaken with full knowledge of the potential impacts of the mandatory quality programme and other 'technical' inputs such as future efficiency and financeability, will be accepted by the regulator should both parties agree. In doing this, the Customer Forum is given real power and responsibility, and the company regains control of its business plan.

While the Ofwat framework seems to exclude this outcome and leaves the majority of the decision-making in the regulator's hands, it would take a brave regulator to over-ride an agreement between a company and a legitimate customer representative which was arrived at through an open and transparent process founded on 'plausible technical inputs'.

Ideally these plausible technical inputs should come in the first instance from the regulator. There is, however, a natural reluctance on behalf of the regulator to do this, thus leaving companies to make the first move.

This might be good for those companies that are willing to take ownership of their plans. Carefully considered and well-argued inputs can, and should, show the company to be a responsible organisation seeking a balanced outcome. In turn, this should encourage the customer forum to support the company's proposals and make it even harder for the regulator to overturn the business plan.

Part of this process could involve proposals in the business plan for innovative solutions to the customer forum, or indeed to the regulator, which deliver sustainable and efficient solutions over the longer term. Companies should not be shy in putting forward proposals even if these do not fit readily with the existing regulatory framework. For example, companies should put forward operating solutions if they deliver better outcomes for customers and, in doing so, should demand at least the same returns as they would achieve with the traditional capital-based scheme. Indeed, there may be a case to ask for higher returns if the risk is greater. Again, it would be a brave regulator that would overturn proposals that both customers and companies believe to be in customers' interests.

Checks and balances

Legitimacy requires there to be checks and balances. It would not be acceptable, for example, for returns to be wildly above the cost of capital. Companies may therefore like to think about 'bounded returns', whereby any variation that is within a certain range of that which is expected flows directly to investors, but returns in excess of that amount are shared. Of course any such mechanism should be symmetrical, thus limiting a company's downside and, in doing so, reducing the cost of capital.

The existence of such bounding may have the added advantage of reducing regulatory scrutiny and intervention. Provided that a company is delivering its outcomes and the customer forum is happy, why would a regulator need to scrutinise a company's absolute performance and activity?

Conclusion

The new regulatory framework, if enacted, will be challenging for companies, particularly if accompanied by legislative changes. But there are opportunities for companies that are positive and proactive with their customers, exemplars on performance, and which have a good understanding of their cost structure. Central to delivering exemplary returns to investors will be developing and presenting a business plan that is clearly and demonstratively in customers' interests.

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[1] Ofwat (2011), 'Future Price Limits – A Consultation on the Framework', p. 34.
[2] There can, of course, be more than one group, particularly at the retail level where customer segmentation is proving to be possible and popular in the liberalised Scottish retail market.