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Pamela Taylor  
Chief Executive

8 November 2012

Mr Caspar Swales  
PC13 Project Manager  
Utility Regulator  
Queens House  
14 Queen Street  
Belfast BT1 6ED

Dear Caspar

### **Representations on the draft determination for the price control 2013 – 2015 for Northern Ireland Water**

These representations are made by Water UK, a trade association representing substantially all the UK's water only and water and sewerage companies; Northern Ireland Water is a member of Water UK. They are a response to the Utility Regulator's draft determination of the price control 2013 – 2015 (PC13) for NI Water.

Our representations draw on our experience and involvement with the range of price control processes for the water and sewerage sector in England and Wales, Scotland and Northern Ireland that have taken place since privatisation of the companies in England and Wales, and introduction of economic regulation in Scotland and Northern Ireland.

We do not comment on all the detail of the draft determination. We focus our representations in three key areas, which are interrelated:

1. The governance arrangements / ownership model for NI Water.
2. Pace of change and efficiency challenge in 2013 – 2015.
3. Establishing the basis for the longer term, post-2015.

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## **Context**

The model of economic regulation for water and sewerage companies that was established by Ofwat in 1989 at privatisation of the industry in England and Wales has worked well. In England and Wales, over the last 23 years, it has provided the basis for significant improvements in company performance – in customer service, drinking water quality and environmental protection, as well as in terms of financial performance and cost savings. The regulatory model has been largely stable and change has been measured and predictable. This has been the basis for investor confidence in the industry and has meant that £110 billion of capital expenditure has been financed at a low cost of capital. The regulatory regime has incentivised companies to deliver and outperform – to the benefit of customers and investors over time. More recently, as the model has been adopted in Scotland and Northern Ireland (recognising different governance and ownership arrangements) impressive results have been achieved, notably in efficiency improvement and operational performance.

## **Summary of our representations**

In summary, we consider that through the proposed determination the Utility Regulator would put too much pressure on NI Water to make significant efficiencies over the course of 2013 – 2015 (around 6% in each year). These efficiencies come on top of the considerable efficiencies achieved and anticipated in the 2010 – 2013 period.

The 6% per annum efficiency assumption is at the top of the range realised by UK utilities since privatisation. It is generally higher than the rates achieved by water and sewerage companies in England, Wales and Scotland. The ability of NI Water to make significant efficiencies over the two years of PC13 is restricted by the governance arrangements that NI Water works under, coupled with the short duration of PC13 mean that:

- Comparisons with England and Wales companies are not valid without clearly and fully taking account of these factors – which we consider would reduce the efficiency assumptions that the Utility Regulator has proposed. There appears to have been only minor adjustments made to take account of the significantly different governance arrangements and the restrictions this places on the company to plan and deliver effectively.
- Efficiencies of this magnitude are too stretching on the company without other offsetting measures in the determination – but because of the governance arrangements there is little ability for NI Water to manage risk in the way that companies in England and Wales can. For instance,

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because of its governance arrangements it is severely restricted in its ability to phase and flex its plans.

This means there is a risk that service to customers will be compromised at a time when NI Water is facing significant challenges. In our view, of utmost importance is the need to have the strategic debate and make decisions over the next two years about the long term arrangements for NI Water – which you rightly highlight in the draft determination. Putting too much pressure on the company now risks harming services to customers which would be likely to adversely affect the debate about the long term.

### **The governance arrangements / ownership model for Northern Ireland Water**

Northern Ireland Water's governance and ownership model are significantly different from the England and Wales water companies and also from Scottish Water. These arrangements significantly compromise:

- The ability to make robust comparisons to the water companies in England and Wales and Scotland.
- The ability of Northern Ireland Water to make efficiency improvements as fast as companies in England and Wales and Scotland.

The companies in England and Wales are all private companies, which provides them and their management with incentives and flexibility to establish, deliver and outperform their plans over the course of the five-year control periods, without having to face the reality or the risk of ongoing government involvement and the changes to funding and plans arising from this, as NI Water does. Because of NI Water's status as a non-departmental public body (NDPB) we expect that this will severely affect Northern Ireland Water's ability to deliver efficiencies at the level and speed of comparator companies elsewhere in the UK. We discuss this further below.

The Utility Regulator has only made minor adjustments in its efficiency benchmarking to take account of the significantly different governance arrangements and the restrictions on the company to make efficiencies at the pace and level that the Utility Regulator considers possible over the two years of PC13.

## **The pace of change and efficiency challenge in 2013 – 2015**

The Utility Regulator's proposed efficiency targets for PC13 for the two years of the price control are very high (around 6% in each year) compared to NI Water's proposals of around 2% for each year of PC13).

The draft determination places great faith in the assumption that because NI Water has / is expected to achieved substantial efficiencies in the three years of PC10 (2010 – 2013) that these can be repeated. The evidence that is presented for this is weak, particularly in the context of a two-year price control and the wider aspects of NI Water's governance.

We do not agree with your argument (paragraph 1.3.2) that a three year control and a two year control, even if some assumptions are rolled forward is equivalent to a conventional five year price control. A 'normal' five year price control provides companies with a sufficiently long timeframe to plan and execute their plans – to deliver their obligations and, crucially, make changes to their organisation and introduce new technologies. Shorter price controls reduce the effectiveness of this since the company has less time to plan and respond, and they do not have clarity on the long term obligations and tariff/financial assumptions. It follows that the scope for efficiency improvement will, all other things being equal, be less for a 'two plus three' price control compared to a five year price control. Clearly water companies should always be planning for the longer term but this will be impacted by the inherent uncertainty ahead of a price control determination of the outputs, revenues and efficiencies for the next control period which will have an impact on longer term planning and delivery of efficiency savings (unless the financial and incentive framework fully mitigates against the transitions from one price control to the next).

You note clearly in the draft determination that NI Water faces constraints on its freedom to plan and flex its expenditure programme, including the need to deliver expenditure in-year (i.e. it cannot re-phase to future years) and it faces in year budget reviews and may have to pay its shareholder in-year out any outperformance. It faces a range of other restrictions on its commercial freedom (e.g. in relation to procurement), through its NDPB status, that companies in England and Wales do not face. It is good that the Utility Regulator recognises these constraints but, looking at the proposals, we do not consider that these are reflected in the assumptions made on efficiency and hence assumptions that are too high have been made. We recognise that many of these issues may apply more to capital expenditure than operational expenditure, but they do impact on opex as well as capex.

The assumptions that the Utility Regulator makes on efficiency are also questionable in the face of the uncertainties over the special factor adjustments compared to companies in England and Wales. We note that the special factor adjustments employed in England and Wales have been developed over many years. This has clearly not been possible for NI Water. The Utility Regulator assumes that the uncertainty in the special factors cancels out (i.e. has an expected value of zero). But because of the high level of efficiencies proposed and the uncertainty of the special factor adjustments, of this the Utility Regulator should take a more cautious approach and review its assumptions on efficiency. In respect of Scotland, we note that WICS took a more cautious approach in its 2002 determination in this area.

In making efficiency assumptions, economic regulators have tended to assume that companies cannot 'catch-up' more than 60%/two-thirds of the 'efficiency gap' over a five year period, see for instance the assumptions that Ofwat has made in its price reviews and the periodic review of Network Rail covering the 2009 – 2014 period made by the Office of Rail Regulation in 2008. In making its assumptions on efficiency, the Utility Regulator appears to be breaking with regulatory precedent, assuming that 'catch-up' will be more than 70% over five years which reduces the scope for efficiency improvement (notwithstanding the point above about the 'two plus three' nature of the price controls) . Given the uncertainties in the special factors, the short duration of PC13 and the governance arrangements for NI Water this is too challenging and risks harming customer service.

### **Establishing the basis for the longer term, post-2015**

The Utility Regulator recognises that NI Water's governance framework is not optimal. We support the development of a long-term (24 year strategy) and the Utility Regulator taking a more strategic view to the next price control, including that this might have a six year duration. We would support a strategic review of the governance arrangements for NI Water. If NI Water is to deliver its obligations efficiently over the longer term, in the context of a longer duration price control, it is essential that the governance arrangements are reviewed to ensure that they are 'fit for purpose' in this context. In this regard, we consider that the next two years should be about ensuring that NI Water continues to improve its delivery for the benefit of its customers and for its owner but that the efficiencies the Utility Regulator is proposing are too high and risk damaging customer services and hence distracting from and harming the strategic review to put NI Water on a stronger footing for the longer term.

**Next steps**

Please do not hesitate to contact me if you would like to discuss anything raised in our representations.

Yours sincerely

A handwritten signature in black ink that reads "Paul McMahon". The signature is written in a cursive style with a large initial 'P'.

**Paul McMahon**

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