

The Consumer Council's response to the Utility Regulator's Draft Determination on the Water and Sewerage Service Price Control 2010-2013.

November 2009

Our reference: PD 20090/357

1. Introduction and Key Messages

The Consumer Council is pleased to respond to the Draft Determination for the Water and Sewerage Service Price Control 2010-2013 (PC10) published by the Utility Regulator (UR) in September 2009. This is the first time water charges and revenues for Northern Ireland Water (NI Water) have been reviewed by the UR and it represents an important step forward in the process of reform in water and sewerage services in Northern Ireland.

The key messages in this response are:

- 1.1. The Consumer Council has been encouraged by the focus on consumer consultation during the PC10 process and the way in which the UR, NI Water, Consumer Council, Northern Ireland Environment Agency (NIEA), Drinking Water Inspectorate (DWI) and the Department for Regional Development (DRD) have collaborated to make sure this consumer consultation properly informs the future development of the service. This must continue throughout PC10.
- 1.2. The Consumer Council acknowledges that the UR has set challenging targets for NI Water in making savings in its operating and capital expenditure programmes and believes that such an ambitious stance is appropriate and necessary to encourage continuing improvements in the management of NI Water.
- 1.3. However, the Consumer Council questions the UR's position on what should be done with the savings from increased efficiency. Rather than simply lowering NI Water's revenue requirement, some of the savings could instead be used to further address the concerns expressed by consumers, bringing forward some of the investment that will be needed to deliver better quality services and bring Northern Ireland closer to the standards experienced in the rest of the UK.
- 1.4. The Consumer Council believes that improvements in performance that benefit consumers will come, at least in part, because of the governance and incentive regime in which NI Water operates. The UR has an important role in structuring and setting the context for that regime. We are concerned that

the Draft Determination does not appear to consider or address these issues as directly as the water regulators have done elsewhere in the UK.

- 1.5. Importantly, decisions in PC10 about revenue requirements are being taken in the context of considerable uncertainties around a future charging policy (i.e. domestic charging). Fundamental issues need to be reviewed by all key stakeholders including the Northern Ireland (NI) Executive.

2. What is PC10 and what is the Consumer Council's role in it?

- 2.1. In the price control review, PC10, the UR independently assesses the amount of money NI Water needs for the next three years to deliver water and sewerage services. Its assessment is informed by consultation with consumers, the water quality and environment regulators and the Government. The assessment becomes a 'price cap' for the period, determining the maximum revenues NI Water can receive. These revenues are needed to fund the cost of operating and investing in the service. PC10 directly affects how much it all costs us as charge payers or tax payers, it affects the quality of the services we receive and it helps make sure NI Water is managed well.
- 2.2. PC10 is the first of what should become a five-yearly price control review process for NI Water. It is a welcome and significant first and an opportunity to help ensure the process provides enduring benefits to Northern Ireland consumers.
- 2.3. Decisions made for PC10 will not just affect water and sewerage services for the next three years but will also set the scene beyond 2013. This is why it is so fundamental.
- 2.4. Water and sewerage services cost a great deal of money, for charge payers or tax payers. But they also contribute a great deal to our quality of life, our economy, our environment and our health. Consumers have every reason to expect those services to continue to improve and come up to the standards experienced elsewhere in the UK and in the rest of Europe.
- 2.5. The Consumer Council's role is to represent the views of consumers. This response is an important way for us to help ensure consumers' interests properly inform the decisions the UR will be making in December. In developing this response, we have adopted a high level approach, focusing on the broader issues of principle rather than trying to second guess the detailed assessments that the UR has to make.
- 2.6. The Consumer Council remains committed to play its role constructively and work with all key stakeholders to get Northern Ireland's water and sewerage services right for consumers.

3. Consumer Priorities

3.1. The Consumer Council has been encouraged by the way that consumers have been listened to during PC10. Their views must remain the focus of key decisions and PC10 must deliver tangible benefits for consumers.

3.2. However, it would be impossible to address all consumer priorities fully during PC10. There has to be a trade-off between what can be done and what is affordable. For this reason, the Consumer Council led and helped formulate extensive consumer research in 2008 which was commissioned by NI Water¹. The results of the research became an important input to the Social and Environmental Guidance published by the Regional Development Minister, which set out his priorities for PC10.

3.3. The top five consumer priorities highlighted by our research for PC10 were:

- Internal sewer flooding
 - It was clear that this is consumers' number one priority. Despite it affecting relatively few properties it is such an unpleasant experience that reducing the risk of occurrence is seen as an imperative.
 - We are pleased to see that a risk register is being put in place and the planned removal of 200 properties from that register is a start. However, the UR must ensure that the target for removal is continuously ambitious with longer term plans being developed to tackle internal flooding.
 - We also consider there are detailed questions for the UR to monitor and report, for example what properties will be removed from the register, how and when.
- Pollution
 - Inland water and coastal waters pollution were consumers' second and fourth priorities respectively.
 - Improvements to sewage treatment and fewer pollution incidents will go some way to meet the improvements consumers want.
 - The Consumer Council will look to the Northern Ireland Environment Agency (NIEA) for assurances of compliance and that the environmental benefits set in PC10 are correct and are being delivered.
- Safety of tap water
 - Most consumers are satisfied with the quality of their tap water but it must not be put at risk through reduced or redirected investment.
 - The Consumer Council will look to the Drinking Water Inspectorate (DWI) for assurances of compliance and that the improvements to drinking water set in PC10 are correct and are being delivered².

¹ Tapping into Consumer Views on Water: A Research Report by the Consumer Council commissioned by NI Water, March 2009

² The UR has set a Mean Zonal Compliance target of 99.8 per cent to reflect recent performance, recent investment and continuing investment.

- Response time
 - Consumers want a responsive company that solves any problems first time.
 - We support the UR's new performance measures³ for NI Water. These will help check the response to consumers and how this improves over PC10.
 - Improvements in customer services will be expected and supported through the development of better data and information systems.

3.4. In addition to these top five priorities consumers have a keen interest in minimising leakage and reducing problems caused by low water pressure. The Consumer Council welcomes that the UR has asked NI Water to review the targets and provide further information.

3.5. Having identified these priorities, it is important to ensure value for money in their delivery.

3.6. NI Water has much work to do to ensure that its infrastructure and treatment processes comply with mandatory EU environmental and quality obligations. Infractions which lead to fines mean a loss of money, not just to NI Water but to Northern Ireland. There is a balance between the cost of improvements and the risk of infractions, but we understand that at present NI Water is behind the rest of the UK. This suggests that, as well as addressing consumer priorities, further investment in these areas is desirable. However improvements must be fully cost effective, and 'gold-plating' and unnecessary costs are to / must be avoided.

4. What to do with savings?

4.1. NI Water made advances during the Strategic Business Plan (SBP) period, 2007-2010. We note that it is projected that NI Water will miss some SBP targets. The UR's final determination should give assurances that the SBP will be delivered. The PC10 business plan is largely dependent on the delivery and success of the SBP.

4.2. The UR has assessed that NI Water should be able to achieve substantial savings compared with the costs it originally set out in its PC10 business plan. The Government signalled that it was prepared to provide the funds to support the PC10 business plan, so the question arises what should be done with those savings?

4.3. We acknowledge that the right balance needs to be struck between lower costs and investing for better quality services and better outputs. However, we also believe that the consumer interest must be the guide to what that balance should be.

³ The UR intends to introduce additional measures of the number and frequency of repeat complaints; the number and frequency of holding responses; and the number and frequency of sewer blockage clearances exceeding 24 hours.

- 4.4. The Consumer Council believes that it may provide better value and be more affordable long-term to invest now rather than later to maintain and improve our water and sewerage services⁴.
- 4.5. The recent downturn in economic activity and the recession over the last six quarters has affected the construction market. Construction contracts during the period covered by PC10 should be negotiated at more favourable rates than we might expect in subsequent years. Cheaper prices now will lower the eventual costs to consumers. Additionally and importantly, consumers would also get the benefit of the improved service earlier.
- 4.6. We understand the UR's concerns about NI Water's lack of clear links between outputs and investment and its capacity to manage a large programme. The UR must be confident in the benefits that any increased investment will deliver before approval. If NI Water clearly articulate benefits which can be efficiently delivered the Consumer Council believes there is value in considering increased investment now.
- 4.7. At present we consider that the emphasis may be too strongly placed on reducing costs rather than using available funding to deliver more. This current emphasis may disadvantage the consumer in the longer term.

5. Efficiency Assumptions

- 5.1. The Draft Determination describes a big gap in the efficiency of NI Water compared to water and sewerage companies in England & Wales⁵ and to Scottish Water.
- 5.2. The UR assumes that NI Water will be able to catch-up with its peers within a reasonable period of time, consistent with the rates of improvement that were originally achieved by those other water and sewerage companies. We have consistently called for challenging, ambitious and realistic targets to be set for NI Water. Overall we are encouraged by and support the stance taken by the UR in rigorously challenging the operating and capital spending of NI Water.
- 5.3. Historically water and sewerage companies have outperformed the efficiency targets set in England, Wales and Scotland. The scale of the gap to England and Wales, the ability to learn from others' advances, and the relatively young status of NI Water combined with the three year SBP period to build momentum all support the UR's assumption that NI Water will not be an exception.

⁴ The Consumer Council agreed with other stakeholders that £38m capex if delivered from reductions elsewhere in the capital investment programme should be redirected to wastewater treatment improvements to address priority compliance and development constraints. NI Water will work with Northern Ireland Environment Agency (NIEA) to agree the detail.

⁵ For example, in 2007/08 NI Water's operating expenditure efficiency gap was 48 per cent to England and Wales average and 54 per cent to England and Wales benchmark or frontier companies. The UR's 2007/08 Cost and Performance Report

5.4. However, the efficiency gains achieved in England and Wales were encouraged by strong economic incentives on the companies. Incentives for NI Water must also be strong if we are to expect them to be achieved. A failure to achieve them will lead to higher costs in due course and/or lower service levels, all to the detriment of consumers or public services elsewhere in Northern Ireland.

5.5. We consider incentives in more detail below.

6. Hard Budget Constraint

6.1. The Consumer Council considers it important that NI Water delivers the outputs that it will be remunerated for through PC10. This is the implied contract between the company and consumers. Accordingly, it is important that NI Water can secure the finance it requires to deliver those outputs.

6.2. As in England and Wales, consumers should be protected against or compensated for a failure to deliver outputs, either directly in the price cap during a period or in the subsequent period. We acknowledge that, while domestic charges are subsidised by the Government, the issue affects mainly non-domestic consumers.

6.3. The status of NI Water as a Government owned service provider means that it may be subject to government imposed financing constraints that could compromise its ability to deliver the agreed outputs. We consider it is important that the Government is able to commit to the levels of financing implied by the outcome of PC10.

6.4. The Consumer Council also considers it important that NI Water has a reasonable degree of flexibility in its funding, which can be necessary for the efficient management of the company's operations and its investment programme. We agree with the UR that while being monitored closely⁶, NI Water should not be micro-managed.

6.5. Similar issues have been encountered in Scottish Water and the Water Industry Commissioner for Scotland has identified the kind of developments in the governance of Scottish Water in recent years that have not been in the consumers' interest⁷. It would be unfortunate if similar issues arose in Northern Ireland.

⁶ NI Water is subject to a number of monitoring mechanisms including the public monitoring plan to be developed following the UR's final PC10 determination. Other methods include the annual information return and regulatory accounts, the annual scheme of charges consultation, quarterly Output Review Group meetings with all key stakeholders and the UR's annual cost and performance report.

⁷ See Section 2.3 of WICS's Staff Paper 2 on 'Governance and incentives', available on http://www.watercommission.co.uk/view_Publications_Main.aspx.

7. Incentives

7.1. The Consumer Council agrees with the UR that the governance and incentive arrangements are central to incentive regulation and central to the interests of consumers.

7.2. A strong incentive regime for NI Water, as for any regulated business, relies on the interests of management being aligned with the interests of consumers. For privately owned, profit seeking-businesses, incentive regulation provides profit incentives for shareholders (as far as possible aligned with consumers' interests) and rely on corporate governance arrangements to align those owner's interests with management's as well. NI Water is not a profit-seeking private business so the UR's regulatory objectives are more directly dependent on management incentives.

7.3. Similar situations exist for Scottish Water and Network Rail. In both of these cases, the regulators have been able to ensure that the management incentive arrangements are structured around regulatory performance measures. The issues for Scottish Water are described in Staff Paper 2 'Governance and incentives' published by WICS in June 2009.

7.4. Incentives for management can be structured in two broad ways:

- Financial incentives – management incentives being linked very clearly to out-performance of regulatory targets; and
- Reputational incentives – the company and its managers being held publicly to account through the transparent reporting of performance in ways that are accessible to consumers.

7.5. Both types of incentive rely on the clear public reporting of NI Water's performance. The UR has a central role to play in reporting the company's performance and facilitating better reporting by the company .

7.6. We would expect the incentive regime to take account of:

- Economic performance – economic incentives need to be placed on the company, however we recognise there are limitations to these incentives for a publicly owned company without a strong profit objective. The Consumer Council would in principle support the provision for a consumer reserve to be established to account for outperformance and provide a mechanism for the benefits to be returned to consumers;
- Service performance – the performance of NI Water must be publicly reported in an accessible and understandable way, for example the overall performance assessment;
- Management incentives - incentives provided to management should be linked to the out-performance of targets. There must be transparency in how any link is structured and what incentives are offered;
- Data management – the quality of data impacts on the incentive regime as poor information makes for poor decision making and poor monitoring of

performance. While there remain significant data issues at NI Water, incentives should be structured to encourage a rapid improvement.

7.7. In our view, the emphasis on incentives in the Draft Determination is not strong compared to what the Consumer Council might expect and is evident in similar situations⁸. The Consumer Council looks to the UR to engage with the Government and NI Water in the coming months to ensure that the performance assumptions behind PC10 are reflected in best practice management incentives and transparent performance reporting arrangements.

8. Data

8.1. The Consumer Council recognises the difficulties that NI Water has experienced in producing reliable, robust information and the steps taken to improve its data.

8.2. The level and quality of data must improve significantly during PC10.

8.3. We have stated that our expectations for NI Water for PC13 would be full Grade A data and that systems are fully functioning for all purposes of data collection and analyses.

8.4. Problems in data can lead to potentially significant implications for consumers. Excuses reliant on legacy issues can be no more. We expect responsibility for all data to be taken by NI Water.

8.5. Consumers should not be burdened with the risk of poor decisions resulting from flawed data. There must be flexibility and protection from such risk.

9. Prospects for domestic charges

9.1. The Consumer Council considers there is value in a review of many issues agreed during the restructuring of Northern Ireland's water and sewerage services as the public policy debate and wider political context has moved on significantly since then.

9.2. The discussion about the full implications of domestic charging or continued deferral should begin afresh. The right balance between water charges and public services needs to be established. The balance that best suits the needs of Northern Ireland should be determined by Northern Ireland Ministers.

9.3. The debate should help ensure that we have a water and sewerage service that is socially, environmentally, politically and financially sustainable.

⁸ See for example Water Industry Commission for Scotland Staff Paper two, 'Governance and incentives', June 2009

- 9.4. These policy decisions go beyond the remit of the UR but we all have a role to play in starting to open up the discussion, including how consumers and NI Water are best protected if the full level of funding set out cannot be committed.
- 9.5. NI Water was established as a Go-Co to be self-financing with comparable charges to England and Wales. Comparability may be untenable due to the current structuring of NI Water.
- 9.6. The impact on relative water costs of the UR increasing NI Water's Regulatory Capital Value (RCV) is offset in PC10 by the UR's strong efficiency targets. There will be less scope for similar reductions in future price controls.
- 9.7. Fundamental questions need to be examined around the level of the RCV and the financial structure of NI Water in today's context.
- 9.8. It is with these concerns in mind that the Consumer Council agrees with the UR in its considerations that the RCV is not yet a fixed policy assumption and needs to be further analysed ahead of PC13⁹.

10. Looking forward to PC13

- 10.1. The tight timeframe of the PC10 process and the 'missing' element of a final business plan from NI Water has led to the rapid turn around of information and caused difficulties with all parties looking for clarification on figures and gaining understanding of figures at a late stage in the process. This process gap needs to be avoided in future price controls.
- 10.2. All stakeholders are keen to learn the lessons of PC10 and in line with the UR's indicative timetable we would encourage the early engagement of principal stakeholders and wider consultation to set out the approach and timeline for PC13.
- 10.3. Climate change, water efficiency, renewable energy and the cost of carbon will become increasingly important as PC13 develops. Consumers have increased awareness of such issues and recognise that some investment might be needed but that this would become more of an issue in the future¹⁰.
- 10.4. Like the UR we expect NI Water's twenty five year strategic direction statement to provide the longer term context for PC13 and beyond.

⁹ The UR's draft determination paragraph 7.1.7

¹⁰ Tapping into Consumer Views on Water: A Research Report by the Consumer Council commissioned by NI Water, March 2009