

Water UK submission to NIAUR on the draft determination of price limits for Northern Ireland Water (PC10)

This submission is made by Water UK, representing the views of the appointed water businesses in the UK, in response to NIAUR's draft determinations of price limits (PC10) for Northern Ireland Water (NI Water).

Three separate price controls are currently in the process of determination by the 3 independent economic regulators, Ofwat, The Water Industry Commission for Scotland (WICS) and the Northern Ireland Authority for Utility Regulation (NIAUR) of their respective water industries in England/Wales, Scotland and Northern Ireland. Water UK has recently responded to the draft determinations issued by Ofwat and WICS (attached for reference).

In accordance with our policy of identifying issues of common concern across our membership, we are writing to highlight our memberships' concerns regarding regulatory issues of process, principle, and approach/methodology with regard to NIAUR's draft determination for NI Water.

Overview

In sum, our concern is that the draft determination leaves too little or no headroom for the company to manage foreseeable risks (indeed, it appears to exacerbate foreseeable risks) – by setting opex at unrealistically low levels, not taking due account of external and uncontrollable factors which are already manifesting themselves, and failing to provide appropriate risk mitigation measures.

Whilst the regulator may hope that, by imposing substantial risks on NI Water, this elicits an unprecedented efficiency achievement, the reality could be very different. There are practical limits to improvements that can be achieved in a short period of three years, in a difficult economic climate and where the company has to effect a massive cultural, organisational and operational shift. It is of note that the effective efficiency challenge set for NI Water is considerably more severe than in any previous regulatory settlement, in UK water or other regulated sectors.

With risks skewed heavily to the downside, a lack of an effective buffer mechanism, and public financing at the core, the Draft Determination

may pose a real risk of compromising service to customers and/or a political wrangle over funding.

In the water sector, the key element of controllable operating costs is labour. The implications of stringent required cuts in operating expenditure – such as proposed by NIAUR in its Draft Determination – will undoubtedly be heavy job losses. Aside from implications for labour force relations in the Northern Ireland community and staff morale, such a scale of manpower cuts must beg serious questions about the impact on operational delivery, translating through to quality of water, environmental performance and customer service.

If the present approach in the Draft Determination is maintained by the NIAUR, we question whether this will deliver an outcome that generates stakeholder confidence in the new industry framework and regulatory regime, or ensures the stability and sustainability of a sector that has a significant role to play in the region's economic prosperity and health. Customer surveys consistently show that above all, customers value reliability and quality of service, and stability and predictability in pricing.

We note the regulator's interest more generally in regulatory reform, and urge him to make PC10 a clear signal of a constructive and sustainable approach to regulation ahead. In particular, it will be crucial for NIAUR in arriving at its Final Determination to set out how it has assessed risks to performance and service delivery, bearing in mind that accountability for delivery lies with NI Water, not the regulator.

Regulatory Process

All our members have common concerns about the regulatory process of their reviews. NI Water is no exception. NIAUR shares, with Ofwat and WICS, a duty to have regard to the five accepted principles of better regulation¹. Yet, all our members have raised concerns – in one way or another – about the transparency, consultation and robustness of reasoning underpinning regulatory draft determinations.

In Northern Ireland, NI Water has only recently been constituted as a 'GoCo' and become subject to economic regulation. A significant (and long overdue) transformation of the industry is now underway to improve

¹ The five principles are: transparency, accountability, proportionality, targeting and consistency.

the service to customers both now and for many generations to come. The company has already made good progress, embarking on significant corporate change, and is on course for achieving the initial efficiency targets set for it for the two years preceding the price control period, ie 2008/9 and 2009/10.

Good regulatory process has its own crucial part to play in building confidence in the regime for all stakeholders, and in encouraging the company in its effort to adopt more efficient and customer focused behaviours. We have therefore been disappointed with the limited degree of transparency, structure and consultation we have observed through the review.

Whilst acknowledging that NIAUR set out with the welcome ambition to pursue a 'light touch' regulatory approach, this instead appears to have given way to a data-intensive process and limited transparency particularly regarding regulatory reasons and evidence given for judgements. Where open and constructive consultation by NIAUR with the company may then have filled in the gaps and permitted greater understanding and confidence, a minimalist approach by the regulator appears to have been adopted. NI Water will have alerted you to the detail of their concerns.

Data weaknesses, complexity and risk

Of course, a key problem facing both NIAUR and NI Water (and indeed other stakeholders, observers and analysts) at this review, is the relative lack of robust data and systems for data capture that the company has inherited from its very recent public sector past. This is undoubtedly a source of frustration for all parties, particularly given the regulator's adoption of the highly data intensive comparative modelling techniques employed by Ofwat.

We are disappointed that the NIAUR has not sought to develop an approach that avoids falling into the same spiralling data complexity that now besets the industry's regulation elsewhere. However, as this is the approach that NIAUR has adopted for PC10, it is important to be clear of the implications for the associated risks in price setting. A lack of robust data adds to risk. In Northern Ireland, with no equity participation and unless effective risk mitigation measures are put in place (see further discussion below), risks will fall squarely with customers (particularly through operational performance and service) or with the government owners.

A lack of robustness with regard to data and underlying analysis should suggest some caution with regard to setting aggressive price limits for PC10. Furthermore, whilst the problems of an evolving dataset may necessarily mean greater recourse to regulatory judgement, given the risks involved, it is all the more important that such judgement is clearly explained. Providing clear reasons is an important element in ensuring the accountability of regulators that helps to secure confidence in their determinations.

As in England and Wales, where companies have been concerned about consistency and robustness of regulatory judgement (for instance in some cases overturning companies' own customer surveys evidence), in Northern Ireland, the company has similar concerns that NIAUR's reasoning sometimes appears to lack rigour, for instance with respect to opex allowances/disallowances. (as further discussed below).

Whilst caution in setting price limits may be indicated, NIAUR might also consider more targeted incentives for data improvement. This might be generated for instance by a commitment to work transparently and constructively with the company – and other stakeholders - to develop a timely, solid and proportionate database and analytical framework for PC13.

Scale and pace of expected improvement by NI Water

It is also understandable that there will be a desire on all sides for NI Water to catch up with its peers elsewhere in the UK. That the efficiency and service gaps are large is not a matter of dispute. NI Water has the benefit of learning from the improvement experience of its peers in the rest of the UK, and hence may reasonably anticipate a faster pace of improvement than was achieved for instance directly following privatisation in England and Wales. However, it will be in customers interests that efficiencies delivered are sustainable and do not compromise service either now or in the future. Determining a pace of improvement in current conditions that is neither too slow nor too ambitious will be crucial to that sustainability.

The pace of change expected in the draft determination for NI Water, however, appears extraordinarily challenging and must raise questions as to whether they are plausibly achievable. In such circumstances, it will be important for the regulator to examine bottom up evidence from the

company as well as its own top down modelling assessment in order to sense check the targets against operational realities. Such an approach is regularly employed by the Competition Commission in reviewing price limit appeals – precisely because it is in this way that the risks of a determination may be more clearly exposed.

The regulator will also want to take into account any reasonable regional peculiarities faced by NI Water – including any possible constraints posed by the state of the local economy and the political and institutional framework for water in Northern Ireland. When comparing NI Water against peers, it is important also to recognise specific factors that may have been relevant elsewhere. For instance, Scottish Water's initial efficiency performance took place against the background of the simultaneous consolidation of the prior 3 regional water authorities into one company, Scottish Water, and the realisation of economies of scale.

Again, clarity regarding the regulator's analysis and judgement will be of paramount importance in providing confidence to the company and to customers that expectations are achievable, even, exceedable.

Common concerns with the approach to base opex and risk mitigation measures

a) base opex

As with companies in England and Wales, who have been concerned about Ofwat's approach to base opex in PR09, NI Water has concerns with the NIAUR's approach to base operating expenditure. It would appear that NIAUR has added to the effective efficiency challenge by making particularly harsh judgements on base opex. In particular concerns that the regulator may have disallowed:

- legitimate 'uplifts' that have either already arisen or may be expected to arise as a result of new externally imposed legal requirements (eg to meet environmental standards);
- costs associated with business transformation (functionality) from a public sector organisation to the new organisational requirements of a regulated business; and
- spend-to-save investments for instance in IT or other systems.

Whilst the regulator has applied the two reasonable key criteria, viz of 'exogeneity' and 'newness', to proposed uplifts from base year opex, the consistency or logic with which these have been defined or applied is not

clear. In addition, in denying transformation and spend-to-save costs, NIAUR appears to have ignored the pragmatic approach adopted by the WICS when dealing with Scottish Water at a similar time of business transition. The WICS' recognition of spend-to-save schemes is particularly farsighted in terms of the incentive this gives the company to innovation.

Furthermore, in Northern Ireland, where the regulator is at the same time proposing substantial efficiency targets, based on the outperformance that has been achieved by others to date, the scope for additional improvement to absorb transitional costs may be unrealistic. Also comparison with the previous performance of other companies must be contextualised to the current realities of the business environment and circumstances in which NI Water operates.

b) risk mitigation measures

Whilst base opex and the efficiency challenge appear to have been set so that there are substantial downside risks from the beginning of the price control period, risk mitigation measures are few and of questionable value.

NI Water has itself requested a number of Notified Items for exogenous uncertainties. Likewise, across England and Wales, there is consensus that the following exogenous costs pose significant cost risk to warrant a Notified Item status:

- Business Rates
- Taxation changes
- Climate change
- Bad debt.

However, in Northern Ireland, it is clear that with only a 3 year price control period, the effectiveness of the IDOK mechanism in providing a risk buffer becomes questionable. The reduced timescale provides a very limited window of opportunity for an IDOK application and may mean that the company remains effectively exposed to substantial exogenous as well as normal business risk. In this case, whether or not there are Notified Items may be academic.

In England, business risks to which the companies are exposed are assumed to be carried by shareholders. In Wales and Scotland where there are no shareholders, the companies and regulators have been

concerned to ensure mechanisms are put in place to provide an equivalent risk buffer, and that these are adequately resourced.

In sum, the effective lack of any risk mitigation measures, means that the Final Determinations must themselves make due allowance for risk. If not, the only levers available to the company in the face of unexpected cost shocks, will be to reduce costs elsewhere, possibly jeopardising operations and/or investment – with implications for the sustainability of service to customers.

This provides an important reason for NIAUR to reconsider the balance of risk in its determination.

Conclusion

The NIAUR Draft Determination for NI Water raises a number of significant concerns – several of which in principle are shared by companies across the UK in relation to their own reviews.

Whilst there is no disputing the efficiency catch-up the company needs to make over time, the effective challenge in the next 3 years appears unprecedented. This is the result in particular of a combination of squeezing the catch up into a short period of 3 years and expecting this to be applied to base opex assessments that already appear to be at the bottom end of any plausible range, reflecting some questionable exclusions.

With a lack of any effective risk mitigation measures, and in the context of currently extraordinarily difficult economic climate, there is a need to consider whether the Draft Determination would secure sustainable efficiencies and a sustainable service for customers.

NI Water is continuing on a major transformation, begun in 2007, and faces a future where, not least as a result of climate change and ongoing economic uncertainties, the challenges to delivery will only get greater. Against this background, it is crucial that the review builds confidence in this key sector – which lies at the heart of the political economy of Northern Ireland. We urge NIAUR to draw on its mature experience of regulating in the energy sector, and its forward-thinking ambitions for a lighter touch and dynamic regulatory regime, to provide in its Final Determination a clear and well-reasoned approach, an appropriate

balance of risk and achievable incentives for sustainable improvement and innovation.