

Regulation of the Northern Irish water and sewerage industry: Statement of Regulatory Principles and Intent

April 2007

Introduction

1. This paper sets out the Northern Ireland Authority for Utility Regulation's (NIAUR's) intended high-level approach to its new duties in respect of water and sewerage services. The paper also highlights some of the main areas of work we will tackle in the coming months, and a number of important themes about the way we will work with stakeholders.

Political context

2. We write at a time of intense debate about the future of Northern Ireland's water and sewerage industry. This debate is to be welcomed if it helps to establish firm public confidence in this industry, which is vital to public health and the environment, and itself forms a significant part of the NI economy¹. A number of approaches could resolve the major inherited problems of this sector and lay a firm foundation for the future. As utility regulator, we will work within whatever legal framework applies, in the interests of customers. We are also happy to deploy our expertise to assist elected representatives in assessing any proposed changes in this area.
3. The legal and economic framework for our water and sewerage industry must be commensurate with the major challenges facing that industry. Any effective strategy to meet these challenges would be likely to embed two key principles:
 - Resources must be found to enable the long-term planning and execution of major capital investments. Resource availability for water and sewerage must be predictable well into the future, not subject to short-term fluctuations driven by public-spending limits; and,
 - Institutional arrangements must drive efficiency into the water industry, so that the large capital injections currently under way are well spent. Independent regulation has a strong track-record in this area.

Early steps

4. To begin clarification of the regulatory framework, NIAUR intends to take forward the following main pieces of work in 2007-8:
 - Spring 2007 – Publish note setting out our approach to reviewing NIW's Strategic Business Plan
 - Summer 2007 – Publish consultation document on metering review
 - June 2007 – Receive first main data return from NIW

¹ Around 1.5% of NI gross value added (i.e., GDP).

- Autumn 2007 – Begin consultation on “Approach to PR09” and supporting information requirements
 - December 2007 – Publish Annual Report collating responses from information requests
 - March 2008 – Publish “Approach to PR09” and supporting information requirements
5. In taking forward our role as economic and customer services regulator, we will work closely with other statutory bodies. As utility regulator we have a number of duties to receive appeals or make determinations in respect of customer disputes. We will work closely with the General Consumer Council to ensure that our role as regulator is confined to those areas requiring our more formal and legally-based approach, and that consumers can still benefit from the Consumer Council’s mediation. We will also work closely with the relevant environmental and quality regulators.
 6. Ministers will continue to have overall responsibility for Northern Ireland’s water industry. They are also envisaged as having a statutory role in providing guidance to NIAUR, if they so wish to exercise. The main thrust of Ministerial policy is clearly expressed in the overall legal framework created by Parliament, notably in the creation of an independent regulator. We therefore expect that guidance will take its place within that wider context. We also expect that Ministers will be keen to manage appropriately the potential conflicts of interest arising from also being the owner of the main provider of water and sewerage services.

Summary of the Statement of Regulatory Principles and Intent

7. The rest of this paper comprises a statement of regulatory principles that NIAUR expect to follow in carrying out our new role. The statement covers a number of topics, and notably highlights:
 - That we place a high value on the experience of Ofwat and the Water Industry Commission for Scotland;
 - That we will recognise the transitional challenges facing NIW, while expecting a rapid transition to the highest standards of performance; and,
 - That we will give due weight to Ministerial decisions taken during the creation of the new regulatory regime, although naturally compliance with our statutory duties is of primary concern.

Overview

1. This Statement sets out NIAUR's approach, intent, and principles to be applied in fulfilling its duties as the economic regulator of Northern Ireland Water Limited ("NIW").
2. The aim of this Statement is to provide stakeholders in NIW – Government as shareholder and the main source of finance, company management, employees, consumers and suppliers – with an initial understanding of how the NIAUR in exercising its functions consistent with its duties is likely to treat the financial, operational and other risks facing NIW. This should assist in each stakeholder gaining a full appreciation of their respective roles in the future development of NIW.
3. Accordingly, this Statement sets out NIAUR's intended approach to the following:
 - the regulatory framework;
 - securing appropriate quality standards and customer service standards for consumers;
 - promoting efficiency in capital and operating expenditure;
 - securing the financeability of NIW's operations;
 - enforcement; and,
 - future developments.

The regulatory framework

4. The Water and Sewerage Services (Northern Ireland) Order 2006 ("the Order") sets out primary and secondary duties for NIAUR along with various duties to "take into account" and "to have regard to" other considerations. NIW is to be appointed by the Government as a water and sewerage undertaker under the Order, subject to a number of conditions set out in its Instrument of Appointment (the "Licence"). The Order and the Licence are closely modelled on their counterparts in England & Wales where water and sewerage undertakings have been subject to independent economic regulation working closely with government since 1989.

Primary duties and NIAUR's approach to regulation

5. NIAUR will act to ensure that NIW is compliant with its Licence conditions and will otherwise exercise the regulator's functions in order to fulfil its duties as specified in the Order.
6. The primary duties of NIAUR will be (i) protecting consumers, where appropriate by the facilitation of effective competition; (ii) securing that regulated water and sewerage services are provided in every area of the province; and (iii) securing that regulated companies (such as NIW) are able to finance their regulated functions. In pursuing the primary duty concerning the protection of consumer interests, NIAUR will be required to have regard to the interests of individuals who are disabled, chronically sick, of pensionable age, on low incomes, and resident in rural areas. Secondary duties upon NIAUR will require it to promote economy and efficiency by regulated companies (such as NIW), secure no undue discrimination between their consumers, protect consumer benefits from the disposal of protected land, protect consumers as respects any non-regulated activities, and contribute to sustainable development.

Best-practice regulation

7. Under the Order, NIAUR will have a duty to have regard to best regulatory practice in carrying out its functions. NIAUR believes its duties will be achieved best by continuing the basic framework of incentive-based economic regulation that has been successfully deployed in other utilities in the UK over many years, and particularly that applied to the water and sewerage industry in England & Wales and Scotland which includes the use of price or revenue caps (limiting the extent to which an undertaker may increase tariffs each year) and benchmarking.
8. In practice this will mean among other things determining periodic price or revenue caps for water and sewerage services, as stipulated under the initial Licence, while having particular regard to output requirements and financeability to support the appropriate financial incentives for the achievement of efficient levels of expenditure and output performance. This implies that achieving higher levels of efficiency will result in higher levels of operating surplus.

9. In carrying out its duty to have regard to best regulatory practice, NIAUR will place significant weight on the Better Regulation Task Force Principles of Good Regulation (transparency, consistency, targeting, proportionality and accountability). NIAUR commits to clear standards of consultation and transparency, and in general to follow well defined processes that are subject to modern governance.
10. NIAUR wishes to maintain an on-going dialogue with all main stake-holders in the NI water industry. These include environmental and quality regulators, representatives of business and household customers and green groups, as well of course as NIW. Open discussion at an informal level facilitates the efficient operation of formal process.

Transition to 2010

11. NIW will be established on 1st April 2007 as a Government-owned corporation. However further transition is then required to place it on a fully commercial basis. In particular, tariffs are being phased in over the three years to 2010 according to the terms of the initial Licence. NIAUR recognises NIW faces a backlog of investment required both to raise quality standards and improve operational performance.
12. NIAUR will respect the policy commitments made by Ministers, in particular as represented by the transitional tariffs, which are subject to specially developed Licence conditions, and the Strategic Business Plan (SBP) or “contract” between DRD shareholder and NIW in the period to 2010. The NIAUR intends using this period to review the SBP and consult on the appropriate output requirements for NIW (including quality and service standards) and efficient levels of capital and operating expenditure for the period after 2010. Accordingly, NIAUR will set new price/revenue controls, efficiency targets and agreed outputs, consistent with other relevant Licence conditions, for the first time and commencing 1st April 2010. In practice, the agreed efficiency levels to be attained by NIW in the year immediately prior to the NIAUR setting prices appears to be less than would otherwise be required to support the glide path of domestic charges to the England & Wales average. The NIAUR recognises the forecast overhang of the three year transitional tariffs into its first year of setting prices such that another and significant charging increase may be the inevitable consequence of Ministerial policy in NIW’s fourth year.

Securing appropriate quality standards and customer service standards

13. The package of initial funding for NIW's regulated activities in the price control period to 2010 will comprise Government funding commitments and revenues from customers under the initial price controls caps. This is intended by the Government to enable the company to improve the quality of its outputs and its service to customers. NIAUR will keep under review the scope and specification of the outputs to which this funding relates.
14. NIAUR will apply to DRD for a Guaranteed Standards Scheme (GSS) whereby consumers may be compensated in recognition of poor performance by NIW. In developing these standards, NIAUR and DRD will, taking note of Ministers' preference for the first GSS to be in place by January 2008, apply the procedure for so doing as laid down in the Order which specifies a consultation process including stakeholders and consumers alike. NIAUR's approach to enforcement of these standards is discussed further below.
15. NIAUR will work closely with NIW, the Government, the quality regulators and consumer bodies in order to establish the appropriate regulated output requirements for NIW that will then be funded in the subsequent price control period. The NIAUR expects to undertake a public consultation on the Forward Work Plan for its first pricing review so that stakeholders are afforded the opportunity to voice their concerns and priorities concerning any potential trade-off between outputs and prices. While the industry must comply with a range of pre-determined requirements, many of which have been established at European level, significant changes in outputs and quality standards can have cost and hence price implications for consumers.
16. NIAUR, in setting NIW's future price controls, will need to be satisfied that the regulated output levels agreed with NIW as deliverable and proposed to be delivered by NIW in future price control periods (following discussions with relevant stakeholders) can be financed if delivered efficiently by the company. In this respect, the allowed prices will reflect the full package of water and sewerage quality, customer service, health and safety legislation and other regulated output requirements being placed on the company for the price control period concerned.

Treatment of vulnerable customers

17. The Order will require NIAUR to have regard to the interests of a range of vulnerable customers in setting future price controls, subject to its primary duties to protect customers more generally, secure service provision throughout Northern Ireland and secure the financing of regulated activities. In the initial price control period to 2010 Government is expected to make an additional grant to NIW to support vulnerable customers. Beyond this period, in the absence of any continuing grant, NIAUR will require that NIW supports vulnerable consumers only to the extent that this can be funded through the wider price control framework consistently with its overall duties.

Promoting efficiency in capital and operating expenditure

18. In setting NIW's efficiency targets in future price control reviews, NIAUR will take into account a number of considerations including what can be regarded as a realistic but challenging rate of 'catch-up' towards the efficiency frontier, subject to appropriate benchmarking and continuing productivity improvement assumptions, and the need to provide sustained and balanced incentives to undertake efficient expenditure at all stages in the regulatory cycle. In this last respect, it will be necessary to have regard to the different pay-back periods for investments in infrastructure assets and operational efficiencies.

19. NIAUR will deploy a range of benchmarking techniques along with measurement of an appropriate assumption of industry productivity growth in order to identify the efficiency frontier and to assess the relative efficiency of NIW. In undertaking these benchmarking/productivity studies NIAUR will be able to make extensive use of the comparative cost data collected by Ofwat and the Water Industry Commission for Scotland (WICS).

Capital and operating expenditure during the initial control period

20. The appropriate level of NIW's projected expenditures during the first price control period to 2010 has not been reviewed by us as regulator in advance of commencement of the legislation giving NIAUR its water powers. However, given the substantial efforts by the DRD shareholder to validate NIW's expenditure projections, NIAUR expects to find that expenditure which has been incurred in line with the assumptions and output expectations in the

initial price control to 2010 will have been efficiently incurred, given the position of NIW. This will be reflected in the way in which the RCV will be rolled forward to the start of the price control commencing in 2010. Conversely, NIAUR is not in a position to provide a “glidepath” for cost efficiency gains in the period immediately after 2010.² Nevertheless, NIAUR will review actual expenditure in the first control period in assessing appropriate price controls for the next control period.

Treatment of legacy expenditure commitments

21. NIW has concluded two recent major PPP contracts on the basis of assuming that the cost variations associated with the contracts are fully recoverable from funders. NIAUR recognises that it is inappropriate to place risks on regulated businesses which they cannot efficiently manage. In consequence, NIAUR will include the costs of the PPP contracts in the regulated cost base of NIW for the purposes of determining the funding from consumer prices after 2010, provided that NIW is managing these contracts efficiently in the pursuance of continuous improvement. As costs relating to these contracts are subject to efficiency review, they are equally subject to efficiency incentives from 2010. This means that benefits from efficiency out-performance may be retained by NIW for a number of years before being passed to customers.

22. The NIAUR expects new contracts, or substantial variations to legacy contracts, which NIW should be capable of managing efficiently, will be subject to normal efficiency review processes.

Duration of future price controls

23. The duration of price control periods beyond 2010 will be consistent with the appropriate incentivisation of NIW and its transformation to a fully commercial business. At present we would expect this duration to be five years, as drafted

² A glidepath is provided for water and sewerage companies in England & Wales, whereby a proportion of the companies’ capex efficiency out-performance is not passed immediately back to consumers at the subsequent price control review but is currently subject to a rolling 5-year period for out-performance. Any opex out-performance is handed back to customers at subsequent Periodic Review. Up to 5 years worth of opex and capex out-performance and the pure profits resulting are deemed appropriate incentive for companies to meet their efficiency targets.

in the Licence. However, we will also have regard to the likely longer-term development of the industry (perhaps a 25 year view). Given our intentions of drawing heavily on the regulatory experiences of England, Wales and Scotland, consideration will be given to the views of Ofwat and the WICS on the duration of price controls.

Forward Work Plans and PR09

24. NIAUR expect to consult on the PR09 during 2007/08 and to finalise the FWP and information requirements for the PR09 by same year end. Since NIAUR intend conducting a Review of the SBP in early 2007/08 it is unlikely to require any Strategic Direction Statement from NIW along the lines currently proposed in England & Wales by Ofwat.

Securing the financeability of NIW's regulated activities

25. In future price control determinations, NIAUR will allow NIW to be fully remunerated for the efficient expenditures it is expected to undertake, including appropriate remuneration for the costs of capital invested in the business and reflected in the regulatory capital value ("RCV"). This should, among other things, enable NIW Directors to fulfil their own statutory duties including duties to shareholders.

Run-off from 2007-2010

26. When the NIW is appointed its licence will limit revenues from 2007-2010. This revenue cap will be subject to a range of correction factors which in principle may allow additional revenue in a following year. Since this mechanism may not apply after 2009-2010, corrections arising in that year or previous years will not automatically be reflected in prices after that year. This particularly applies to corrections for high levels of bad debt; for data errors or lacunae; and for revenue over- or under-shoot. In setting the correction factor through the first price review, NIAUR will take full account of any revenue adjustments (up or down) which would have been allowed to NIW by the continuing operation of the revenue cap and correction mechanism.

Initial Regulatory Capital Value

27. NIAUR recognises the importance of the RCV and its stability in providing a consistent incentive to efficient investment and financing to the long-term benefit of consumers. NIAUR will use an RCV for NIW as an integral part of its price control determination for future price control periods.

28. NIAUR will recognise that Ministers have set an initial RCV for NIW, following a write-down of historic cost assets, in establishing the price caps in the initial Licence. This RCV has been used both to determine the initial capital structure of NIW and the assumed tariff path. NIAUR will acknowledge and respect the use of this initial RCV by Ministers to those ends. In the absence of any direct market value indicator, and in the interests of stability and sustained and efficient investment by the company throughout and beyond the initial price control period, NIAUR is likely to adopt this initial RCV as the starting point for determining the RCV in its own price control determinations.

Rolling forward the RCV during price control periods

29. NIAUR will adopt the approach currently applied by Ofwat in England & Wales towards rolling-forward the initial RCV, underpinning a principal of ensuring adequate incentives for efficient investment.

30. It is currently envisaged that bad debt above a threshold level during the price control period to 2010 and costs not reflected in tariffs due to the exercise of a Ministerial Policy Limit or “veto” will be rolled forward in the RCV (where such costs have not otherwise been explicitly subject to an additional Government subsidy). NIAUR will follow this approach, so that such bad debts would be included in the RCV at 2010; but will review this approach in respect of subsequent bad debt in the light of the wider structure and levels of tariffs that are associated with future price control determinations.

Treatment of gains from the disposal of surplus property

31. Disposals of surplus property will be set out in a 10-year Estates Management Plan (EMP) due 1st April 2009 which will complement the first Regulated Asset Management Plan to apply 1st April 2010 and due 1st September 2009. The Annual Land Disposal Return will be used by NIAUR to supplement the EMP and its powers to approve or otherwise any proposed land disposals.

32. On the assumption that NIW is meeting the efficiency targets embodied in its Strategic Business Plan, NIAUR will be content for surpluses from the disposal of surplus property during 2007-2010 to be retained by NIW, given that the Government is providing subsidies to NIW during this period. These will be used for the purposes of funding future expenditure in the regulated business, returning funds to the Government as shareholder, or mitigating consumer price rises, at the discretion of DRD/DFP. After 2010, NIAUR will likely take the view that proceeds from the disposal of surplus property ought to be shared between NIW and customers as currently prescribed within Ofwat's framework.
33. NIAUR intends issuing a Land Disposals Policy during 2007/08 detailing any stipulations required to obtain approval to proceed with land disposals; this will likely include a "best price" provision established under England & Wales Licence precedent.

Investment grade credit rating and WACC

34. UK utility regulators have typically required regulated companies to sustain investment-grade credit ratings for the purpose of efficient finance-raising. Accordingly, regulators have been mindful of the achievement of the appropriate level of financial performance, given efficient expenditures, to support an investment grade credit rating in making their determinations of regulated prices. It is also recognised that the rating of the company will provide the shareholder and NIAUR with an additional effective, objective, and independent assessment of the quality of NIW's performance.
35. In objectively assessing the quality of NIW's performance and securing that NIW is remunerated such that it is able to finance its functions and financial risk to the shareholder is adequately rewarded, NIAUR will similarly have regard to the assumed profile of revenues and efficient expenditures over the price control periods concerned. Given the backlog in asset renewals, NIW may not be in a position to reach an investment grade credit rating at an early stage during its initial price control period given the need to invest in excess of its internally-generated funds. In line with the Licence NIAUR will expect NIW to be rated by 1st September 2007 and to reach and sustain an investment-grade credit rating by 30th June 2009. (This to be a rating by a recognised

rating agency (e.g., Moody's, Fitch, S&P, not a "shadow rating.)

36. From 2010, NIAUR will set the weighted average cost of capital to remunerate investors in its price controls consistent with the risks faced by NIW, taking account of its investment grade and its experienced cost of capital. NIAUR recognises that the financial ratios and business performance of NIW may not reflect an investment grade credit rating until such time as the shareholder has determined that management should have raised the performance of the business to a level consistent with sustaining an investment grade credit rating.

Enforcement

37. NIAUR has a duty to enforce where any company (appointed as a water and sewerage undertaker) is failing to comply with its Licence conditions or other statutory requirements. This duty is supplemented by NIAUR's ability to accept undertakings from undertakers in lieu of enforcement action. Undertakings from NIW, if presented to us, will be considered carefully in line with the legal framework put in place by Government to govern their form and substance. NIAUR intends to consider each undertaking on its merits, and is presently minded to look favourably on tough and ambitious undertakings presented by NIW, particularly given the likely legacy breaches of European law which NIW will inherit.

38. NIAUR is likely to approve a Financial Penalties Policy during 2007/08 taking account of its full statutory duties. That statement of policy will indicate a preference that any fines imposed, due to NIW's failure to comply with either Licence conditions and/or failure to achieve prescribed standards of performance, should benefit customers (through requiring higher investment without higher water charges) rather than taking the form of payments to the Consolidated Fund.

Performance standards

39. In practice, performance standards and the associated GSS will come into force as soon as the due process of consultation as laid down in the Order has been worked through. NIAUR recognises NIW faces a significant transformational challenge following incorporation and will take this into

account in introducing performance standards. Equally, NIAUR will be committed to ensuring prescribed performance standards are achieved and that necessary and proportionate enforcement actions are taken where necessary.

Wastewater legacy issues

40. NIAUR recognises there is a particular backlog of investment with respect to wastewater collection and treatment that currently presents quality compliance issues. Consequently, with respect to the enforcement of sewerage standards, NIAUR will in the short-term take into account the steps being taken by NIW to reduce the investment backlog and raise standards. However, NIAUR will expect the investment backlog to be reduced within the foreseeable future, and additional and more exacting enforceable quality standards to be achieved.

Future Developments

Metering

41. NIAUR is committed towards promotion of water efficiency and conservation and as such intend to conduct a Metering Review during 2007/08 to inform any future policy decisions. This work will take account of apparent widespread consumer dissatisfaction with domestic charges being based upon the rateable value of homes. Whilst the terms of reference of this review are yet to be decided it is hoped these will include consideration of any impacts for the first pricing review from progress towards universal metering.

Climate Change and Sustainability

42. NIAUR has amongst its secondary duties a requirement to contribute to sustainable development and in regulating NIW it shall seek to foster commitments towards reducing the NIW carbon footprint. In its first information gathering request to NIW NIAUR shall address this issue by monitoring NIW's progress towards sustainability and a reduced carbon footprint via appropriate metrics which in time will be developed into appropriate performance targets.