

# Simplicity versus complexity: the water sector



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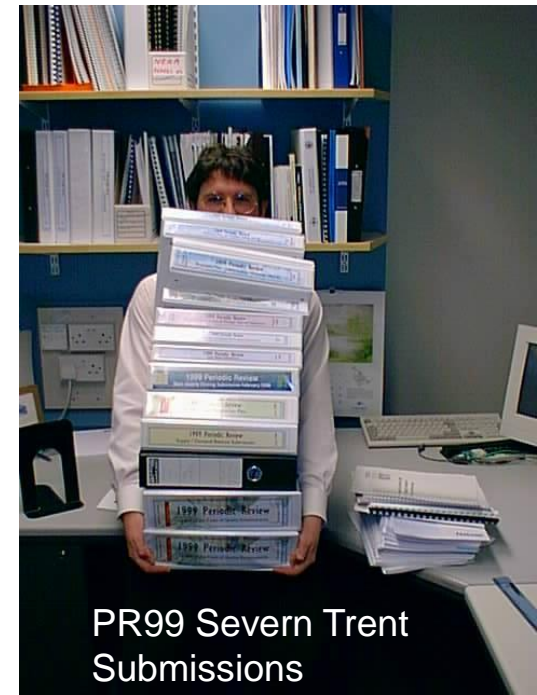
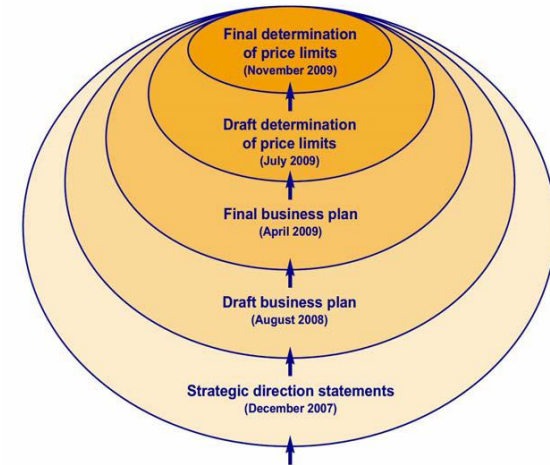
# I will cover in turn:

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- Just how complex is water sector regulation?
  - Business Planning
  - Annual Reporting
- Why has it become so complex?
- What are the consequences?
- What are the benefits of a simpler model?
- Where now?

# I. So how complex is water sector regulation?

- The business planning process has become enormously complicated
- A process that lasts over 2 years
- Size of submission is over 2,000 pages
  - Capital maintenance submission alone was over 500 pages
- Ofwat's approach has become an ex ante process of seeking to "get the answer right" (not allowing incentives to drive companies to deliver the "right answer")



# I. So how complex is water sector regulation? (2)

- Annual submissions – the so-called June Return
- 67 tables with 1,200 lines of data
- Before commentaries were discontinued in 2011, nearly 900 pages of commentary



## II. Why has water sector regulation become so complicated?

### 1. Gaming? Mis-trust?

- Companies putting in bids not plans
- Massive out-performance
- “You get the regulator you deserve”
  - "Britain's biggest water company is to cut its investment programme by £350 million - but it will not be passing on the savings to its 7 million customers. ... The latest price rise was ... was based on a £2.1 billion capital investment plan agreed with the company. But now, six months after the review, Thames says its investment target is only £1.75bn - down £350m, or £70m a year - equivalent to £10 off every domestic bill." The Observer, 1995

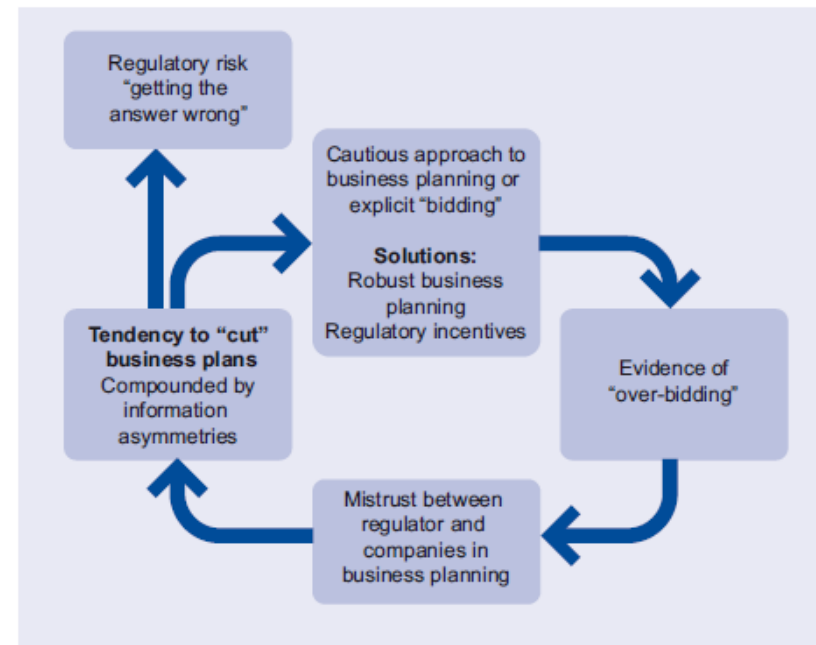
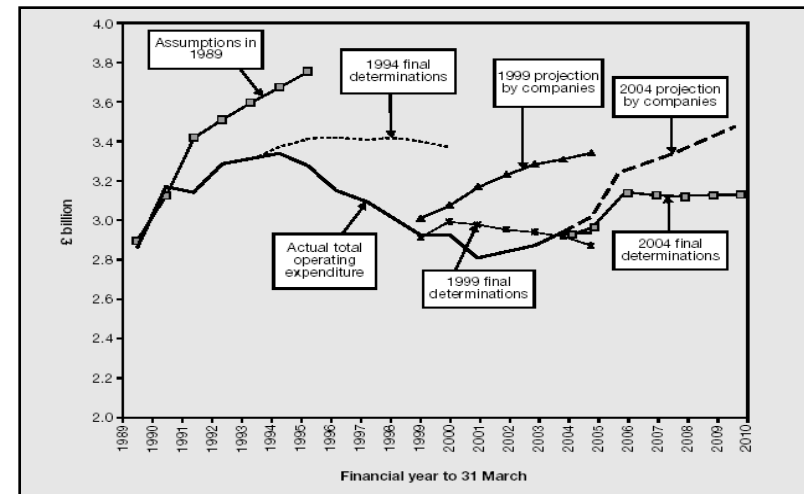


Figure 2.20: Focus of regulation becomes 'getting the right answer' rather than providing the right incentives

## II. Why has water sector regulation become so complicated? (2)

### 2. Organisational behaviour

- Organisations grow
  - “Work expands so as to fill the time available for its completion”.
- Intellectual curiosity
  - “While undoubtedly very clever, some schemes in our price controls, such as the IQI sliding scale, are virtually unfathomable to those outside the cognoscenti.” Alistair Buchanan, Ofgem
- Risk averse nature of public bodies
  - “Some believe that civil servants are risk averse and that they exhibit blame-avoidance strategies. Risk aversion is reinforced by the processes through which regulation is developed and made.” Report produced for the Risk & Regulation Advisory Council
- Letting the “best be the enemy of the good”
  - “Micro-management rests on a misunderstanding of the nature of information. Incentive regulation is a discovery process. Neither the companies, nor the regulators can know all the relationships in the system; indeed, incentives are there to change these relationships.” Sir Ian Byatt
- A self-reinforcing cycle
  - “The cycle of data provision seems to have become self-reinforcing. The more Ofwat demands, the more the companies want to provide, in order to ensure Ofwat accepts their business plans”. Defra / WAG review of Ofwat

## II. Why has water sector regulation become so complicated? (3)

### 3. A lack of innovative thinking?

- Failure to understand the power of incentives
- Carry on doing what has always been done
- A detailed approach to comparative efficiency may have been fit for purpose for ten years but beyond that it is questionable
- Heavy reliance on econometric models
  - Data issues
  - Increased reliance on so-called “special factors”
- Reluctance to use market based information

**“.....we are not convinced by the suggestion that competitively tendered costs are efficient costs..... The market place can be dynamic and using competitive price does not automatically guarantee an efficient outcome. We judge companies by the key test of net outcomes, not by the management or procurement process used to achieve the outcome.”**

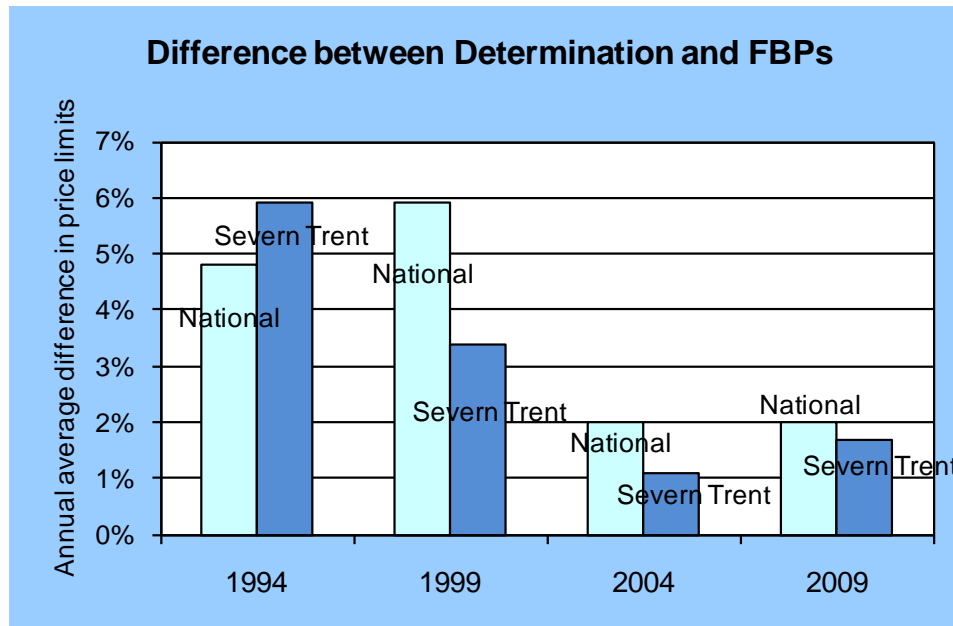
### III. What have been the consequences?

- Industry has become dependent on regulatory decisions
  - Incentives for meeting specific targets
  - Ofwat did not “fund us” to do that
- Not to the benefit of customers
  - Measuring contact times
  - Versus customer satisfaction (SIM)
- Lack of a long term perspective and/or focus on critical issues
- Excessive risk aversion through focus on detailed outputs rather than outcomes – e.g. Serviceability targets lead to higher cost through over-compliance with standards
- Unnecessary regulatory risk
  - The risk of Ofwat “getting the answer wrong”
- Excessive regulatory burden/cost
- Lack of capital market competition



### III. What have been the consequences? (2)

- Increasing frustration from some companies!
- Ofwat could have recognised sooner that companies have tried to overcome the past
- There are still significant differences between Determination and company plans – but are some plans still “bids”?



# IV. A different model would deliver significant benefits

- Severn Trent set out its thinking in Changing Course
- Benefits
  - Increased efficiency
  - More innovation
  - More sustainable solutions
  - Reduced regulatory costs
- How it could be done
  - Higher-level outputs, set for longer periods
  - Increased emphasis on customer engagement
  - More incentives and a better balance between rewards and penalties
  - Simplified approach to price-setting and reduced information requirements, e.g. A simpler approach to depreciation

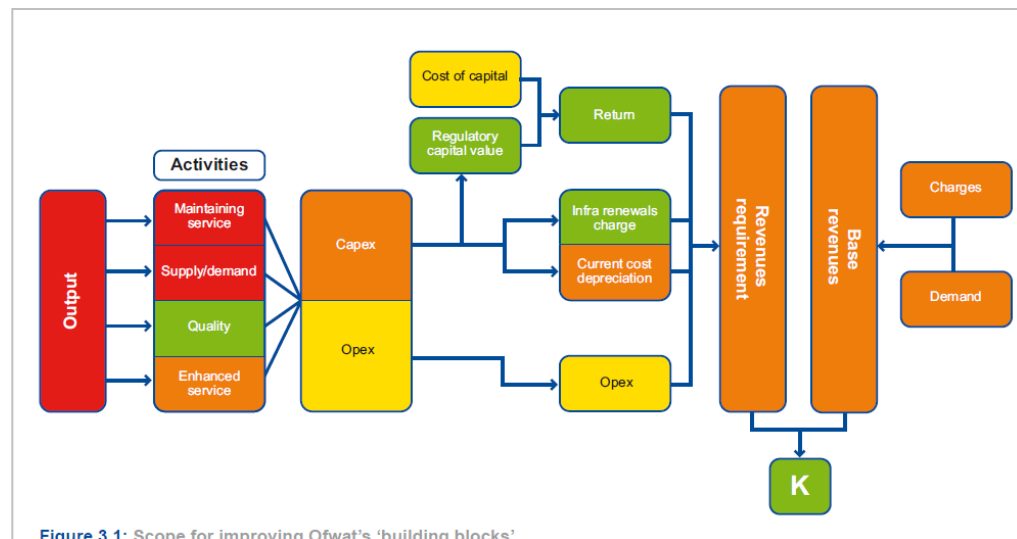
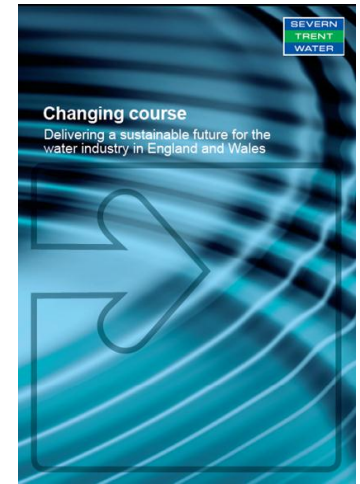
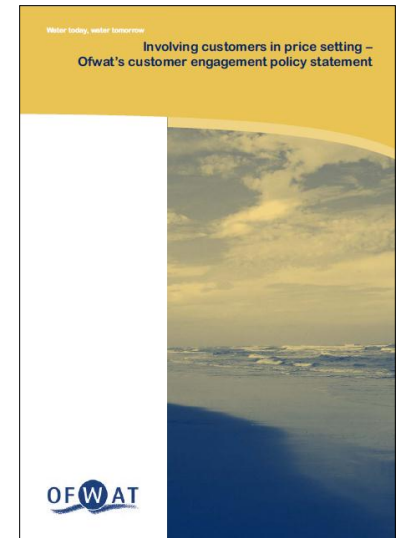
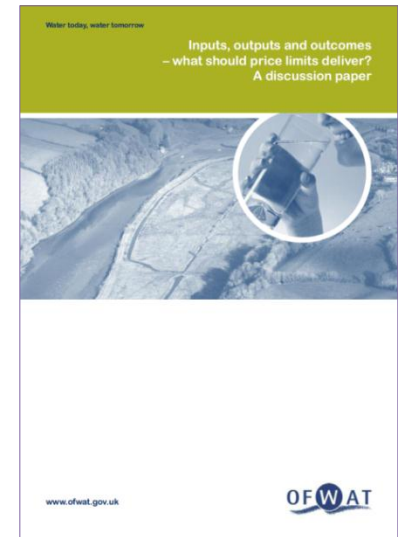


Figure 3.1: Scope for improving Ofwat's 'building blocks'

## V. Ofwat are “grasping the nettle” on this

- Increased focus on outcomes and outputs
  - And a move away from a focus on activities and inputs
- A risk based approach to regulation
  - No June Return
  - High level KPIs
  - Companies delivering their business plans
- Customer engagement
  - A real emphasis on companies putting well evidenced plans supported by customers
  - Combined with a commitment to lower levels of scrutiny and a (draft) determination that resembles the plan



## VI. Concluding thoughts

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- The regulation of the water sector has become overly complex
- There are logical explanations for this but reform has perhaps taken longer than necessary
- There are real benefits to be realised from a less detailed – more incentive based regime
- We are very supportive of Ofwat's overall direction of travel