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Water Regulation: Is it Fit for Purpose?

Water Seminar
Downing Street

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Questions

- is the medium- to long-term policy framework fit to address water resources demands and climate change?
- are the emerging financial structures and the financial regulatory framework sustainable?
- do the immediate problems (leakage, special dividends, M&A premia, etc) indicate that the last periodic review was misjudged?

And therefore . . .

- are there a series of practical reforms which might better serve the public interest?

The medium- to longer-term challenges

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- on the demand side
  - population growth
  - house building and household formation
  - south-east
  - climate change
- on the supply side
  - Victorian reservoirs
  - boreholes, aquifers and environmental constraints
  - desalination
  - new reservoirs
  - decentralised water storage
  - grey water
  - climate change
  - etc, etc

But . . . no price to equate supply and demand

Metering, hosepipe bans and other demand-management tools

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- metering does not make price equal to marginal cost (which is usually ♎ zero)

- metering has costs as well as benefits

- price elasticities hard to predict

- income characteristics combine with lack of information

- time dimension crucial

⇒ not a panacea, but probably useful

And the other longer-term challenges . . .

- the WFD
- diffuse pollution
- wetlands and nature conservation

⇒ polluter pays principle for agriculture, roads, etc

Financial structure

Privatisation	Now
– green dowry (positive cash)	– exhausted balance sheets
– 10 year RPI – X	– 5 year RPI – X
– market value $\approx$ 1/10th CCA	– RAB premium
– CAPM cost of capital	– financial ratios and financing monies

The balance sheet problem

- interest cover – why does it matter?
- "debt is cheaper than equity" – but only if equity risk goes to customers (Welsh) or tax payers (Network Rail)
- regulation assigns regulatory risk

⇒ financing monies, or rights issues or rate of return regulation

The wrong answer at the periodic review

- 5.1% CAPM WACC + financing $\Rightarrow$ 6.2—6.8%
- Ofgem NG = 4.2%
- Scottish Water = 3.5%

And not sustainable

- at 2009/10 interest cover requirement $\rightarrow \uparrow$ further financing monies

But this is an average:

- cost of debt very low
- cots of equity much higher

$\Rightarrow$ M&A to replace RAB with debt

Immediate problems

- completion of financial engineering, M&A, share price movements
- Competition Commission case (SEW and Mid Kent)
- special dividends and the RWE exit strategy
- leakage and failure to meet output targets
- information and SFO

And . . .

- higher water bills feeding through

Solutions

Longer-term policy framework

↓

Periodic review reform

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Immediate actions

Longer-term policy framework

- water resources
- WFD
- metering
- etc

⇒10–20-year framework

⇒context for guidance and periodic reviews

Periodic review reform

A package of measures, including:

- 10-year indicative price cap (as BAA / CAA)
- indexed cost of debt to market
- split cost of capital and end to financing monies
- rolling CAPEX, IDOK reform and more flexible mechanisms for under/over spends
- tightening up the management force and directors' duties
- special administrator specification

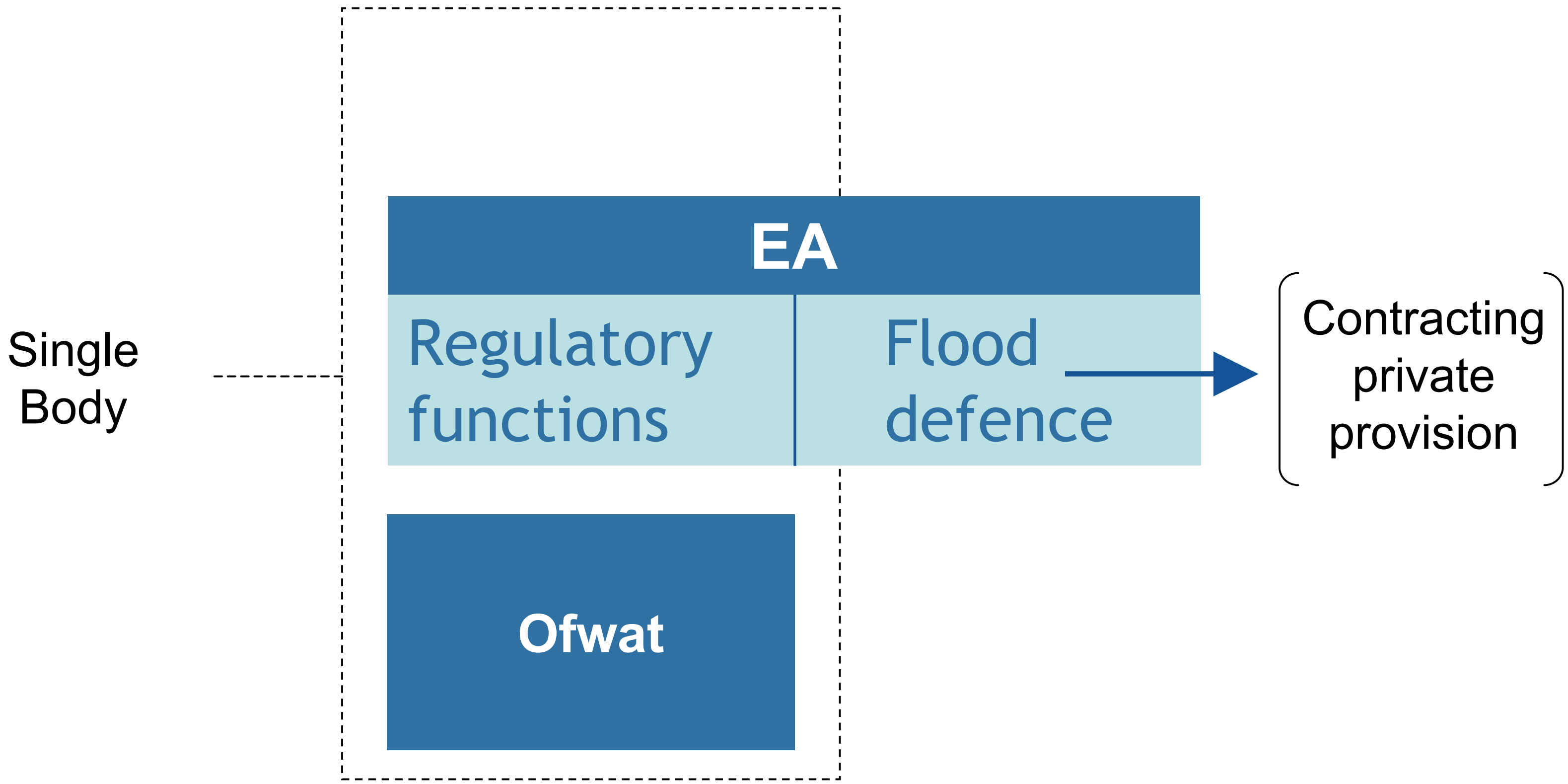
and more joined-up approach by Ofwat/EA/DEFRA . . .

Immediate actions

Some possibilities include:

- financing monies NPV-neutral pre-financing CAPEX post 2010 statement
- licence amendments, log-ups, etc
- directors' responsibilities
- tough line on investment for M&A *in public*
- clear fines, not negotiated CAPEX deals

and for good governance



Conclusions

- much has been achieved
- but after nearly two decades, model needs to change
- big challenges ahead require a political, sectoral, medium-term framework
- the periodic review methodology needs modernising, particularly its financial dimensions if it is to maintain public acceptability
- 2004/05 periodic review was better on process than outcome
- package of practical reforms could be easily implemented
- and institutional reform would help a lot too

⇒ act now or wait until a crisis in 2008/09

For information

'Regulatory Reform, Capture, and the Regulatory Burden',

Oxford Review of Economic Policy, Autumn 2006

'Is the Water Regulatory Regime Fit for Purpose?',

August 2006, available at: www.dieterhelm.co.uk/publications

'Split Cost of Capital, Indexed Cost of Debt and Longer Periods – a Reply to Critics', March 2006,

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