

## **Response to the DEFRA's Ofwat review: call for evidence**

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### **Non-confidential**

#### **• Summary of key points**

- We welcome this opportunity to review the role of the regulators and their relation to government. The challenge for the review is to develop a system whose legitimacy and credibility is accepted by all those with interests in the industry.

- We note the importance of the government having the ability to set long-term objectives and targets which the regulator is mandated to achieve, and to identify the instruments at the regulator's disposal. There is an important line to be drawn between setting the broad policy framework and substantive goals, on the one hand, and detailed implementation, on the other. Given the specialised knowledge and expertise of the regulator, policy objectives are more likely to be secured if the regulator is left with the task of choosing between different instruments. The setting of clear and achievable targets will ensure that the regulator is held sufficiently to account.

- We recommend greater coordination between government departments and agencies with respect to achieving broader social and environmental objectives.

- The current order of decision making in determining quality of provision and its financing provides higher quality, cost, price and profits than would occur with a more integrated approach. The review may want to consider whether this is appropriate in considering future regulatory cycles.

- Consumer bodies play several roles: providing information to regulators; acting as advocate for consumers as a whole; and a source of impartial information to help consumers make individual decisions in their own interests which will have beneficial effects for the market as a whole. In monopoly markets the information and advocate roles are likely to predominate. Where choice is available (in this case of metering and, eventually, in supplier) the latter may be more relevant. We recommend the retention of the Consumer Council for Water in the short term, with reviews of its institutional location and function as the industry develops.

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<sup>1</sup> The ESRC funded Centre for Competition Policy is an independent research Centre which provides research of real world relevance with academic rigour. The Centre includes expertise in the law and economics of regulated industries, of competition policy, and of the interaction between the two. The current response is from two senior members of the Centre in their role as independent academics. We provide references to relevant publications as part of our evidence. The views expressed are those of those authors and not of the Centre. Contact details: [c.waddams@uea.ac.uk](mailto:c.waddams@uea.ac.uk); [m.harker@uea.ac.uk](mailto:m.harker@uea.ac.uk).

## Introduction

The original vision for economic regulation was intellectually robust and offered a practical short term solution to the problem of controlling monopoly power held by newly privatised companies. In economic terms, there were aspirations that competition might develop so that regulation would be needed only on a temporary basis (though the long term need to regulate the network parts of the businesses was never in doubt). The Cave review has addressed this more recently, recommending slow opening of markets, including, eventually, the domestic sector. The industries had been privatised partly to release them from short term government objectives and interference, and so the independence of regulators (from government) was an important dimension of the new arrangements. The strengthening of general competition law in the early 2000s was another way to curb economic power of the incumbents where it was relevant.

The forces which had led governments to intervene in the nationalised industries remained, even if the route for such intervention had changed. Governments addressed this by making legislative arrangements for and issuing environmental and social guidance. Governments appointed regulators (and approved but did not generate their budgets) and inevitably they were tempted to influence them, particularly under pressure from interest groups and the media who sought a particular solution for environmental and social issues. The result was amendment of legislation (a Water Act in 2003) and social and environmental guidance which trod a delicate line between generality and specificity. We welcome this opportunity to review the role of the regulators and their relation to government. It occurs in a particular context; the need for extensive investment in infrastructure at a time of financial stringency, and for the regulators themselves to demonstrate that their activities provide good value for money.<sup>2</sup> The challenge for the review is to develop a system whose legitimacy and credibility is accepted by all those with interests in the industry.

We address questions asked in the review in turn:

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<sup>2</sup> The regulators are funded from licences rather than taxation, so their costs are born by consumers rather than citizens, but since they provide necessities, the practical distinction is moot.

## 1. Statutory Framework and decision making

### A. *Government's objectives for independent regulation of the water sector and boundary of responsibility between Ofwat and Government*

Any government clearly has multiple objectives, and elections can be seen as a way of choosing the government who will best be able to make these inevitable trade-offs. One of the difficulties with the way the regulatory system has developed is that many of these trade-offs have been made by regulators rather than government, raising the conundrum that an unelected body which is independent of government (albeit appointed by it) is left to make such, essentially political, decisions. Conflicts are inherent in developing any policy, and we see it clearly in energy policy<sup>3</sup> where, for example, the need for sustainable and secure energy supplies both put upward pressure on energy prices, challenging the achievement of affordability. Similar issues arise in water, particularly following the Walker Review's recommendations on water affordability. How should responsibility for addressing such difficult issues be allocated, and how can the structure of regulation support a robust system of doing so?

To deliver objectives, the government and regulator need instruments and targets. We see the government as taking responsibility (and ownership) for setting all three, but with close input from the regulator. The objectives, and their relative importance, must be a matter for Parliament. The exact interaction between them in a particular sector will, however, be better understood by a specialist regulator .

Once the government has established what it wants to achieve and identified the instruments which the regulator (or relevant others) can use to achieve it, targets should be set for the regulator and the industry. If multiple objectives are to be achieved it is crucial that such targets should remain stable over a number of years, and if they are reviewed, this should be undertaken openly and with clear consultation. A commitment to change objectives (both legislative and under social and environmental guidance) no more than once every five years (or the lifetime of a Parliament) would ensure the right balance between flexibility and the need for stable predictable rules.

The guidance itself should be clear about the objectives and might include specific targets for achievement, i.e. it should focus on the end to be achieved, and how it is to be measured, rather than the means. The detailed means of how to achieve the targets should be left with the regulator, though of course they will inform what is seen as a realistic target. But the details of its introduction and how it can most effectively deliver these ends is better left to the regulator.

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<sup>3</sup> Waddams Price, Catherine, Equity, Fuel Poverty and Demand (maintaining affordability with sustainability and security of supply) in Jamasb, T. and Pollitt, M., Eds. Electricity and Heat Demand in a Low-Carbon World: Customers, Citizens and Loads, Cambridge University Press, forthcoming, 2011.

Limiting the opportunities for government intervention to broad objectives and guidance will provide confidence and greater stability for the industry, and so encourage more investment and lower its cost

It is important in identifying these instruments and setting targets that their likely impact is fully considered. Delivering social and environmental objectives through water prices will adversely affect both consumers as a whole and the competitiveness of UK businesses, as compared with overseas companies which do not carry such burdens – handicapping the UK businesses which bear the burden, when this cost is borne by taxpayers elsewhere. If government believe this is appropriate, its impact should be measured through a rigorous cost benefit analysis in a regulatory impact assessment, which must be more than a mere box ticking exercise if the process is to retain the confidence (and so avoid attempted subversion) by all parties.

This confidence building exercise also needs to encompass belief that the regulator will in fact follow the objectives set by Ministers, and there needs to be a clear methods of accountability (beyond the annual report to Parliament). This accountability process needs to be clearly set out and accepted by parties in advance to ensure stability of the system, and that Ministers can resist the temptation to intervene inappropriately with details.

In summary, we note the importance of the government having the ability to set long-term objectives and targets which the regulator is mandated to achieve, and to identify the instruments at the regulator's disposal. There is an important line to be drawn between setting the broad policy framework and substantive goals, on the one hand, and detailed implementation, on the other. Given the specialised knowledge and expertise of the regulator policy objectives are more likely to be secured if the regulator is left with the task of choosing between different instruments. The setting of clear and achievable targets will ensure that the regulator is held sufficiently to account.

### *B. Merger regime*

The merger regime in the water industry is unique in requiring mergers over a certain size to be referred to the Competition Commission, without requiring a first stage referral from the OFT. This was introduced on the grounds of reducing the potential for yardstick competition if one of the big WASCs was taken over, and two such mergers (with common actors) were examined by the CC, and rejected on the grounds of reducing the number of comparators. However water is not the only industry where comparators are used (for example electricity distribution) and it seems odd to retain this anomaly. Substantial lessening of competition can include reductions in the such 'comparative competition', so it may be sensible to remove this anomaly.

*C. Clarity of regulator's objectives: the statutory duties*

The regulator generally exercises its powers against the backdrop of statutory duties, which disclose a hierarchy of interests. Under the original legislation (Water Industry Act 1991), these duties were relatively straightforward – the regulator was required to ensure firms fulfilled their functions and were in a position to finance their activities. There were a number of secondary duties, including the need to take into account the interests of rural customers in the fixing of charges, and disabled and elderly customers in securing quality. The regulator was also required to promote efficiency and facilitate effective competition as “he considers appropriate”<sup>4</sup>.

The Water Industry Act 2003 introduced a “consumer objective” – to promote the interests of consumers, wherever appropriate through the promotion of effective competition and in furthering those objectives, the regulator was required to take into account the interests of vulnerable consumers. These are clearly set out, though not defined at detailed level. Such generality seems appropriate so as not to hamper the regulator from being able to exercise appropriate discretion, and guidance helps to supplement these general objectives.

*D. Learning from other regulatory experience*

The simultaneous review of Ofgem offers opportunity for consistency across regulation, particularly in regard to environmental and social guidance, in identifying both the objectives (which should be consistent across government departments) and the appropriate instruments (which may well differ between regulators). We welcome the coordination between DECC and DEFRA in conducting the reviews, and hope that both will be able to draw on the work already undertaken by BIS, as well as with the Treasury who also have a close interest both in the finance of the regulators and their influence on wider economic issues, particularly investment. It seems unlikely that the original model of pure economic regulation, without regard to other objectives, is realistic at this stage. However, there are dangers in identifying inappropriate (and inconsistent) instruments to achieve different objectives – a recent example in energy shows that while competition may reduce the overall level of price and offer choice in the market as a whole, it cannot simultaneously address issue of low income. Attempts to use this instrument to meet these different objectives is likely to result in harm to the competitive process, including detriment to vulnerable consumers<sup>5</sup>. Equally if vulnerable consumers are to be protected, they may face a confusing array of rights and opportunities if, say, Ofgem and Ofwat were to introduce these independently of each other – quite apart from other agencies who might seek to intervene. The importance of coordination between departments – in providing objectives, identifying instruments and setting targets - and of joined up agencies in delivering these objectives, is crucial if the regulation system is to

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<sup>4</sup> Water Industry Act 1991, s.2 (now amended by the Water Industry Act 2003).

<sup>5</sup> See for example evidence to Ofgem consultation, <http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Response%20from%20Catherine%20Waddams.pdf>.

encompass wider goals than purely economic ones. Other models are available both from historical UK experience, and from experience elsewhere. Many other regulatory systems have been adapted from the UK model, and identifying what has worked well in different circumstances can provide valuable information for the current review. Information within the Better Regulation Executive can provide a lead on this.

We recommend greater coordination between government departments and agencies with respect to achieving broader social and environmental objectives.

## **2. Relations with other water regulators**

Ofwat is the only economic regulator, but both the Environment Agency and the Drinking Water Inspectorate regulate the quality of water and the environment, with direct effects on the costs of the water and sewerage companies. The current arrangement, in which the regulators of quality set their standards, and the economic regulator is bound to allow companies sufficient resources to implement them, results in quality, costs, prices and profits being higher than they would be if a single body took into account both the benefits and costs of improvements.<sup>6</sup> Given the difficulties posed by rising prices, particularly in south west England, an alternative institutional arrangement may deliver a more appropriate trade off between quality and cost.

## **3. Protecting, serving and representing consumers**

One of the questions raised in the consultation document is the future role of the Consumer Council for Water. The question is particularly pertinent in the wake of the abolition of Consumer Focus, leaving no specific energy consumer body and raising questions about the appropriate functions for a statutory and publicly funded (albeit through the license fee) consumer body in regulated industries. We see three potential roles, which are likely to vary according to the circumstances of the industry, thus suggesting that different forms of consumer bodies may be appropriate at different stages<sup>7</sup>.

Most industries do not have a sector specific consumer body, so why are they needed in regulated industries? The three roles which they may be required to perform are: to provide information about consumer preferences which the regulator requires to perform its function, in other words to 'represent' consumers in a passive sense to the regulator; secondly to be more proactive as an advocacy agent to enable consumers' voices to be heard, because they cannot be expressed in other ways; and third to encourage and support consumers in being active in the market. Most of these roles are unnecessary in fully developed markets because consumers can express their preferences by changing supplier or complaining directly to the

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<sup>6</sup> For a simple economic model of this effect see see David P. Baron's article "Noncooperative Regulation of a Nonlocalized Externality" [\*The RAND Journal of Economics\*](#) Vol. 16, No. 4 (Winter, 1985), pp. 553-568

<sup>7</sup> M Harker L Matthieu and C Waddams Price "Regulation and Consumer Protection" in D Parker (ed) *International Handbook of Economic Regulation*, Edward Elgar, 2006, Ch 10.

provider. Such actions are not available where there is a monopoly supplier, and so consumer bodies can act as a partial substitute in these circumstances.

The primary duty of the regulator is 'to further the consumer objective ... protect the interests of consumers, wherever appropriate by promoting effective competition' There is little effective competition in the provision of water and sewerage services, and in the absence of a market where consumers can express their preferences by choosing between alternatives (for example reliability of water supply against price) the regulator clearly needs information about consumers to identify what their objective is, where this is interpreted to mean both preferences about particular outcomes and their relative importance. The problem for the regulator and any body wishing to represent a single consumer objective in this sense is that different consumers will have different preferences, and these need to be aggregated in some way to determine an appropriate trade off between investment which will raise costs and prices and the quality that such investment can deliver. To fulfil its duties, the regulator clearly needs information about consumer preferences which can be aggregated in some way. Collection of such data in a 'passive' way could be performed equally well outside or within the regulatory body itself, though an external body may find it easier to make the results public.

However the second role, advocacy on behalf of consumers, may be more difficult for a subsection of the regulator to perform. There is a long literature on the possibility of regulatory capture, either by the regulated firms or by narrow political interests, and this strand of reasoning argues for an independent body to represent consumers as a counterweight to the influence of companies, who invest considerable resources in trying to influence the regulator in their own interests. Where there is any danger of capture, an independent body may be able to provide some counterforce. However there are also some problems in this justification for a separate body. If it changes the regulatory role to that of a referee between companies and consumers, the regulator may become less focused on its primary duty of consumer protection. And the difficulties of aggregating disparate consumer preferences are transferred to a body which may have fewer resources to do so than the regulator, and which is then left to choose itself which consumers it should prioritise. A consumer body which feels it has to justify its own existence will be tempted to pursue high profile campaigns which gain media coverage and political attention. This will not necessarily provide the best representation for consumers as a whole, and may obstruct provision of disinterested information about consumer preferences for regulatory decision making. However it is unlikely that anyone else will undertake such an advocacy role for consumers – there is no obvious reward which might tempt a privately funded company into this area.

The third function of a consumer body may be to help consumers to make good decisions in markets where such a choice is novel or poses other difficulties. This is particularly important if competition is to bring benefits to the market – if consumers do not exercise their choice, or exercise it poorly, competition will not provide a discipline for providers, and if regulation is withdrawn, the supposedly competitive outcome may be worse than the regulated one<sup>8</sup>. In a transition to competitive

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<sup>8</sup> Chris M. Wilson and Catherine Waddams Price, Do consumers switch to the best supplier? Oxford. Economic. Papers. 2010 62: 647-668

markets, this advisory work should be needed only temporarily, as consumers become used to new arrangements. Moreover we have seen that as markets become established private comparison sites may take over the role of assisting consumer choice. In this case an independent body needs to ensure that the advice offered really is in the consumers' interests and is not distorted by the commercial rewards to the comparison service.

The water industry is at a very early stage of competition, which has failed to develop in any meaningful way. Even though the Cave report encourages the development of further competition, choice of provider for final consumers is a very distant prospect. The Scottish water regulator claims that there have been benefits from introducing choice for customers, in the ability it gives to negotiate better deals with the incumbent, and an independent body may be able to assist with this process. The main choice for many consumers is whether to transfer from an unmeasured to a measured water supply<sup>9</sup>, and impartial advice for individual consumers in making this decision may be valuable, as increased metering seems increasingly to form part of the regulator's priorities.

We therefore identify the regulator's need for reliable information about consumer preferences, which is currently collected and published by the Water Consumer Council. We see some benefit in retaining an independent body for the immediate future, both to publish this information, and to help consumers to exercise the choices that are available to them, for example in metering. While we see no evidence of regulatory capture, the presence of an independent consumer body provides a safeguard and deterrent against such an eventuality. As competition develops, the role of the consumer body is likely to change, in line with the arguments outlined above. It would therefore be sensible to have periodic light touch reviews of the underlying objectives and function of the consumer body and its optimal location within the regulatory structure in light of those functions.

It is also important that other interest groups, for example, those campaigning for disadvantaged consumers, have been consulted sufficiently and have enough confidence in the system that they will not seek to undermine it. For this reason it is crucial to have a system where all interested parties feel they have had sufficient input into the policy, even if they are dissatisfied with the outcome. Various groups claim to speak on behalf of consumers, or particular groups of consumers, and the best way of ascertaining such views in the most legitimate way needs to be explored. Finding ways to capture such views 'legitimately' may be an important aspect of the regulator's specialist role which the review may want to consider.

29 October 2010

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<sup>9</sup> Kerry Gardner and Catherine Waddams Price, Consumer Choice in the Water Sector to be published by Ofwat as part of their Future Regulation project, 2010