

Finding the right balance Summarising the debate at the 2010 Water UK City Conference



A building sense that regulatory and operating arrangements within the water industry need to change, and an understanding of the important changes ahead, dominated discussions at Water UK's 10th annual City Conference held in London on Thursday 25 February. This was attended by over 170 delegates representing all the water industry's key stakeholders. Deloitte were again delighted to be involved as one of Water UK's Partners, enjoying the chance to hear and contribute to the diverse views from the wide array of speakers, with question sessions and panel debates giving added opportunity to elicit opinions. This report summarises the key issues discussed.

Tipping point

Opening the conference, Pamela Taylor sensed that the water industry was reaching a tipping point, where the incremental changes in regulation and the gradual developments in the way the industry operates in the 20 years since privatisation need to be supplemented by more fundamental reforms, intended to secure a sustainable future for the industry. Pamela highlighted the continual flow of new initiatives, whether from Ofwat, the Cave Review, the Walker Review, the Environment Agency or draft election manifestos from the major political parties, all of which are designed to improve the water industry for the benefit of the customer. However, she also reminded the conference that any changes cannot be allowed to happen without taking full account of the needs of investors. They after all are the people who will fund the things that need to happen, and without their support the cash hungry arrangements that have been carefully built over the past 20 years will start to crack. Pamela suggested a framework of four areas for debate, themes that would reoccur in presentations and discussions throughout the day and provide a benchmark against which to measure reform in years to come: the strengths and weakness of the current regulatory model; the scope to work innovatively with other infrastructure providers; building investor confidence and the ability to continue to raise funds in a cash-negative industry; and the scope for more responsive economic regulation, less focused on capital investment.

Key speakers included:

- Mike Barnett, Fund Manager, Invesco Perpetual
- Richard Bartlett, Head of Debt Capital Markets, Royal Bank of Scotland
- Robin Cohen, Partner, Deloitte
- Adrian Cooper, Managing Director, Oxford Economics
- Regina Finn, Chief Executive, Ofwat
- Keith Harris, Director of Finance and Policy, Wessex Water
- Huw Irranca-Davies, MP, Minister for Marine and Natural Resources
- Doug King, Vice Chairman, Deloitte
- Mike McKeon, Finance Director, Severn Trent
- Alan Sutherland, Chief Executive, Water Industry Commission for Scotland
- Pamela Taylor, Chief Executive, Water UK

Strength and weaknesses of the current system

Robin Cohen of Deloitte reminded the conference of the water industry's successes since 1989 – in particular £85bn of investment – success that was powered forward by clear policy objectives such as low cost, reliable, safe water, and delivered by striking a balance between investor risk and efficiency incentives. However, Robin pointed out that the environment that led to such success has changed, resulting in more challenges going forward. Contrary to standard economic theory, as gearing levels have risen in the industry, the cost of capital has fallen significantly, resulting in reductions to the 'equity buffer'. As a result, the relative scope for high-powered efficiency incentives in the regulatory framework declines. Reflecting on the experience of other regulated industries, Robin stated that taking steps to incentivise more efficiency gains should not be based on an ideological approach to regulatory theory but rather be driven by clear policy objectives and rooted in a deep understanding of how the water industry operates and what particular activities could be reformed to deliver the most gains.

Scope for innovation

Keith Harris and Mike McKeon both picked up on the idea of introducing more innovative solutions based on their knowledge of how the industry works. Keith suggested that attention should be paid to the fact that there is at least 20% more supply of water than demand in the system, and that the practical problems of moving water around the country are diminishing. Now is a good time to consider whether establishing a market to trade in water would be good for customers. He said that a concerted effort should be applied to understanding the economic benefits of allowing water companies to trade in water and if the benefits were there, to structure regulatory incentives to allow trading to be delivered. Prefacing the recently published Severn Trent report *Changing Course*, Mike laid out six fundamental changes to securing a sustainable future being flexible implementation of the framework directive; the introduction of a market-based trading framework; the Environment Agency developing a more flexible approach to consents; Ofwat revising their approach to what they incentivise; water companies taking responsibility for driving innovation in strategic and technological solutions; and the Government setting out prioritised outcomes. He went on to suggest that if Government were to agree a clear roadmap on what policies needed to be delivered and when, then regulatory changes, innovation, and new ways of doing business could result in £10bn less debt across the industry and 13% lower bills for customers by 2030.

Building investor confidence

Mark Barnett eloquently extolled the virtues of the water industry as an equity investment of choice for funds. He highlighted the stable regulatory environment, recognition of the importance of returns to equity investors, and the in-built growth of a monopolistic industry as reasons why long-term investors have stood by the remaining publicly listed companies. However, Mark was forceful in saying that such support should not be taken for granted and the events of the past 12 months, where shifts in the position of the regulator have led to 15% underperformance by water companies, should be taken as a warning that equity will always sell out if higher returns and lower risks are achievable elsewhere. He felt that the regulatory regime had in recent times not been sufficiently transparent and open to allow a debate between the need to maintain investment while minimising the impact on customer bills. Neil Griffiths Lambert, of Moody's, echoed the view that the regulator needs to communicate better over the longer-term. In the panel debate, he mentioned that while investors accept the need for change, and are willing to support innovation, it must be on the understanding that changes are evolutionary rather than revolutionary. There needs to be a clear understanding as to why change is happening and what the benefits will be, and in scoping the impact of any change, the concept of a regulated return on the underlying capital value of the business, with no risk of having stranded assets, is a non-negotiable requirement of investors.

Flexible and responsive economic regulation

Regina Finn defended strongly the PR09 process and the fact that the "balanced outcome" was not challenged by 20 of the water companies. She felt that many of the comments from companies relating to how tough the settlement was, were aimed at investors rather than the regulator, and that there were still opportunities for well managed companies to outperform (e.g., through energy prices or the capital incentive scheme). As Doug King from Deloitte pointed out, in the subsequent Q&A session, such analysis ignores the failure of the regulatory process in allowing a £2.5bn capex gap to emerge between the final business plans and the draft determination. Ofwat should have been working much more closely with the companies, such that fundamental differences in approach were addressed at an earlier stage in the process. Regina was very open about the way forward and the need for reform, admitting that Ofwat did not have a monopoly on good ideas. She acknowledged that there were serious challenges to be addressed, and a review was required of Ofwat's scope and powers to ensure that the regulatory regime was fit for purpose and able to continue the successes of the past.

In particular, Regina said that the industry needed to measure any reform against customers' views on "the value of water", ensuring that changes such as universal metering, sustainable drainage initiatives and upstream trading of water are all considered in the context of what customers see as important.

Contributing to the debate on how regulation may change going forward, Alan Sutherland outlined one vision of the future, talking through the lessons learned in Scotland from introducing supplier competition. His key message to the water companies of England and Wales was 'be patient'. Introduction of competition took seven years in Scotland and would likely take a similar amount of time in England and Wales. Considerable effort is required to get the frameworks in place to achieve even modest benefits. More positively, Alan presented a vision of a future regulatory regime that was less complex (potentially removing hundreds of lines of regulatory reporting), less open to gaming, and more encouraging of Opex innovation. He suggested more cohesion between regulators and the industry, and in particular a greater focus on delivering results and outcomes rather than process. If an Opex solution produced a better result for customers than a Capex solution why not structure regulatory incentives to achieve that goal?

Key note address

Huw Irranca-Davies used his key note address to pick up on the themes of the day. He reflected that "Future Water" in 2008 was not meant to be an end to the debate, but rather an evolving discussion on what is to be achieved in the industry. He acknowledged the importance of Government input, stating that policy priorities are a matter for them and clear messages need to be put forward on what needs to change and how fast change needs to happen before the regulatory regime can be developed to ensure that companies act in the way Government intended.

Huw reflected on the Cave and Walker reviews, and while Government is in the process of considering its response to both, he was clear that the success of attracting investors to the industry over the past 20 years should not be forgotten and financeability of the industry should never be put in doubt. He then put down a marker of Government priorities by saying that Defra were currently drafting a water bill to address the Cave, Walker and other reviews, including the adoption of private sewers by 2011. He felt that such a bill had broad cross party support and a consultation before the summer could lead to legislation early in the new parliament.

Investors value the certainty of independent economic regulation ...

Finally, Huw asked the industry to engage in a review of Ofwat's roles and responsibilities, asking the question as to whether their role should be broadened or cut back. The success of the industry in delivering bills £100 lower than they would have been without the efficiencies achieved since 1989 should not be ignored, but where do future improvements come from? The issues of climate change and affordability have never been explicit considerations for Ofwat, but should that now be the case? Investors value the certainty of independent economic regulation, but are there any ways to ensure that predictability and reliability of regulation can be maintained in the future? These are issues on which the Government is inviting contributions.

Summary

The speakers all agreed that now is the time to consider change, but not just for change's sake. One of the reasons for the difficulties in the regulatory process in 2009 is the fact that it was carried out in a vacuum, separate from ongoing dialogue about what the water industry is trying to achieve in the long-term. A regulatory regime that incentivises innovation and new ways of working is required to deliver efficiencies over the next 20 years – comparable to those that have been achieved over the past 20 years. This will require a very challenging move away from rewarding "pouring concrete" and focus more on allowing companies to make greater returns if they can deliver on new operational efficiency challenges framed clearly in the unique arrangements of a water business. It is easy to see why getting water companies to use surplus water from outside their region may be more efficient than building a new reservoir, however it is very hard to reform the regulatory regime to manage that process. Even harder, is to introduce reform in a way that leaves the RCV concept in place, which is a pre-requisite of ensuring continual investor support. Simply introducing more competition in ways that Ofwat is currently proposing is not going to be the answer. This debate will need to move forward rapidly in the next 18 months to avoid continual uncertainty in the market undermining investor confidence, while ensuring that the debate is concluded with sufficient lead time to allow companies to focus on the 2014 price review.

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