

PROSPECTS FOR COMPETITION IN THE PROVISION OF WATER SERVICES

EXECUTIVE SUMMARY

This Report contains an assessment of the prospects for the further development of competition in the provision of water services.

A basic paradox

Notwithstanding the many challenges to, and complexities of, policy development for the water services sector, we detect a simple paradox at the heart of public policy in this area, perhaps best illustrated by the Ministerial Foreword to Defra's recently published *Future Water: the Government's water strategy for England* (February 2008). The Secretary of State ends that Foreword by saying that:

“We are all increasingly understanding that we need to value water more, use it more wisely and play our part in taking responsibility for protecting this essential and unique resource. This strategy aims to help all of us to do so.”

The oddity is as follows. The Secretary of State appears to be seeking policies that will (a) lead to better, more realistic valuations of the commodity water, (b) encourage efficiency in the ways water is allocated and used, and (c) involve large numbers of people in these processes. Now consider the question: do we know of processes capable of effectively achieving these objectives, namely participatory valuation and allocation of a commodity? There is an easy general answer to this question: competitive markets. Such markets tend to involve large numbers of participants, and they are, by some margin, the institutional structures that tend to be most effective in discovering values and allocating resources efficiently, particularly in conditions of uncertainty and change.

In contrast, as the history books tell, central planning is hopeless at discovering the value of scarce resources, tends to massive inefficiency in resource allocation, and involves the few, not the many, in the determination of values and allocations. We characterise the market and regulatory environments associated with central planning as typically being in states of “informational poverty”, using poverty in its relativistic sense, with the relevant comparator here being the kinds of stocks and flows of economically valuable information observed in competitive markets.

If the Secretary of State's views are taken seriously, the development of competitive processes should be the first ‘policy strategy’ that comes to mind. Yet, in the document that follows the Ministerial Foreword, discussion of competition does not appear until the final substantive chapter, where it appears almost as an afterthought; as if, having produced a text on planning, someone has reminded the authors that this is a policy statement from a UK government nominally committed to liberalisation and the Lisbon Agenda.

Past false starts, and the position now

It follows that the prospects for the development of competition in the water industry should be good, but the reality is that they are quite possibly not very good. There have been a number of false starts in this policy area in the years since privatization of water services in England and Wales nearly twenty years ago now, and the latest attempt to move forward, in the form of those provisions of the 2003 Water Act dealing with market opening and with access to water networks, is widely regarded as having resulted in failure.

Scotland, which has just launched its own market-opening initiative (on 1 April, which it is to be hoped is not portentous), may do better, but on that we will have to wait and see. Those who are sceptical about the potential contributions of competitive markets can certainly point the fact that there is limited evidence of success.

Given all this, and given that the Government has launched its own review of the role of competition in the sector, we suggest in this study that now is probably a sensible time to look at the policy issues in a wide perspective, to try to understand how competition might help achieve public policy objectives, where the priorities should lie, and how public policy might be shifted away from its current, central planning tendencies, which cannot be expected to lead to anything other than the systematic failures that such tendencies have always produced when seeking to value and allocate scarce resources.

Competition as a discovery process

We have sought to make some initial progress in these tasks, by first of all considering what competition is (answer: rivalry), what forms it can take, and how it is affected by what we have called the 'rules of competition' (RoC), by which we mean to refer to a wide range of influences on market conduct, from general law to shared understandings of market participants.

Since it is almost self evident that rivalry is not an end in itself, competition stands to be assessed as a means for achieving some other purpose. The emphasis is on competition as a 'discovery process', in which new information is constantly discovered, interpreted and utilised on a scale and with an effectiveness that is typically well beyond the capacities of monopolistic entities.

We also emphasise the relationship between competition and the specific context – physical, social and economic – in which it operates. Good rules of competition are rules that cause competition to work well in the relevant context, and one of the principal tasks of regulatory policy is to help in the discovery, development and enforcement of such rules in a given, specific set of circumstances (in this case the supply of water services).

In contrast to the individualistic nature of the myriad, particular decisions that are taken in competitive markets, such 'discovery of rules that work well' is a collective/social activity.

Determining priorities: the abstractions regime and the value of water

Given these various points, in assessing the prospects for competition it is natural to ask: where might the discovery capacities of competition be most valuable? Our conclusion is that the answer is likely to lie at the water resource management and water abstraction stage of the value chain. As *Future Water* indicates, there is much to be learned about the economic value of water and about how best it might be used in the face of uncertainties surrounding climate change.

Current charges for water abstractions are poor indicators of value, as is evident from the fact that it costs substantially more to abstract water in Northumbria than in the Thames region, where a desalination plant is currently being built to meet demand for incremental water. That geographic pattern of water values makes no economic sense.

It is also manifestly clear that although there have been some moves to allow trading of abstraction rights – the first step in developing more effective valuation and allocation arrangements – the current arrangements are a long way from satisfactory.

In effect, the Environment Agency subjects abstraction rights trading to a substantial tax (in the form of a reduction in the rights), which discourages trading. Not only does this restrict the development of competition, but also it has the effect, by restricting trades, of accomplishing very little in terms of reduction of abstractions. As Ofwat has argued, this is poor policy targeting.

Redefining the role and conduct of the Environment Agency

Given the scope of the study, while it seems clear that there are a number of steps that could be taken to improve the abstractions trading regime, we have not sought to develop any proposals in detail. We are, however, of the view that there is potentially great merit in the Environment Agency being given a more explicitly specified but simultaneously more commercial role in the buying and selling of abstractions rights in pursuit of its water resource management responsibilities.

In effect, the Agency is responsible for the management of natural ‘systems’, which tend to give rise to economic externalities that are not easily fully marketized because of the locational specificity of the relationships between causes (e.g. excessive abstraction at a particular location) and effects (consequential environmental damage, possibly across a wider area).

The economic structure of the Agency’s task is therefore not entirely dissimilar to that of ‘system operators’ or ‘network managers’ in other network sectors. The organisational architecture and conduct of these institutions might therefore offer some guidance as to the possibilities for the future although, as always, institutional development will need to respond the specifics of the water resource context.

Better valuation processes for abstractions matter for network development

Making progress in developing markets that are more effective in discovering the value of raw water, including variations in value according to location, season and time of day, is important for network development. The rationale for bulk transfers of water from location A, say, to location B is that the water is more valuable at B than A. In terms of the broad direction of investment in major projects, therefore, network investment efficiency will continue to be impaired for so long as the value of abstracted water is not determined in appropriate ways.

And here, therefore, is another major, potential benefit of markets in raw water: the information discovered from competition at that point in the supply chain is also of value in making decisions about water services infrastructure, even though the latter may remain monopolistic. Further, given that major infrastructure projects are very costly – the replacement value of water company assets in England and Wales is of the order of £230 billion – even relatively modest improvements in the discovery of information relevant to investment decisions can have substantial benefits.

Valuing water matters for sewerage too

It can also be noted that, looking forward, better valuation processes for raw water may also have positive effects on investment decisions in relation to sewerage and sewage treatment. Environmental constraints are pushing for enhanced treatments that return higher quality water back to the environment, which, in effect, means that that the environmental constraints are implicitly placing higher value differentials on water of different qualities.

Improved, more transparent, market valuation processes could also help in eliminating inefficiencies that might arise as a result of the generally poor value information that tends to exist when markets are absent (i.e. when decision systems suffer from the informational poverty characteristic of central planning).

Access arrangements: one of the false starts

In order to be able to develop water trading, it is important that new entrants into water services be able to obtain non discriminatory access to the networks of incumbent water companies. Policy in this area has, unfortunately, got itself snagged on a particular approach to access pricing called the Efficient Component Pricing Rule (ECPR) which, oddly, takes potentially competitive retail prices as the starting point for setting charges for access to monopolistic networks, and which has a global track record of failure in implementation.

Ofwat is now calling for changes in the legislation so that access charges can be set on a more ‘standard’ basis, to reflect the costs of the network services that are being provided, albeit on a geographically averaged basis. We are of the view that Ofwat could change its approach without any requirement for primary legislation, and should do so without waiting for Government to act – a view we believe is fairly widely shared – but it would also seem sensible for the Government to accept and act on Ofwat’s proposals, if only to clear up any ambiguities and bring to an end a debate that is closer to economic theology than to substantive policy discourse.

The size of the retail market that is open to competition

Expanding the scope for competition at the retail level by reducing the threshold volume at which an end user is entitled to choose a water supplier is also a development that, over time, can be expected to bring benefits, both directly to consumers as a result of retail competition for their custom and indirectly, by improving discovery in the market for wholesale water.

There is a caveat here, however. Experience in the energy sector indicates that, when industrial and commercial markets were first opened up to competition in 1982 and 1983, nothing very much happened; there was no significant entry. The lessons from that experience – which has been repeated in the water sector in that there has been no significant market entry in the period since the introduction of the Water Act 2003 – is that it is not to be expected that competition will necessarily develop automatically once statutory restrictions are withdrawn. Rather more development work on the rules of competition than that typically needs to be done if market liberalisation is to work well.

A pretence of competition?

We suspect there is a danger that those who are inclined more to central planning than to competitive discovery processes, but who recognise that some ‘compromises with competition’ might have to be made, will tend to favour a focus on retail competition, which might serve to keep competitive pressures ‘in their box’, and well away from resource management.

The Scottish Parliament took such a view in restricting competition in Scotland to a retail-only form, although the Water Industry Commission for Scotland is taking a very pro-active approach in seeking to maximise the scope of its remit under the legislation and, as the discovery process proceeds, it might easily generate new information that will cause the Parliament to think again.

The risk to consumers in an excessively heavy focus on retail competition is that there are non-trivial costs in establishing the systems and arrangements that could sustain such competition. In the absence of the development of wholesale water markets and of reformed access arrangements, the benefits of retail market opening could be quite limited, and the costs incurred could be disproportionately high in relation to those benefits.

In contrast, if the abstractions regime were improved and access arrangements reformed, suppliers would have greater scope to respond to consumer wants and the effects of retail competition would likely be leveraged into network decisions and into wholesale market decisions. In this context, it is perhaps worth remembering that there were established wholesale markets in both electricity and gas (albeit not particularly deep in the latter) before monopoly franchises at the retail level were fully withdrawn.

Squaring the circle: economic valuation of water + consumer protection

In the absence of effective valuation processes, the economic value of water, including its geographic and temporal (year to year, seasonal, time of day) variations, remains to be discovered. Some commentators are of the view that water is not particularly scarce, and that most of the perceived shortfalls in water resource management plans are simply the result of the supply-side distortions and rigidities created by the current policy framework. If that is right, market-based valuation of water will not lead to any very major price hikes.

At bottom, such a view amounts to a price forecast for markets that do not yet exist. Whilst the forecast may be right, we think it prudent to recognise that the introduction of market mechanisms would create a realistic possibility that there would be significant increases in the value of water in at least some regions. That is, there is a risk that public policy would be ill advised to ignore. How then might the economic pricing of water, and possibly also of component parts of water networks, be reconciled with consumer protection?

The transitional problems are not unique in their general form

Assessment of approaches to resolving the trade-offs between economic valuations and consumer protection is beyond the scope of the study, but, by way of providing signposts, we have made a few preliminary points.

First, the most important of the issues is distributional in nature, and concerns the question of to whom the rents from water scarcity are allocated. The ability to reach an initial 'scarcity rent settlement' provides Defra (and it has to be Defra, the EA and Ofwat can't do this) with a policy instrument that can be used to offset distributional effects of changing water values (most likely in an implicit, rather than explicit way).

Second, this is not a new problem. In fact it is the norm in regulated sectors that 'economic' prices do not square with the revenue requirements of the overall regulatory settlement. Mostly these prices are 'too low', but sometimes they are 'too high' and, either way, adjustments to bring the two into line are the rule, not the exception. Regulators are very frequently engaged in seeking 'tariff rebalancing' of one sort or another.

Overall conclusion

Our main conclusion then is that competitive discovery processes have potentially very important roles to play in the water sector, particularly at the wholesale level, where we know that we know relatively little about the economic value of water, including its spatial and temporal variations, and how to use it most wisely.

The Secretary of State has posed a straightforward challenge, based around the notions of the value of water, its efficient allocation, and wide participation in the valuation/allocation processes; and we are of the view that competitive processes could be developed which are not only capable of meeting that challenge, but that could be expected, on the basis of experience, to be rather more effective in meeting it than any feasible, alternative approach.