The Search for Legitimacy – The Roles of Regulation and Competition

XVth World Water Congress - Special Session SS2

Session organised by Shepherd and Wedderburn LLP
27 May 2015
The Search for Legitimacy – The Roles of Regulation and Competition

Gordon Downie - Chair
The OECD Perspective

Céline Kauffmann
Why regulate?

- Monopolist sector
- Asymmetry of information
- Balance economic, social and environmental interests
- Important externalities
- Fragmentation of actors
Alternative models of water service regulation

Regulation by government
- Austria
- Germany
- Netherlands

Regulation by contract
- France

Independent regulation
- UK
- Italy
- Portugal
<table>
<thead>
<tr>
<th>Regulatory functions for WWS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tariff regulation</td>
</tr>
<tr>
<td>Quality standards for drinking water</td>
</tr>
<tr>
<td>Quality standards for wastewater treatment</td>
</tr>
<tr>
<td>Defining public service obligations / social regulation</td>
</tr>
<tr>
<td>Defining technical / industry and service standards</td>
</tr>
<tr>
<td>Setting incentives for efficient use of water resources</td>
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<tr>
<td>Setting incentives for efficient investment</td>
</tr>
<tr>
<td>Promoting innovative technologies</td>
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<tr>
<td>Promoting demand management</td>
</tr>
<tr>
<td>Analysing water utilities’ investment plans / business plans</td>
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<tr>
<td>Information and data gathering</td>
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<tr>
<td>Monitoring of service delivery performance</td>
</tr>
<tr>
<td>Licensing of water operators</td>
</tr>
<tr>
<td>Supervision of contracts with utilities / private actors</td>
</tr>
<tr>
<td>Supervising utilities’ financing activities</td>
</tr>
<tr>
<td>Carrying management audits on utilities</td>
</tr>
<tr>
<td>Customer engagement</td>
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<tr>
<td>Consumer protection and dispute resolution</td>
</tr>
<tr>
<td>Advice and advocacy</td>
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</tbody>
</table>
Establishment of water regulators

OECD Survey respondents

Source: OECD (2015), The Governance of Water Regulators
Why are water regulators established?

<table>
<thead>
<tr>
<th>Reason</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>To protect the public interest</td>
<td>29</td>
</tr>
<tr>
<td>To make service providers more accountable</td>
<td>18</td>
</tr>
<tr>
<td>As part of a broader process of regulatory reform</td>
<td>17</td>
</tr>
<tr>
<td>To accompany a privatisation process</td>
<td>8</td>
</tr>
<tr>
<td>In response to an international commitment</td>
<td>3</td>
</tr>
<tr>
<td>To curb corruption</td>
<td>2</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
</tr>
</tbody>
</table>

- Establish independent price-setting process
- Harness regulatory expertise in public sector

Source: OECD (2015), The Governance of Water Regulators
## What do they do (functions)?

<table>
<thead>
<tr>
<th>Function</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tariff regulation</td>
<td>33</td>
<td>1</td>
</tr>
<tr>
<td>Monitoring of service delivery performance</td>
<td>32</td>
<td>2</td>
</tr>
<tr>
<td>Information and data gathering</td>
<td>27</td>
<td>7</td>
</tr>
<tr>
<td>Analysing utilities’ investment/business plans</td>
<td>27</td>
<td>7</td>
</tr>
<tr>
<td>Customer engagement</td>
<td>25</td>
<td>9</td>
</tr>
<tr>
<td>Consumer protection and dispute resolution</td>
<td>25</td>
<td>9</td>
</tr>
<tr>
<td>Incentives for efficient investment</td>
<td>24</td>
<td>10</td>
</tr>
<tr>
<td>Defining technical &amp; service standards</td>
<td>22</td>
<td>12</td>
</tr>
<tr>
<td>Incentives for efficient use of water resources</td>
<td>22</td>
<td>12</td>
</tr>
<tr>
<td>Uniform systems of accounts</td>
<td>20</td>
<td>14</td>
</tr>
<tr>
<td>Promoting demand management</td>
<td>20</td>
<td>14</td>
</tr>
<tr>
<td>Promoting innovative technologies</td>
<td>18</td>
<td>16</td>
</tr>
<tr>
<td>Licensing of water operators</td>
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</tr>
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<td>Carrying management audits on utilities</td>
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</tr>
<tr>
<td>Defining public service obligations</td>
<td>15</td>
<td>19</td>
</tr>
<tr>
<td>Supervision of contracts with private actors</td>
<td>14</td>
<td>20</td>
</tr>
<tr>
<td>Supervising utilities’ financing activities</td>
<td>11</td>
<td>23</td>
</tr>
<tr>
<td>Quality standards for drinking water</td>
<td>9</td>
<td>25</td>
</tr>
<tr>
<td>Quality standards for wastewater treatment</td>
<td>4</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: OECD (2015), The Governance of Water Regulators
Thank you!

Documenting the features of a sample of 34 water regulators

Based on a detailed survey drawing on the Governance of Regulators Principles

Developed in close co-operation with the water regulators of the Network of Economic Regulators

Launched at the World Water Forum on 13 April 2015 in Korea

Celine.kauffmann@oecd.org
Their institutional landscape

Government

Ministry of Environment
All but Mozambique

Ministry of Finance
Ex: Uruguay, Chile, Australia/NSW

Ministry of Transport and Infrastructure
Ex: Albania, Italy

Ministry of Housing
Ex: Bulgaria, Colombia, Indonesia, Romania, Ukraine,

Ministry/Department of Agriculture
Ex: US

Ministry of Health
All but Armenia, Estonia, Ireland, Portugal, UK/England & Wales, Uruguay

Ministry of Economic Development and Trade
Ex: Albania, Kosovo, Ukraine

Ministry of Economy
Ex: Bulgaria, Chile, Latvia, Uruguay

Ministry of public works
Ex: Belgium/Flanders, Bulgaria, Chile, Indonesia, Mozambique

Public agencies

Economic Water Regulator

Environmental agencies
Ex: Australia, Belgium, Scotland, Hungary, Ireland, Portugal, UK/England & Wales, US

Competition Authorities
Ex: Australia/ACT, Bulgaria, Portugal, UK/England & Wales, Ukraine

Other stakeholders

Ombudsman
Ex: Australia, Indonesia, UK/Scotland

Customer Association/Commission
Ex: Australia, Romania, UK/England & Wales, US

Water Association
Ex: Australia, Brazil, Bulgaria, Romania, US

Operators / Associations Operators
Ex: Australia, Bulgaria, Ireland, Italy, Kosovo, Portugal, UK/England & Wales, US

Association of regulatory agencies
Ex: Brazil/RGS, US

Operators

Municipalities and local authorities
Ex: Albania, Belgium/Flanders, Brazil/RGS, Bulgaria, Colombia, Estonia, Indonesia, Italy, Malaysia, Portugal

Source: OECD (2015), The Governance of Water Regulators
How do they ensure regulatory quality?

- Is consultation with regulated entities before making a regulatory determination required by the authoring legislation?
- Is there a legislative requirement in place to conduct public consultation in advance of making a regulatory determination?
- Is an economic assessment of the costs and benefits required to be prepared by the regulator to justify a regulatory decision?
- Is periodic ex-post evaluation of existing WWS regulations mandatory?

Source: OECD (2015), The Governance of Water Regulators
The Legitimate Role of the Economic Regulator

Alan Sutherland
XVth World Water Congress - Special Session SS2
The Legitimate Role of the Economic Regulator

Edinburgh International Conference Centre, Edinburgh
27 May 2015

Alan D A Sutherland
Water Industry Commission for Scotland

www.watercommission.co.uk
The OECD defines three principal models for the regulation of water and waste water services. Not surprisingly, the OECD’s ‘English’ model dominates in the UK.

<table>
<thead>
<tr>
<th>England &amp; Wales</th>
<th>Scotland</th>
<th>Northern Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ofwat</td>
<td>Water Industry Commission for Scotland</td>
<td>Utility Regulator of Northern Ireland</td>
</tr>
<tr>
<td>Companies are privatised</td>
<td>Scottish Water is publicly owned</td>
<td>Northern Ireland Water is publicly owned</td>
</tr>
<tr>
<td>Ofwat’s statutory duties are complex and go beyond simple price setting</td>
<td>The Commission has to set charges consistent with the Scottish Government’s Objectives for the water industry and its principles of charging</td>
<td>Statutory duties are closely modeled on Ofwat’s (because NIW was originally to be privatized)</td>
</tr>
</tbody>
</table>
How can we make economic regulation as effective as possible?

• How does a regulator address the inevitable asymmetries in information that exist with the regulated company?

• How does a regulator allow for and encourage innovative approaches by the regulated company?

• How does a regulator ensure that customers’ interests are properly reflected in the trade-offs that have been made in the price-setting process?
How does a regulator address the inevitable asymmetries in information that exist with the regulated company?

• By creating change

• By asking broader questions

• By challenging the regulated company with reference to other sectors or customer experiences
How does a regulator allow for and encourage innovative approaches by the regulated company?

• By avoiding change!

• By open dialogue

• Focusing on cash, not total expenditure
How does a regulator ensure that the customers’ interests are properly reflected in the trade-offs that have been made in the price-setting process?

- Competition where possible
- Involving customers, where it is not....
There are perhaps three key conclusions that can be drawn from the UK experience

Conclusion 1
• Clarity in the governance arrangements and in the respective roles of the different organizations is critical

Conclusion 2
• The mixed economy was vital in getting Scotland established on the right path
• But the profit incentive does not necessarily seem to be correlated with better performance, environmental compliance or innovation
• Rather it is reputation that seems to drive managements

Conclusion 3
• Customer engagement, both in deciding how to make the best of the current arrangements and also to help policy makers achieve better outcomes, is likely to become increasingly important.
• The Holy Grail is to achieve a water company that responds to its customers as if it could lose them…
The Role of Customer Engagement in Securing / Promoting Legitimacy

Stephen Littlechild
Regulation and the search for legitimacy: the Customer Forum

Stephen Littlechild

World Water Congress XV
Edinburgh, 27 May 2015
OECD Context

• Water is a highly capital-intensive and monopolistic sector, with important market failures where coordination is essential
• Water policy is inherently complex & linked to health, environment, agriculture, energy, regional development and poverty alleviation
• Principle 10: Engage with stakeholders within and outside the water sector for meaningful, informed and outcome-oriented contribution to decision-making and implementation
Customer engagement

• Can customer engagement increase legitimacy?
  – Monopoly – scope for water competition limited
  – Policy complex – need for government role
  – What impact on customers? Is it what they prefer?
  – If customers support policy, this aids legitimacy

• What forms can customer engagement take?
  – US: negotiated settlements
  – UK: customer engagement in airports
  – UK: customer engagement in energy and water
  – Scottish Water sector: the Customer Forum
US Negotiated Settlements

• “If you can agree, we don’t need to act”
• US Federal Power Commission 1960s - backlog of cases – resolved by settlements
• Fixed period rate freezes – more certainty for both parties, better efficiency incentives
• Florida PUC 1980s/90s – settlements got better terms for customers, better incentives
• Canada National Energy Board from 1997 - better incentives, better relationships
UK Customer Engagement

- Civil Aviation Authority 2005 proposed constructive engagement at airports
  - Asked airlines & airports to agree traffic forecasts, quality of performance standards, future investment
  - CAA retained responsibility for opex, cost of capital, financing and final price control
- Despite initial scepticism, it worked
  - And improved understanding and relationships
  - Repeated in 2010 where competition not possible
Water and energy networks

- Fast track reviews for well-prepared plans supported by informed customers
- Company plans reflected customer views
- Companies & customers very supportive
- Regulators praised process & outcomes
  - Except for operating cost projections
  - So only the “best” were fast-tracked, others rejected
- Was customer engagement pointless?
- Future challenge: how to reconcile fast-tracking with customer engagement?
Scotland, Water Regulation & Customer Forum

- Regulator (Water Industry Commission for Scotland - WICS) wanted more effective regulation & more customer representation
- Created the Customer Forum with Scottish Water (Co.) & Consumer Focus Scotland
- Remit: research programme to ascertain & represent customers views in price review
- Later: to seek to agree Business Plan with Scottish Water – basis of price control?
Customer Forum in practice

• Guidance: to be consistent with WICS views to be conveyed through the process
• WICS issued guidance notes throughout
  • On costs, capex, efficiency, performance standards
  • And responded to CF & SW enquiries & concerns
• Enthusiastic & effective participation by all
• Reached agreement on Business Plan
• WICS Draft Determination consistent with it
Conclusions

• OECD: Some aspects of water sector where competition not feasible, and
• Need to involve public interest guidance
• Customer engagement can harness customer views consistent with this
• E&W challenge to reconcile with efficiency
• Customer Forum achieved this: legitimacy
• Scope to extend to other countries too? Yes
Legitimising Customer Charges through Customer Choice

Liz McRobb
XVth World Water Congress

Retail competition: new markets, new regulation

Presented by Liz McRobb, Shepherd+ Wedderburn LLP.

EICC, Edinburgh, 27 May 2015
Why regulate to open markets?

The Scottish experience shows that regulation or “setting the rules” is a hugely important aspect of developing the conditions in which competition can flourish. The English experience is that negotiated access has not succeeded:

- Privatisation without competition?
- Albion Water competition law challenge

“Without referees and a rule book, competition becomes self-defeating. Much like giving all the players in the football game their own whistle.” Alexander Italianer, DG for Competition, European Commission
The case for regulated access

Without rules, new markets do not spontaneously erupt

With the wrong rules, markets do not flourish

• Water privatisation in England and Wales and the threshold for large customers – negotiated access, lack of switching

But often there is a need to start somewhere and move towards full market opening e.g. rail and energy – three EU regulatory packages with more work to do
Developing the legal and regulatory framework

The Scottish experience – discussed by others at this Conference
The English experience – in the midst of developing the rules that will support retail competition for business customers
Water Act 2014
DEFRA established High Level Group to oversee implementation – market opening April 2017
HLG set up industry Open Water Programme – developing the codes, agreements, market governance and central systems and processes needed to support retail competition
Figure 3: How the non-household retail market will work
The main players and their roles

- Multiple wholesalers - water and sewerage companies, water only companies, inset appointments – wide variation in scale and sophistication
- Retailers – integrated within an incumbent monopoly business, legally separated within an incumbent’s group, new entrant retailers
- Market operator – industry owned not for profit – holds register of all customers, records switches, calculates sums due by each retailer to each wholesaler
- Government – setting policy via the 2014 Act, setting charging guidance, developing exit regulations, enabling regulations to support appeals of regulatory decisions to the CMA, timely commencement of legislation
- Ofwat – implementing policy by developing the statutory codes, licensing framework, charging rules, enforcing code compliance
- Other key stakeholders – Drinking Water Inspectorate, Environment Agency
- CUSTOMERS!
The need for standard rules – building customer confidence

CUSTOMER

- Water Wholesaler A
- Water Wholesaler B
- Water Retailer
- Sewerage Retailer
- Sewerage Wholesaler
## Registration Transfer

<table>
<thead>
<tr>
<th>Time</th>
<th>Incoming Retailer</th>
<th>Market Operator</th>
<th>Outgoing Retailer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 BD of receipt of T108.R</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>See process step a</td>
<td>Submit Transfer Registration Application T108.R</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Confirmation Notice - reject</td>
<td>End</td>
<td>Registration Valid?</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Load Incoming Retailer and RSD T108.M Wholesaler also Notified</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Cancel?</td>
<td>Cancel Registration (CSD 0103)</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td></td>
<td>Yes Raise an objection?</td>
<td></td>
</tr>
<tr>
<td>Within 5 BD of receipt of T108.M</td>
<td>Request Read from Data Owner(s) for Sub Meter(s) T109.M</td>
<td>T108.M</td>
<td>T125.M</td>
</tr>
<tr>
<td>Yes</td>
<td>Interim Duty Supply Point? Yes Metered Service Component ?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
<td>Yes Metered Service Component</td>
<td></td>
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<td>Yes</td>
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<td>Yes</td>
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<td>l</td>
<td></td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Within 2 BD of receipt of T108.M</td>
<td>Obtain Transfer Read(s) (T or S) T105.W T105.R</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>Receive Transfer Read and/or Calculated Discharges T105.M Meter Read Submission (CSD 0202)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>Update Central Systems and notify T125.M</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No</td>
<td></td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Within 2 BD before and 2 BD after RSD (5 BD after if Estimated Transfer Read or Calculated Discharges)</td>
<td>Discharge Points? Yes T125.W</td>
<td></td>
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<td>No</td>
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<td>Yes</td>
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<td>No</td>
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<td>f</td>
<td></td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
- T108.R
- T109.M
- T105.W
- T105.R
- T125.W
- T125.R
- T112.M
- T113.M
- T146.M
- T152.M
- T153.M
- T154.M
- T133.M
- T155.M
- T156.M
- T163.M
- T139.M
- T140.M
- T144.M
- T145.M
- T147.M
- T158.M
- T159.M
- T129.M
- T138.M
- T104.M
- T136.M
- T160.M
- T121.M
- T123.M
- T128.M
- T167.M
- T168.M

**Process Steps:**
- Submit Transfer Registration Application
- Load Incoming Retailer and RSD
- Notify Registration Acceptance, RSD and relevant data
- Receive notice of loss and RSD
- Cancel Registration (CSD 0103)
- Receive Transfer Read and/or Calculated Discharges
- Update Central Systems and notify

**Timeframes:**
- Within 1 BD of receipt of T108.R
- Within 5 BD of receipt of T108.M
- Within 2 BD of receipt of T108.M
- Within 2 BD before and 2 BD after RSD (5 BD after if Estimated Transfer Read or Calculated Discharges)
Lessons learnt

• Creating the legal and regulatory framework is an art not a science
• Interaction of legislation, licensing and codes is crucial
• Essential to recognise it will never be “right”/”perfect”
• But essential to make a start and create the right governance conditions to allow the market rules to evolve with the market
• Results so far in Scotland
  – Annual Gross Value c. £375m/$580m
  – Estimated net customer saving £138m/$230m (‘09/10 prices)
  – C. 20% customers switched
  – Over 2/3rds of customers have negotiated a better price and/or service
  – £37m/$62m over 4 years direct public sector saving
  – Estimated set up costs £22.5m (‘09/10 prices), pay back circa 5 years after market opening.
• What will we be able to say for England by 2020?
Liz McRobb
Partner, Energy and Utilities
Shepherd and Wedderburn LLP

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Questions?
Thank you