
LETTERS & NOTES ON REGULATION

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Privatisation and untoward consequences in water services: the regulator's role

Utilities were privatised:-

- to enable them to finance investment outside public expenditure controls,
- to improve choice for customers through greater competition, and
- to harness private enterprise to increase efficiency through incentive regulation.

A regulator (Ofwat) was appointed, **independent** of Ministers, with statutory duties to secure that regulated companies carry out their legal duties, and can finance them, and to protect customers from abuse of monopoly power.

Privatisation has enabled a sustained increase in investment resulting in a substantial (some 25%) increase in the quality of drinking water and waste water discharged to rivers and coastal waters.² There has also been a substantial (also some 25%) improvement in efficiency. Greater choice for customers has not, however, been achieved.³

The privatisation settlement was intended to introduce market forces into previously government controlled monopolies. This involved some separation of powers; Ministers remained responsible for the structure of the arrangements and for ensuring adequate water quality, while the regulator became responsible for promoting efficiency and for enabling competition.

This separation of powers provided a valuable framework for the allocation of responsibility between Ministers & Regulators. Unhappily, it has become blurred. Rather than set objectives for the quality of **outcomes**, Ministers have become involved in overturning market signals by mandating **inputs** into the companies' productive processes. This was avoided with respect to leakage, but in the case of the Thames tunnel, Ministers have overridden Ofwat's judgement.⁴

Practical management of these divisions of responsibility may involve guidance to regulators but only when such guidance is clear and explicit; it must not overrun regulators' statutory responsibilities.⁵

Considerations of the respective roles of technical analysis and political judgement are common place in public expenditure issues, and policies and procedures have been put in place to deal with them. Officials are expected to implement the political objectives of the government of the day, but there are provisions for Parliamentary scrutiny through the Public

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² Although improvements have slowed from about 2004

³ With the exception of retail, non-household, services in Scotland.

⁴ Ministers have also encouraged the regulator to pursue social policies which go beyond non-discrimination and choice in mandating tariff structures.

⁵ Nor should it push regulators into undertaking social functions, which, as non-elected bodies, they are not competent to discharge.

Accounts Committee (PAC) and requirements for adequate transparency, for example, through Accounting Officer letters to Ministers.

Rather than develop comparable procedures in the area of regulated utilities, Ministers have exploited the credit card seemingly available to them to secure financing, by customers, of specifically determined Ministerial projects by mandating them as objectives of the utility. This enables them to avoid the constraints of consequential taxation. Such projects may or may not depend on analysis of markets and of options for delivery: they may rest on unproven assertions.

An independent regulator, with statutory powers, is needed to protect customers from any unholy alliance between big business and big government.⁶

If the carrying out of such projects is part of a political objective, arrangements should be in place for proper transparency and accountability. Currently arrangements within the water legislation are not being properly used. Ministers have legal powers to issue Licences to private companies and scope to provide finance through gilt-edged borrowing at rates well below those available private utilities.

When Ministers do not follow this route, Regulators should consider explicitly and publicly whether making customers pay for the additional costs of private financing is consistent with the proper exercise of their statutory powers. In cases such as the Thames tunnel, where options have not been properly explored and where incremental environmental benefits are minimal or negligible, their statutory duty to customers should be paramount.⁷

Regulators should be ready to explain, to the wider public, what analysis they have undertaken, what conclusions they have reached and, where appropriate, to consult before making decisions. Without exposing these issues, in particular the potential impacts of options on customers' bills, they fail to provide the framework for considered choices to be made. Ensuring such clarity should be regarded as an essential counterpart to Accounting Office letters written by Permanent Secretaries to their Ministers and as essential input into any PAC investigations.

⁶ Entrepreneurs naturally try to grow their businesses; in a well-functioning market economy this must be for the benefit of customers and not at their expense

⁷ Customers should not be expected to pay twice, as in this case, because Ministers have committed themselves to a project.