Off average?

The upstream competition provisions of the Water Bill raise the spectre of regional de-averaging of prices. Anthony Legg looks at what this could mean and for whom.

The Water Bill, currently on its journey through Parliament, includes provisions that will for the first time allow new entrants to supply water resources and dispose of sewage ("upstream activities"). The Bill will also remove the costs principle with the aim of increasing the profit margins available to new entrants, making entry to upstream markets more attractive.

Whether there is a vast number of potential entrants waiting in the wings is unclear, but these provisions raise the prospect of customers that are otherwise identical paying different amounts for their water and sewerage simply because the upstream activities they use are located in a different part of a water company's region. In other words, an end to so-called regional averaging of charges.

This possibility arises not only because new entrants might be able to supply water (or dispose of sewage) at a different cost to incumbents, but also because retailers could pay different amounts for the use of the network (to transport the water from source to tap), depending on whether the water is supplied by a new entrant or the incumbent.

The latter depends on the way that access prices are determined for the network. Under the Bill, Ofwat will need to issue guidance to companies on how to set their access prices, and while no such guidance can be expected for some time, it is likely that access prices will need to reflect the specific infrastructure actually used by the new entrant. And because the infrastructure (pipes, treatment works and so on) used by the new entrant will vary in design and condition, the cost of accessing the relevant pieces of infrastructure will vary within regions and is unlikely to be the same as the average cost that incumbents will be required to charge retailers.

The potential for new entrants to undercut incumbents, leading to loss of market share, is not the end of the potential problems for established water companies. Economically efficient access prices would reflect the marginal cost of access to the infrastructure. However, the costs incurred by the incumbent will also include a share of the fixed costs of operating and maintaining the network along with the sunk costs of investment in the assets in the first place.

The result could be that incumbents do not earn enough revenues to cover all their costs, potentially jeopardising investor confidence in the sector. And while the government and Ofwat will both be keen to avoid such an outcome, this will only be possible if either the access price reflects the full cost of the investment (making new entry less likely) or if the incumbent is able to recover its costs by increasing charges to other customers.

Further exacerbating the issue, it is likely that it will be the lowest cost-to-serve customers who switch to new entrants, leaving incumbents to serve the remaining higher-cost-to-serve customers. If this then means that incumbents increase charges to other customers, then the spectre of a vicious circle looms. By increasing charges it becomes harder for incumbents to compete with new entrants, leading to more relatively low cost customers switching away from incumbents, leading to increased charges making it harder to compete and so on.

It is worth remembering that it was concerns about this kind of downward spiral that led to the costs principle being enacted in the first place, concerns which have been echoed by the Consumer Council for Water and which are part of the reason the Welsh Government has chosen not to extend competition in the same way as in England.

However, it is important to note that the Bill explicitly limits the amount of water that can be supplied by upstream new entrants to the amount consumed by customers who have switched to new entrants. Consequently, the risk to incumbents from upstream entry depends in part on how much retail competition emerges and how effectively they compete in that retail market. Plus, competition (upstream and retail) is limited to non-household customers only.

Nevertheless, regardless of how quickly competition in retail and upstream markets emerges, it is clear that there are potential risks to incumbents and to consumers from the opening of upstream markets. If incumbents are not able to compete effectively with upstream new entrants by de-averaging prices (and charging each customer a cost-reflective tariff) or by being able to increase charges to other customers (who have not switched), then returns to investors may be compromised. If the willingness of investors to continue to provide the very substantial amounts of capital they have provided to the sector since privatisation at the competitive cost at which it has been supplied is undermined, then all customers' bills will rise.

However, if incumbents are able to move away from regional averaging of charges, or to effectively cross-subsidise losses on one group of customers from other customers, then some customers are bound to be worse off.

Whether this means companies need to be allowed to de-average their prices in order to compete (and how quickly they need to be allowed to do this) depends on how much new entry there is in upstream activities, on customer preferences and on the government's policy priorities. While at this stage it is unclear whether much new entry will emerge and these risks crystallise, it is clear that the government and Ofwat face some tricky choices. It will not be easy to balance the competing aims of trying to encourage competition, ensuring some customers do not end up unfairly cross-subsidising others and retaining investor confidence in the sector. It remains to be seen how the debate will play out. The Bill is just the beginning.

This article first appeared in Utility week on 13 September 2013

Anthony Legg
+44 (0)20 7632 5046
Anthony.legg@fticonsulting.com