

ENERGY AND WATER – THE DANGERS AHEAD: THE CHALLENGE FOR A SECOND TERM GOVERNMENT

Executive Briefing

An Agenda for Government

This report examines the water industry in England and Wales and the energy (gas and electricity) industry across the UK.

Its aim is to identify the potential problems in these industries which, if they emerged, would probably not be containable within the current legal and regulatory framework but would instead become political.

In the course of our research it has become clear that potential opportunities are sometimes interlinked with the potential risks. Seized in time, these may offer government a chance to shape these industries in a more profound way than at any time since privatisation.

The conclusions of this report take the form of a series of questions which we believe government should now address in depth by means of a review of each industry.

Since the government is currently conducting an Energy Review (with a long term time horizon, to 2050), issues being examined there are not considered here. The issues in energy identified here could also be addressed as part of that Review and this report is therefore part of a submission to it.

Underlying Themes

A State of Flux

Despite some marked differences between them, both industries are in a state of flux, being subject to a series of interacting forces building pressure for change. These include:

- Environmental demands.
- The government's own social agenda.
- Problems induced by regulation itself.
- Moves by players within the industry.

The First Term Response

In water, the government made a series of significant, albeit piecemeal changes (for example, the ban on disconnections). While this was surely the right way to start, such changes when combined with industry-inspired developments, eventually need to give way to a more all-embracing approach.

In energy, the 2000 Utilities Act *did* represent a coherent package of changes. Yet it seemed to centre on tidying up and completing an old agenda, rather than taking forward a new one.

The Second Term Change of Perspective

A government that has been so amply re-confirmed in office has to assume that it will be in power for some considerable time. This calls for a fundamental change of perspective. Whatever modifications it made during its first term to the system it inherited, the challenge now is to create a system that will still be functioning smoothly a decade or more hence.

HISTORY, RISKS, OPPORTUNITIES: WATER

The Record Since Privatisation

Although we have not scrutinised past performance in detail, the balance of opinion seems to be that the regulatory system in water has successfully delivered the investment to improve standards that was seen as the major strategic objective at the time of privatisation. Moreover, despite some serious incidents (especially Camelford) - and some serious criticism (for example, over pay)- the industry has retained public confidence and has not gone the way of the railways.

Following privatisation in 1989, prices rose by around 40% up to 1999, since when they have fallen back by about 10% following the last price review. The number of employees has declined by almost a third since privatisation.

The structure of the industry and the way that it operates have changed little since privatisation in 1989. Water companies continue as monopolies in their country, region or area. In most cases, they continue both to own and operate the assets. The ban on their taking one-another over and the absence of competition for customers means that the biggest change has been the acquisition of the companies by either foreign companies or domestic, non-water companies.

Risks and Opportunities

Beneath the surface, however, considerable pressures are building up. The risks here are not, for the most part, new ones; rather, we see the challenges arising from the very *persistence* of long standing problems.

The report identifies the following significant risks in the short and medium term:

- ***The combination of continuing rises in environmental standards, price controls and the companies' continued reliance on borrowing to fund investment.*** We find the strains here to be increasing, with no obvious mechanisms for resolving conflicting objectives. If it 'gives', either the higher standards will not be achieved, the companies will get into financial difficulties or the price controls will have to be eased.

- ***The industry's attempts to restructure itself.*** Welsh Water has managed this, with assets and operations now separated. Other companies are looking for ways to escape from the current industry structure. There are dangers here: the success of water privatisation may in part be due to the fact that it has always been clear where responsibility lies. But there are also opportunities, for example to bring assets back into public (regional?) ownership, or to free up companies to develop as international water operators.
- ***The present two-tier charging system.*** The current system - where non-metered customers pay according to the rateable value of their dwelling while metered customers pay according to usage - is inherently unstable. If there were a flight to metering, provoked for example by competition, many households on low and medium incomes would lose out, not just the narrowly defined 'vulnerable'.
- ***Incentives for investment in infrastructure to maintain the current assets.*** The incentives within the regulatory system to defer investment where possible, combined with the absence of *immediate* obvious problems if the replacement of aging but still functioning assets is postponed, may lead to serious and expensive problems over time. In water, the concern here is more with the sewerage system.
- ***The balance between supply and demand.*** The potential for imbalances comes from changes in the climate and our use of water. The Environment Agency takes a long term view but action depends on plans put forward by the companies to Ofwat set within five-year planning cycles. This may be too short. Prolonged shortage is liable to become a big political issue.

There is also the matter of the introduction of competition in water. Although the report has not examined it in detail, the question that would arise from our analysis is whether competition is the right 'big' challenge to be presenting to the industry at a time when other strategic issues clearly need addressing.

HISTORY, RISKS, OPPORTUNITIES: ENERGY

The Record Since Privatisation

If the water industry has hardly changed since privatisation, the energy industry could hardly be more different. Our overall conclusion is that the original privatisation agenda has been worked through to a largely successful conclusion. In particular, competition is now widely established to such an extent that price regulation for suppliers is about to cease.

Most suppliers to domestic customers now offer both gas and electricity. This supply business is fully separated from the distribution business (pipes and cables). The industry is now populated by a mix of British, American and other European companies.

Since privatisation, gas prices have fallen by 35% and electricity prices by 20%, reflecting falls in the wholesale prices for energy. Employment has fallen sharply by (at least in electricity) almost a half.

Risks and Opportunities

Unlike water, the risks that we have identified in the energy industry only in part arise from long-standing 'internal' pressures. In addition, new challenges that have been set for the industry by government in both the social and environmental fields are also relevant.

Thanks to the current Energy Review, we have not needed to be comprehensive here. In particular, we have restricted our attention to near-term, domestic (as opposed to international) issues. Once again, a number of risks are identified in the report as being significant. They are:

- **The number and age profile of engineers.** The concern that the long decline in the number of employees in the energy industries has resulted in too few engineers is exacerbated by the low rates of recruitment over the past decade. A step change in engineering training is needed simply to stabilise the situation. Although the consequent problems will be different, the question is pertinent to both gas and electricity.

- **Electricity generation in the medium term** The issue here is whether the UK might find itself with insufficient generating capacity at some point in the next few years (e.g. as nuclear power stations are de-commissioned). While this may not be a pressing problem right now, the crisis in California offers a salutary warning that a system of 'regulation and market' can go badly wrong in energy, with wide-ranging adverse consequences. California contains important lessons for the UK and should caution against complacency.
- **The Fuel Poverty Strategy:** The government's target is to eliminate fuel poverty for all vulnerable households by 2010 and a number of initiatives are in train to progress this. But whether the approach is sufficient remains unclear. Will the initiatives operate on the scale envisaged? Even if they do, are they sufficient? Who has responsibility for reviewing the strategy and amending it in the light of experience, changed circumstances etc
- **Prices paid by customers using pre-payment meters.** The higher prices paid by these customers is a long-standing issue which now affects up to 20% of households, mainly with low incomes. Although accepted in the UK, well-informed outside economists have been astonished at it, in terms of both economic justification and social justice. The issue for government is whether the existing regulatory institutions are too soft on this subject - perhaps because economics has little to say on the subject of equity.
- **Targets for alternative energy.** While the switch from using coal to generate electricity means that the Kyoto targets are not too onerous for the UK, the government's target for a 20% reduction in carbon emissions by 2010 is much more challenging. Once again, the concern is whether the current proliferation of initiatives – for energy efficiency, use of renewables, combined heat and power etc – will collectively be sufficient to achieve the target. If it looks like not, what is the mechanism – and who is responsible – for doing something about it?

CONCLUSION: THE WAY AHEAD

A New Settlement

Although the specific challenges facing the energy and water industries are different, we find they share a sense that their future is now uncertain in a way that it was not even five years ago. One way that people have put this to us is that the 'settlement' that was made at the time of privatisation no longer serves and that a new settlement for each industry is now therefore needed.

Besides clarifying the industry's public policy objectives, such a settlement would have to:

- Set out an intellectual framework to guide the resolution of conflicts between environmental, social and economic goals.
- Establish an institutional framework that, while allowing it room to develop of its own accord, can steer each industry as time passes and new circumstances arise.

Such a settlement could only be created following a review. We therefore recommend that the government should:

- ***Initiate such a review in water: with the new Water Bill not due before autumn 2002, there is a clear opportunity here.***
- ***Either extend the remit of the Energy Review or consider the questions we have identified as part of their response to the Energy Review in early 2002.***

Energy and Water – The Dangers Ahead: Challenges for a Second Term Government

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Questions for Review

Water

The focus of a water review needs to be on the underlying conflicts now present and the intellectual framework needed to resolve them, in particular:

- The conflict between environmental standards, the costs of financing the investment and consumer prices.
- The instability and potential unsustainability of the current two part pricing structure.

The review should also consider what scope there is for new forms of ownership and organisation within the industry (for example, a leading role for regional assemblies).

Such a wide-ranging review would also help government decide whether competition is the right 'big' issue to be guiding and shaping change in this industry over the next period.

Energy

In contrast to water, a review in energy needs to focus on the institutional framework for implementation, in particular:

- Whether the combination of 'strategy plus targets plus monitoring' is strong and flexible enough in such a complex industry.
- Whether, like water, there is a case for a second regulator who is not economically-led (e.g. a 'Sustainable Energy Agency').
- Whether there is a case for re-creating the Department of Energy.

Water and Energy

In addition, there are two questions that both reviews would need to address:

- Whether responsibility for driving forward the government's social agenda for these industries should be vested in a separate institution devoted to the task.
- How multiple regulators should take one-another's concerns into account and how conflicts between them should be resolved.