

Scottish Water

The drift to privatisation and how democratisation could improve efficiency and lower costs

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Introduction

Scottish Water is a public corporation¹ responsible for delivering water and sewerage services in Scotland. It was created in 2002 under the Water Industry Act (Scotland), which amalgamated the three water boards² who were previously responsible for delivering water services in the North, East and West of Scotland.

This report examines the regulatory environment which governs Scottish Water and recent changes in policy and regulation in the Scottish Water sector.³ The regulatory framework in Scotland is similar to the privatised system in England. It is in many respects a 'marketised' system that prioritises notions of market efficiency as the key driver of activity in the water sector. We argue that this produces very different outcomes than those systems guided by the values of public or social ownership of water.

We provide a detailed examination of the role, responsibilities and orientation of the Water Industry Commission for Scotland (WIC), the key regulator in the Scottish Water sector. We show how the approach of the WIC and the regulatory framework operating in Scotland is in line with international trends, which have increasingly tended to prioritise the role of the market and privatisation. The legislation that established Scottish Water allowed for private sector involvement in the capital investment programme in the water industry in Scotland. This led to the formation of Scottish Water Solutions, a joint venture between Scottish Water and private companies.

The latter half of the report focuses on the policy options facing Scottish Water, which include privatisation, mutualisation or democratisation and evaluates which is likely to safeguard the public interest and the sustainability of water to the Scottish public.

¹ A public corporation is defined as being 'an industrial or commercial enterprise under direct Government Control; has a board whose members are appointed by Ministers, and which meets at least quarterly; employ their own staff, who are not civil servants; and manage their own budgets'. (Scottish Executive, 2002:9)

² East, West and North of Scotland Water

³ This report was commissioned by the Scottish Trades Union Congress on behalf of the Trades Unions working in the Scottish Water Industry.

Background

Water and sewerage services in Scotland are delivered by Scottish Water, a publicly owned company which 'aims to be as efficient and effective as water companies in the private sector'⁴. Its main functions are to provide clean water to 2.2 million households and 133,000 non-domestic (i.e. mainly business) properties; and to treat wastewater across an area one third of the size of Britain. Scottish Water is now the single provider of water services to Scotland's 5 million population, and the fourth-largest in the UK.⁵ In 2005/06 its turnover was £1,019 million⁶ and total fixed assets in 2006 were £3,255.4 million.⁷ Scottish Water is a public utility run like a private company. It has sought to cut costs by reducing its workforce by 35%⁸ since the creation of the corporation in 2002, whilst increasing its investment programme. At the same time as these job losses the top management team at Scottish Water have earned exorbitant bonuses for a more 'effective' service.⁹ Should they outperform the objectives set by Ministers over the next 4 years the management team of Scottish Water will earn in excess of £170,000 each.¹⁰

In 1989 the water sector in England and Wales was privatised. Scotland's water and sewerage operations remained, and have continued to remain, in public hands. That said this has not been a smooth ride for a publicly owned water industry in Scotland. In 1995 Scottish local authorities were reorganised by the then Conservative Government. This restructuring initially included plans to privatise water and sewerage agencies that were then under local authority control. These proposals were met by a widespread campaign against water privatisation. A referendum on the issue in March 1994, organised by Strathclyde Regional Council, saw 71% of the eligible electorate vote (1.2 million ballots). The result was emphatic: 97% rejected water privatisation. Opinion polls across Scotland at the time registered similar levels of opposition to plans to take water ownership out of the public sector.¹¹ Faced with such widespread hostility to these plans the Conservative administration opted to restructure water regulation in Scotland by creating three authorities to assume responsibility for water from the regional councils.

This report examines a wide variety of literature and policy documentation on the global water system and the policy context in Scotland. We assess the evidence provided by the industry and its regulators as well as the main policy options found in the literature. Our analysis suggests that those siren voices proposing privatisation or

⁴ Scottish Water, *About Us*, (2006)

http://www.scottishwater.co.uk/portal/page?_pageid=225,483511&_dad=portal&_schema=PORTAL

⁵ See Appendix 1 for further details.

⁶ Scottish Water (2006) *Annual Report and Accounts 2005/2006*, Financial and Business Review, p. 28 (http://www.scottishwater.co.uk/pls/portal/docs/PAGE/SWE_PGP_NEWS/0606%20-%20JUNE%202006/SWE_NEWS_AREPORT06/PRINTED%20ANNUAL%20REPORT.PDF)

⁷ Ibid p.29

⁸ ibid., p. 31.

⁹ Hutcheon, P, 'Scottish Water bosses to net GBP1m in new bonus scheme', The Sunday Herald, September 3 2006; p,7

¹⁰ ibid

¹¹ System Three Scotland, 'General Public's Attitudes on Government's Proposals for Water and Sewerage Services', 11 November 1995.

Anderson Crooks, K (1996) 'Water Warfare in Scotland: A Case Study in Issues Management'. (<http://list.msu.edu/cgi-bin/wa?A2=ind9612d&L=aejmc&T=0&P=6455>)

mutualisation as the solution to the problems of the Scottish water industry are largely mistaken in their analysis. The evidence we quote shows how the system of governance in which the Scottish water industry operates is a marketised system. The operation of the system tends will inevitably increase the political and economic pressures for privatisation of the industry. We show however that neither privatisation - nor its near cousin mutualisation - will prove an efficient or sustainable future for the industry. On the contrary the most efficient, cheapest and sustainable future for the industry is to keep it in public hands in the context of a serious re-democratisation.

Part 1 Water Policy: Trends in Governance and Regulation

The International context

Global water: scarcity and inequality

Globally water is a resource that is in crisis. Barlow and Clarke state that the hard news is ‘humanity is depleting, diverting and polluting the planet’s fresh water resources so quickly that every species on earth - including our own – is in mortal danger. The earths water is finite’.¹² The UN Economic and Social Council observe that this crisis is due to ‘increased demand for finite water resources, contamination of water supplies and degradation of eco-systems’, not to mention climate change. Furthermore, underlying these factors are ‘continuing population growth, urbanization, industrialization and intensification of agriculture’.¹³ It is unsurprising therefore that in 1995 Ismail Serageldin, vice president of the World Bank, should make his now famous prediction, that ‘if the wars of this century were fought over oil, the wars of the next century will be fought over water’.¹⁴

In addition water inequality is on the rise. The UN estimated that in 1995 1.76 billion people (out of an approximate 5.7 billion population) were living under sever water stress.¹⁵ And, that in 2025 it is estimated that about two thirds of the world’s population, about 5.5 billion people, will live in areas facing moderate to severe water stress.¹⁶ This is hardly unsurprising given that water-use increased six-fold during the twentieth century, more than twice the rate of population growth and that as a consequence in some parts of the world, for example the USA, India and China, groundwater is being consumed faster than it is being replenished.¹⁷ What's more today in the world 1.1 billion people, or 18% of the world’s population, lack access to clean water. About 2.6 billion people lack access to basic sanitation. More than 2.2million people, mostly in developing countries, die each year from diseases associated with poor water and sanitary conditions, while every week an estimated 42,000 people die from diseases related to low quality drinking water and lack of sanitation. Over 90 per cent of them occur to children under the age of 5.¹⁸

It was in the knowledge of these statistics that the World Summit on Sustainable Development (WSSD) in 2002 set Millenium Developoment Goals (MDG's) to halve the proportion of those without clean drinking water and adequate sanitation by 2015. In December 2003 the UN general assembly proclaimed the decade 2005-2015 as the International decade for action “Water for Life”. The aim to stop the “Unsustainable exploitation of water resources”, while the major themes are “scarcity, access to sanitation to health, water and gender, capacity building, financing, valuation,

¹² Barlow, M. and Clarke, *Blue Gold: The Battle against Corporate theft of the Worlds Water*, Earthscan Publications Ltd, 2003, p,5

¹³ ‘Freshwater management: progress in meeting the goals, targets and commitments of Agenda 21, the programme for further implementation of Agenda 21, and the Johannesburg plan of implementation’ UN Economic and Social Council 11th February 2004

¹⁴ Shiva, V, *Water, Wars: Pollution, profits and privatization*, Pluto Press, 2002, ix

¹⁵ ‘International Decade for action, Water for life 2005-2015 Factsheet on water and sanitation’ UN – Water, 2005 <http://www.un.org/waterforlifedecade/factsheets.html>

¹⁶ ibid

¹⁷ ibid

¹⁸ WHO/UNICEF 'Water for Life', (2005) http://www.who.int/water_sanitation_health/waterforlife.pdf

integrated water resources management, trans-boundary water issues, environment and bio-diversity, disaster prevention, food and agriculture, pollution and energy¹⁹.

The issues outlined in the UN Water for Life campaign are relevant to all parts of the world, rich and poor, north and south, first and third. Therefore, it is reasonable to state that how water is governed is of vital importance everywhere. Yet how to govern water so as to ensure the fulfilment of the MDG's and in a fair, equitable, affordable and sustainable way in both wealthy and poor countries has sparked much dispute and disagreement. The scarcity of water and the issues around governance have encouraged the commodification of water and pressure to deal with issues of supply and governance by market mechanisms.

The 'Washington Consensus'

Since the collapse of the Soviet bloc, the market has reigned triumphant. Market principles and market rules are now dominant the world over and globalisation has accelerated as new markets have opened up, services have been commodified and capital can move freely and unhindered. This change has been termed the 'Washington Consensus' or neo-liberalism. Cox summarises the Washington Consensus as the 'privatisation of the means of production, deregulation of all economic activity, encouragement of competition and balanced budgets'.²⁰ Hobden and Wyn Jones say that the set of policies most closely associated with the neo-liberal project is a reduction in state spending, currency devaluation, privatisation and the promotion of free markets.²¹ A leader in this global transformation was the UK Conservative Governments of Margaret Thatcher and John Major. Heffernan states that Thatcherism (neo-liberalism) was 'an ideological project and a vehicle which advanced a post social democratic neo-liberal order'.²² This manifested itself through a rejection of state collectivism and universal welfare provision, public ownership and state intervention. Instead they believed in low taxation, less public spending, less public borrowing, limited government, privatisation and deregulation of business.²³

According to Leys the consequences for democracy of this transformation are sobering.

The power of market forces, whether affecting macro-economic policy generally through the financial markets, or micro-economic policy through pressure from TNC's and their home governments, has greatly increased and the autonomy of most states – except perhaps the USA or oil rich states like Saudi Arabia- has greatly declined. National policy making is now pervasively influenced by this new circumstance.²⁴

¹⁹ 'Water for life' UN, <http://www.waterforlifedecade/>

²⁰ Cox, M, 'International history since 1989' in Baylis, J, & Smith, S, 'The Globalisation of World Politics', Oxford University Press, Oxford, 2001 p,120

²¹ Hobden, S, and Wynn Jones, R, 'Marxist theories of International Relations' in Baylis, J, & Smith, S, 'The Globalisation of World Politics', Oxford University Press, Oxford, 2001 p,213

²² Heffernan, R, 'New Labour and Thatcherism; Political change in Britain', Macmillan Press, Basingstoke, 2000 p,18

²³ ibid

²⁴ Leys, C, 'Market Driven Politics, Neo-Liberal Democracy and The public interest', Verso, London, 2003, p, 25

Water in the Neo-Liberal era: Commodity or human right?

Despite the pressing water crisis, or possibly because of it, the dominant attitude amongst the major countries and international institutions, like the International Monetary Fund (IMF), World Bank, EU, World Trade Organisation (WTO) and the European Union (EU) is to solve it through market mechanisms. This dominance declares Barlow comes down to,

Economic freedom, not democracy or ecological stewardship, being the defining metaphor of the post-cold war period for those in power... In this global market economy, everything is now up for sale, even areas of life once considered sacred, such as health and education, culture and heritage, genetic codes and seeds and natural resources, including water.²⁵

Joseph Stiglitz, for 4 years an advisor to President Bill Clinton and then 3 years a Chief Economist at the World Bank, writes of how :

At the IMF, decisions were made on the basis of what seemed a curious blend of ideology and bad economics, dogma that sometimes seemed to be thinly veiling special interests'. And, that 'ideology guided policy prescription and countries were expected to follow the IMF guidelines without debate' and that these 'did not just produce bad results; they were undemocratic.'²⁶

Shiva writes that 'not only has the World Bank played a major role in the creation of water scarcity and pollution, it is now transforming that scarcity into a market opportunity for water corporations'.²⁷ The idea of policy being guided by ideology, through organisations like the World Bank is not irrelevant to Scotland: especially when one considers the links between that organisation and the WIC (See Appendix 6)

This ideological direction is also demonstrated by the conditions imposed on loans or aid. As Shiva states 'It is common for the World Bank and IMF to demand water deregulation as part of their lending conditions. Out of the 40 IMF loans disbursed through the International Finance Corporation in 2000, 12 had requirements for full or partial privatisation'.²⁸ Indeed the British Government is also complicit in this promotion of privatised water supply in some of the worlds poorest countries.²⁹ Though this is a scrutiny of global policies by global institutions it once again informs us of the global and national terrain in which Scotland is situated. Moreover, it is important to position Scotland in this background as it is clear that within the current globalised and national political and economic landscape Scotland is as exposed to these influences as anywhere.

²⁵ Barlow, M, and Clarke, T 'Blue Gold: The Battle against corporate theft of the Worlds Water', Earthscan Publications Ltd, 2003, p,81

²⁶ Stiglitz, J., *Globalisation and its discontents*, Penguin Books, London, 2002 p.XIII-XIV

²⁷ Shiva, V, 'Water, Wars: Pollution, profits and privatization', Pluto Press, 2002, p,87

²⁸ Ibid, p92

²⁹ 'Dirty Aid, Dirty Water The UK Government's push to Privatise water and sanitation in poor countries', World Development Movement, February 2005

The solution proffered to the impending water crisis is to introduce market principles to its operation and supply. This solution was espoused by the Dublin UN conference in 1992 and has subsequently been taken up by dominant organisations like the UN Council for Sustainable Development, the EU and influential corporate lobby groups like the World Water Council (WWC), the Global Water Partnership and Aquafed. They were also instrumental in setting up ‘The Report of the World Panel on Financing Water Infrastructure’ called ‘Financing Water For All’. This report was charged with forming ‘a panel of experts to address the ways and means of attracting new financial resources to the water field’.³⁰ Unsurprisingly, since the panel was made up almost exclusively of financiers, World Bank officials and representatives from Water TNC’s they were pragmatic about where finance should come from and welcomed private sector involvement. They emphasised that this was necessary to assist in the implementation of the MDG’s.³¹ Nothing though was said of how much of a business opportunity this was for Water TNC’s. Though the World Bank had previously estimated the potential water market at \$1trillion and Fortune magazine identified the water ‘business’ as the most profitable (service) for investors.³²

If Scotland increasingly sees water as commodity and an economic good, rather than a fundamental human right, at the same time as there is water scarcity elsewhere then it is clear that the temptation will be to sell some of Scotland’s plentiful water supply. This would result in selling more than is being replenished, therefore potentially jeopardising water sustainability, whilst simultaneously pushing prices up.

The General Agreement on Trade in Services is an attempt to open up service provision to the market. This means that governments can be prosecuted by the WTO for disallowing private sector attempts at the running of essential and public services. According to a paper from CEO ‘The specific function of the GATS within the unholy trinity of the IF, World Bank, and the WTO is not only to deepen the existing level of liberalisation that has already been imposed but to legally bind it; ie, to lock in that liberalisation and to make it irreversible’³³. However, they add, in terms of water there has been a co-ordinated and concerted campaign against privatisation. In the EU this saw retreats from particular governments EG Belgium and Norway and the Water TNC’s themselves who were fearful of the bad publicity received as a consequence of attempts to force water as a part of GATS.³⁴ Hence, in late February the European Commission announced that they would exempt water from the new plurilateral General Agreement on Trade In Services (GATS).³⁵ This was seen by many as a retreat from privatisation and moreover an admission of doubt at the private sector’s ability to meet the MDG’s.

Even the industry recognises the enormity of the task of meeting the MDG’s and the inability of the private sector to meet them. In January 2002, for instance, J.F Talbot, Chief Executive of Saur International, the fourth biggest water company in the world,

³⁰ Camdessus, M, et al ‘Report of the World Panel on Financing Water Infrastructure, Financing Water for All’, (2003), vii

³¹ ibid

³² Shiva, V, *Water, Wars: Pollution, profits and privatization*, Pluto Press, 2002, p.88

³³ Derkwith, C, ‘Water almost out of GATS’ A Corporate European Observatory Briefing, 2006

³⁴ Ibid, p.3

³⁵ Ibid, p.1

³⁵ Hall, D, ‘Financing water for the world– an alternative to guaranteed profits’, March 2003, (<http://www.psiru.org/reports/2003-03-W-finance.doc>)

referred to the huge scale of the needs and how necessary water was for sustainable development but openly asked ‘is it a good and attractive business? He also said that the private sector simply does not have the financial capacity as the ‘scale of the need far out-reaches the financial and risk-taking capacities of the private sector’.³⁶ The question of risk is a key one for the private water companies. Where they have failed it has been a consequence of them failing to meet the expectations of the consumer in terms of service, cost and capital investment while simultaneously still making money, which is the legal obligation of any water company. Thus, taking the risk out of investments in water is a prime focus of the water companies. Taking the risk out of the water business for water companies has included lobbying for soft loans, grants and subsidies, entering into PPP contracts (where they have guaranteed contracts but ultimate ownership and risk lies with the state) and mutualisation. In these cases the risk lies with the owners of the assets: namely the members/public. Given this context of global water scarcity it is clear that how water is governed is fundamental to its supply and sustainability.

It is reasonable to assume that in the third world the water companies have found it difficult to square the circle of ensuring massive investment to address years of none or little investment while simultaneously making it affordable and equitable and at the same time satisfy their shareholders. As a consequence many of the main private operators have collapsed through their realization that they could not fulfil their obligations and public protest due to ineffectual service and escalating cost. This has led to the cancellation of contracts in places like Cochabamba in Bolivia, Buenos Aries, Grenoble in France, Jakarta and many more. The effect of this has seen a calculated retreat by the private water companies. The concern being that ‘their expansion plans are now focusing on the potentially most profitable markets in Europe, the US, Canada and Japan’.³⁷ Clearly Scottish Water, with its plentiful supply, markedly smaller workforce, existing market organisation and the huge investment currently being made to improve its infrastructure may be an attractive acquisition for the private firms currently beating a tactical retreat from the third world.

The pressure to involve the private sector in the Scottish Water industry comes from the International Financial Institutions and the Trans-National water corporations. These pressures can either be acceded to by elected politicians or resisted. The next section shows that in Scotland, the pressures to marketise have not been resisted.

³⁷ Brennen et al, ‘Reclaiming Public Water, Participatory alternatives to Water privatisation’ TNI Briefing Series No 2004/7, (2004), p,4

Water Policy in Scotland: Legislation

In practice, the restructuring of the Scottish water industry has meant an incremental increase in private involvement in Scottish Water. Academic analyses of contemporary governance have found that private involvement has increased in all areas of government even when it is unpopular with the people. Rhodes (1997) observes that the UK government has introduced 'quasi-markets through purchase-provider splits when services could not be privatised'.³⁸ Teeple, (2000), notes that 'where the process is politically problematic the preferred route has been privatisation by attrition and the gradual reduction of services'.³⁹ This very process is underway in Scotland.

Devolution has had a significant impact on the governance of water in Scotland. There have been three Acts of the Scottish Parliament passed since the start of Devolution. The 2002 and 2005 Acts, in particular, have encouraged and facilitated both private sector involvement and practices into the publicly owned Scottish Water Industry.

Water Industry (Scotland) Act 2002

- This Act restructured the industry; creating the new regulatory framework to ensure effectiveness in both customer service and cost, and fulfilment of all Scottish Water's statutory obligations.
- This legislation established the WIC as a ministerial advisor. This advisory role was highly significant. The general functions of the Commissioner were that 'Scottish Ministers may, after consulting the commissioner, give the commissioner directions of a general or specific character as to the exercise of the commissioner's functions; and the commissioner must comply with any such direction'.⁴⁰
- The advisory role for the WIC was pivotal. The Scottish Executive set policy objectives for Scottish Water. Under this framework the WIC suggested revenue limits for Scottish Water to Scottish Ministers for a strategic review period (currently 4 years). Scottish Ministers then approved, rejected or amended WIC advice. Scottish Water annually proposed a charges scheme which the WIC approved with or without agreed amendments. If no agreement was reached, Ministers decided the charges scheme.
- This Act also created the Drinking Water Quality Regulator (DWQR) and the Water Customer Consultation Panels, Scotland (WCCPS). SEPA was the other regulator within water regulatory framework. For a summation of their roles see Appendix 6.

³⁸ Rhodes, R.A.W. *Understanding Governance, Policy Networks, Governance, Reflexivity and Accountability*, Buckingham, Open University Press, 1997, p.16

³⁹ Teeple, G, *Globalization and the decline of social reform*, Aurora, Garamond Press, (2000), p.95

⁴⁰ Scottish Executive *Water Industry (Scotland) Act 2002* Part 1, section 1, paragraph 3.

- The act also paved the way for Scottish Water to enter into joint ventures with private partners in providing water services in Scotland. This led to the formation of Scottish Water Solutions (SWS), who build and operate much of the new investment in the Scottish Water Industry.⁴¹
- The Water Industry Act (Scotland) Act 2002 also created a tripartite structure whereby the Scottish Executive set Ministerial Objectives. The Water Industry Commissioner (WIC) advised on the costing and prices for the Ministerial Objectives, whilst Scottish Water then implemented the Ministerial Objectives at the price that was set by the WIC. Ministers are advised on the objectives by a group of stakeholders known as the Water Industry Objectives Group (WIOG). This is made up of the regulators and business interests such as the CBI and housebuilders as well as COSLA. There are no Trade Unions or Environmental organisations represented.

Water Environment and Water Services (Scotland) Act 2003

- This was essentially the Scottish legislative response to ‘The EU Water Framework Directive - integrated river basin management for Europe’⁴². The Scottish Executive were statutorily obliged to implement this Act.

Water Services (Scotland) Act 2005

- This legislation enacted potentially profoundly important modifications of the regulatory framework. It replaced the Water Industry Commissioner with a Water Industry Commission for Scotland comprising six members⁴³ and was given statutory powers. These resulted in the WIC now setting the budgets for Scottish Water to meet the objectives for water services in Scotland set by Ministers. This has, arguably, significantly curtailed the ability of the Parliament and the Executive to influence water services in Scotland.
- The act enhanced the statutory powers of the Water Customer Consultation Panels Scotland (now Waterwatch Scotland), the customer representative body. It did so by transferring the transfer of the complaints procedure from the WIC to Waterwatch. Despite having powers over customer representation given to Waterwatch the WIC still plays a critical role in this process as Waterwatch must make their representations on behalf of customers through the WIC

The WIC now determines the charge limits for Scottish Water based on its assessment of the total revenue needs of Scottish Water. Disagreements between Scottish Water and the Water Industry Commission can now lead to appeals to the Competition Commission. The Competition Commission is a UK organisation. Thus accountability for Scottish Water has been taken further away from the Scottish Parliament and

⁴¹ For a profile of the different private actors involved and the managerial structure of SWS, see appendix 3.

⁴² ‘The EU Water Framework Directive - integrated river basin management for Europe’ (http://ec.europa.eu/environment/water/water-framework/index_en.html)

⁴³ The new Chief Executive is the former Commissioner Alan Sutherland.

people. There are serious concerns regarding this, voiced prominently by the STUC during the consultation process. As they noted, the Competition Commission:

were simply not qualified to play that role in relation to a public service such as Scottish Water, which has clear political direction in relation to public policy. A political question arises as to whether it is the right for the judgments in relation to the balance between economic efficiency and public policy considerations to be arbitrated by a bunch of economists sitting in London.⁴⁴

It could also be argued that this could also be applied to the WIC, given that they too are economists with no interest in social and environment public policy considerations.

- The 2005 Act opened the non-domestic customer base to competition. Scottish Water had to create another arm of its operations to compete in this ‘market’. The new arm of Scottish Water will be called Scottish Water Retail Limited. This body is to act entirely separately from Scottish Water and will in essence be a private firm working within a public corporation.
- The WIC is in charge of judging who meets the criteria to compete in this market. They are in charge of distributing licences and determining charges. This once again places a great deal of responsibility and power in the hands of the economic regulator.
- The Water Industry Commission is charged with monitoring economic efficiency and establishing competition in the provision of services to non-domestic customers under a licensing framework established under the Water Services (Scotland) Act 2005.
- Proposals to introduce the private sector into domestic water supply in Scotland were rejected on the basis that new water retailers could ‘cherry-pick’ customers from wealthier areas rather than providing a uniform service to all.⁴⁵

It was feared it would

Leave only low-banded households and those receiving discounts as customers of Scottish Water. Scottish Water’s revenues would be reduced, and it would have to increase its charges and might not be able to maintain discounts. This is contrary to the executive’s social objective for its water charging policy, which is to maintain these discounts and to keep the link between water charges and council tax banding, as this broadly affects ability to pay.⁴⁶

⁴⁴ STUC, Written evidence for Stage 1 of the Water Services etc. (Scotland) Bill - 15 September 2004

⁴⁵ Scottish Parliament Information Centre (SPICe) ‘Water Services Etc (Scotland) Bill Briefing Paper’, 28th July 2004, 04/49, p14

⁴⁶ ibid

This continues to be a strong argument against the privatisation of Scottish Water. Yet if competition, proposed by many in the lobby for privatisation, was taken to its logical conclusion this is exactly what would happen.

The Influence of EU legislation

International legislation also has affected the governance structures of Scottish Water. It is widely accepted that the opening up to competition of the non-domestic sector of Scottish Water's business was intended to protect Scottish Water as a public utility. The rationale being that it would fend off those who might use the Competition Act to open up the domestic sector to competition; or, in other words privatise Scottish Water. What was not mentioned at the time was the potential impact of other directives that originated from the EU: namely, the procurement and utility directives.

The utility directive 2004/17/EC said that it was for 'co-ordinating the procurement procedures of entities operating in the water, energy, transport and postal service sectors'.⁴⁷ Moreover, it states that the directive is required so as to,

Guarantee the opening up to competition of public procurement contracts awarded by entities operating in the water, energy, transport and postal services sectors.⁴⁸

It was adopted by the Scottish Parliament on January 31st 2006 under the name 'The Utilities Contracts (Scotland) Regulations 2006'. The UK government also had a statutory duty to implement the directive and whilst Scotland drafted its own legislation the principles of the bill directive essentially remain the same in Scotland as in the rest of the UK. The Office of Government Commerce (OGC) said that the directive would,

achieve significant savings through encouraging more efficient ways of working [and that they support] co-ordinating public sector procurement activities and managing several initiatives to open up government markets to competition and encourage private sector organisations to work better with the public sector⁴⁹

The Review of Public Procurement in Scotland - Report and Recommendations by John McClelland (also known as the McClelland programme) was said to be 'a far-reaching and ambitious undertaking that aims to improve procurement across the Scottish Public Sector'⁵⁰. Its vision is said to be

The implementation of structures, capability and processes to provide continuous improvement in procurement across the Scottish Public Sector in order to deliver Value For Money improvements and support increased

⁴⁷ Directive 2004/17/EC Of The European Parliament and of the Council of 31 March 2004

⁴⁸ Ibid, para 9

⁴⁹ OGC 'Introduction to Procurement'

(http://www.ogc.gov.uk/introduction_to_procurement.asp)

⁵⁰ Scottish Executive, 'The Public Procurement Reform Programme, Implementing Improved Procurement in the Scottish Public Sector', General Briefing 6th October 2006

efficiency'. And that, In order to achieve these efficiencies it required 'Transparent, standardised procurement processes - helping businesses (their emphasis) to identify and bid for public sector opportunities.⁵¹

These directives and the interpretation of then by the Scottish Executive has - and may well have future - further implications for the public sector and more specifically for Scottish Water.

Regulation of water services in Scotland

Therefore the current regulatory structure is a complex balancing act between advancing the interests of consumers, competitors and investors, while promoting a wider, 'public interest' agenda. Regulation needs to balance

- minimum prices to benefit the consumer (maximise consumer surplus)
- ensure adequate profits are earned to finance the proper investment needs of the industry
- provide an environment conducive for new firms to enter the industry and expand competition
- preserve quality of service
- identify parts of the business which are truly naturally monopolistic
- take into consideration social and environmental issues.⁵²

Regulators are responsible for overseeing industries vital to social and economic wellbeing (e.g. power and water). It is important that there is a proper system of democratic accountability, where there is a high degree of separation from political intervention but not complete independence from political scrutiny. A well-functioning regulatory system is one that balances accountability, transparency and consistency. The question of openness and transparency within the Scottish Water Industry is a concern. Donald Dewar in 1999 was keen to ensure that all stakeholders were represented on the boards of the three water authorities. This saw each water authority with between 12 and 14 members each.⁵³ Today Scottish Water has eight board members.⁵⁴ When Scottish Water was formed a broad representation of various stakeholders was seriously curtailed.

The relative secrecy of the regulatory framework surrounding the Scottish Water Industry stands in marked contrast to regulation practiced elsewhere. Palast, (2003) offers a template of how regulation of utilities works in the USA. He says amongst other things that 'rights of transparency and participation, or 'due processes' must be observed'.

⁵¹ ibid

⁵² Parker, D., 'Regulation of privatised public utilities in the UK: performance and governance', *International Journal of Public Sector Management* (1999)

⁵³ Scottish Parliament Information Centre, 'The Water Industry' Devolved Series/21 21 December 1999

⁵⁴ Scottish Water, About US, Who We Are, The Board, http://www.scottishwater.co.uk/portal/page?_pageid=225,483530&_dad=portal&_schema=PORTAL Moreover, unlike the previous Water Authority Boards, Scottish Water's board is almost exclusively made up of people from a business background.

This means no secrets, in the USA utility prices are set in a glass bowl. Anyone with an interest in utility prices can join the process. This includes all customers -domestic and industrial alike – as well as those with a particular agenda, such as the protection of the environment, protection of poor people and the development of the economy.⁵⁵

Moreover:

State or federal, elected or appointed, what all US utility regulators have in common is that their decisions, and all the facts on which they base them, are transparent to all and open to binding challenge by any.⁵⁶

The contrast of this system to the Scottish one was demonstrated by the case of Scottish Power which took over an electric utility in Oregon and Utah. According to Palast, (2003);

The purchase was delayed as the regulator held public hearings. They also had to open all internal plans, information and records for public scrutiny. In fact, the US regulators required Scottish Power to sign a legal waiver allowing the US regulators to see documents of the company's entire international and Scottish operations, which are not available to the public or government in Scotland itself. Most extraordinary from the point of view of the execs from Scotland was that they were subject under oath to questioning by dozens of consumer advocates, among many others.⁵⁷

The legitimacy of the regulatory system depends upon public confidence and is associated with accountability, transparency and consistency. Accountability means that regulators, while having a large degree of operational independence, work within clearly agreed rules and are democratically accountable for their actions. Regulators should be required to justify their rules both to the industries and to the general public, which in the UK is through Parliament. Consistency requires a high level of uniformity and continuity in regulation. This reasoning is enshrined in company accounting legislation and should also be applied to public services, (see Appendix 4 for a recommended summation of what the role of the regulator should be).

The regulatory framework within the Scottish water industry that was borne from the 2002 act, and enhanced in the 2005 act, is a replica of the English and Welsh regulatory framework, designed for their private industry. This was pointed out by Alan Sutherland in a written submission to the Environment and Rural Development Committee. He extolled the virtues of the success of the water industry in England and Wales saying,

A key common thread behind the companies success is the existence of a sound regulatory, financing and corporate governance structure for the industry. Its features include: 'Independent regulation with powers of determination, subject to appropriate appeal; A clear and appropriate role for

⁵⁵ Palast, G, et al, 'Democracy and regulation How the Public can govern essential services', (2003), p66

⁵⁶ ibid, p72

⁵⁷ ibid, p122

ministers to provide guidance to the regulators; Ring fencing of core water and sewerage activities (this ensured Wessex Water's survival after the collapse of its parent Enron); Financial discipline and tight budget constraints; Audit by Reporters, independent of both company and regulator; Effective incentives on companies to deliver, through accountability to stakeholders and the publication of objective performance assessments by regulators.⁵⁸

He also said that many of these key success factors are now in place in Scotland.⁵⁹ We have shown that all of these are common features of the Scottish Water Industry today and how the increasing marketisation of the industry would assist in a seamless transfer of ownership from the public to private sector should it be desired.

The complexity of this regulatory framework, and the centrality the WIC before and after the 2005 Water Services (Scotland) Act, is illustrated in appendix 5. The roles of each regulator and the how the industry is structured is explained in appendix 2.

The Water Industry Commission

The WIC is made up of a Chief Executive, Alan Sutherland, a Chairman, Sir Ian Byatt and four other members. Alan Sutherland is in charge of the day to day running of the WIC. Prior to the Commission there was a Water Industry Commissioner, who was Alan Sutherland himself. The remit of the WIC is to set budgets for Scottish Water to deliver the ministerial objectives. According to the WIC, 'We have a statutory duty to achieve best value for customers. We do this by setting prices for water and sewerage services that deliver Ministers' objectives for the water industry at the lowest reasonable overall cost'.⁶⁰

The WIC's view that private competition is more effective and delivers better results for customers is no secret. They said in their annual report for instance 'We have a role in facilitating competition in the Scottish Water industry. Competition will promote further efficiency gains and, where practicable, further choice for customers'.⁶¹ This belief in competition and the use of market principles in delivering water in Scotland is a thread running right throughout the Commission's annual report. Alan Sutherland states that 'Competition should bring lower prices and better services'.⁶² The report favourably reviews the water industry in England in contrast to Scotland and applauds the Scottish Executive for allowing incentives 'to encourage good performance by Scottish Water...by linking managerial bonuses to (economic) outperformance of the regulatory contract'.⁶³

The members of the WIC are men with similar backgrounds (see Appendix 6). The Commission's economists with an expert knowledge of the water industry is in line

⁵⁸ Sutherland, A, Water Industry Commissioner, Written evidence for Stage 1 of the Water Services etc. (Scotland) Bill, Environment and Rural Development Committee Report (2004)

⁵⁹ ibid.

⁶⁰ WIC Annual Report 2005/06 Page 3

⁶¹ WIC Annual Report, 2005/06: 3.

⁶² See Hall, D, Lobina, E, (2001) 'UK Water privatisation a briefing', Public Services International Research Unit (PSIRU), Greenwich , and Hall, D, Lobina, E, 'The relative efficiency of public and private sector water' Public Services International Research Unit (PSIRU), Greenwich, (2005), Both these pieces of Research by PRISU challenges this assertion

⁶³ WIC Annual Report, 2005/06: p11

with recommendations by the Better Regulation Taskforce, a government appointed body made up of members of the business community who declared that: ‘The boards of regulatory bodies should include both executive and non-executive members. They should be appointed for their expertise rather than to represent stakeholder groups’.⁶⁴

The Executive, the Parliament and the Environment and Rural Affairs Committee in their scrutiny of the Water Services (Scotland) act (2005) supported this view when they voted for the change from a commissioner to a commission. There are concerns that the absence of stakeholders and the predominance of experts, namely economic experts with a neo-liberal ideological training, may well make the regulator unresponsive to the needs of customers. It is also worth asking if having a tight coterie of experts with a similar background simply entrenches homogeneity within the process and in effect is just the same as having only one commissioner. Further, there is genuine concern that the WIC may use their powerful position in the regulatory framework to shape an industry ripe for private takeover. Whilst the WIC may say that it is independent of the Executive, their backgrounds suggest that they are instinctively sympathetic to a marketised water industry. Further, it could be argued that since the chairman is appointed by the Executive the WIC is acting as a buffer for the Executive on politically controversial matters.

One of the key planks of the arguments for private sector involvement in water in Scotland is to suggest that privatisation has been an almost unqualified success in England and Wales. Indeed the English and Welsh models are often cited by the WIC as models Scotland should strive to emulate. Alan Sutherland said in 2003.

‘The industry in England and Wales has proved that it is possible to deliver better service, water quality and environmental compliance for customers, while also making significant improvements in its level of efficiency. There is no reason why Scottish Water should not be able to achieve a similar level of performance for customers here in Scotland and so justify the public sector model for the industry in Scotland’.⁶⁵

Alan Alexander, ex Chairman of Scottish Water, in his evidence to the Audit Committee of the Scottish Parliament early this year confirmed the marketised structure of Scottish Water.

He said;

‘It is extremely important to remember that the industry is a public sector industry, but we try to operate within the disciplines and constraints that have been successful in transforming the industry south of the border. Sir Ian knows more about that than anybody’.⁶⁶

The reasoning behind these assertions and comparisons, are deeply problematic. As Jeanette Findlay (2004) stated, the comparators and methodology used by the WIC in

⁶⁴ Better Regulation Taskforce 2001, ‘Economic regulators’

<http://www.brft.gov.uk/taskforce/reports/BRTF%20Economic%20Regulation.pdf>

⁶⁵ WIC, (2003) Costs and Performance Report 2002/03, p2/3

(<http://www.watercommissioner.co.uk/Documents/costsandperformance2003.pdf>)

⁶⁶ Audit Committee: Overview of the Scottish Water Industry

(<http://www.scottish.parliament.uk/business/committees/audit/or-06/au06-0102.htm#Col405>)

contrasting England and Wales to Scotland is ‘almost foolhardy’.⁶⁷ She based her analysis on this on different factors like the debt write off when water in England and Wales was privatised; government grants totalled £6.6 billion, increased investment as a consequence of them being able to borrow on the open market; England and Wales having over 20 years headstart in terms of investment and differences in topography, geography and population density.

Quality and Standards 2006 – 2014: Strategic Business Plan and Final Determination

Scottish Water has been charged with meeting objectives under the third capital and investment programme, Quality and Standards III.⁶⁸ Under the process of determining charges relating to the capital investment programme, Scottish Water devised a Strategic Business Plan, which contains costs to fulfil objectives. During this period the WIC also develops a determination of charges, which goes out to consultation for stakeholders’ comments.

Tensions emerged recently within this structure between the Scottish Executive, the WIC and Scottish Water over the proposed business plan for Scottish Water 2006-2010. The WIC insisted that all the necessary investment in the water industry in Scotland could be accomplished for £2.15 billion. Scottish Water believed that it needed £3.3 billion to meet its objectives. This massive disparity calls into question the competence of the policy process, and why it was so. It also illustrated how the actions of the WIC could result in a situation that calls for further change to its governance structure. It also raises the question of whether the Final Determination of Charges, put forward by the WIC, and the one that is to go ahead, will provide enough resources to ensure that Scottish Water meets all its objectives. Should Scottish Water not meet the Ministerial Objectives it may create a clamour for further changes to the ownership and governance structures of Scottish Water.

There is doubt from various quarters that Scottish Water have been allocated enough resources to ensure the Ministerial Objectives are delivered. For instance, Alan Watt, Chief Executive of the Civil Engineering Contractors Association, expressed concerns about the budget set by the WIC. Watt claimed he was disappointed but not surprised by the Final Determination of charges and warned that it could hit jobs: ‘Scottish Water will now be forced to review the size and scope of its works programme...the immediate upshot will almost certainly be a dearth of work on the ground over the next year, leading to downsizing across the water industry’⁶⁹. From an environmental perspective there are serious concerns that thousands of homes are at risk of flooding with sewerage because the required upgrade of Scotland’s ‘crumbling Victorian sewers’ is not being funded properly, an example being the forced postponement of 148 projects to improve faulty sewerage pipes⁷⁰.

⁶⁷ Findlay, J, Financing the Scottish Water and Sewage Industry, Research Paper for the STUC, (2004), p12

⁶⁸ Scottish Executive, ‘Investing in Water Services: Objectives for 2006-2014 (<http://www.scotland.gov.uk/Topics/Environment/Water/17583/Investment>)

⁶⁹ ‘Engineering chief fears for Water jobs’ *The Herald*, December 5th 2005,

⁷⁰ Edwards, R. ‘Sewer repairs hit by funding crisis’ *The Sunday Herald*, January 29 2006.

Homes for Scotland also claim that '8000 projects are being delayed or abandoned because Scottish Water has failed to connect water and sewerage'.⁷¹ Allan Lundmark, director of planning at Homes for Scotland, warned that 'Development constraints are already kicking in and it will not be possible to maintain current rates of housebuilding without more investment'. Sir Ian Byatt, Chairman of the WIC, rejected this charge saying that the budget set for Scottish Water 'is quite enough for needs, That does not mean there will never be development restrictions...But, as a general rule there is plenty of money to service water and sewerage for new houses in Scotland'.⁷²

Moreover, from a letter uncovered through FOI we found evidence of concerns from insiders that there is not enough money to meet the objectives. Scottish Water stated, 'improvements will be achieved through a combination of capital investment, capital maintenance and operational practices. *There is insufficient capital funding to achieve the required investment through capital investment alone*'.⁷³ This is a detail that has not been openly declared by anyone in the process. Moreover, there are other stakeholders and interested parties who have concerns that the draft determination of charges as set by the WIC may prove not to be enough.

Alf Young, Herald columnist, commented 'there is deep unease that the targets being set by the Scottish executive and its regulators for Scottish Water's next phase of development, from 2006 to 2010, are neither realistic nor deliverable under the charging regime that they propose'.⁷⁴ The STUC concur, noting that the requirement for Scottish Water to 'deliver a massive investment programme, over a short time-scale, with no real charge increase is like a 'magic circle' that could not be achieved... (due to) short term political demands to keep water charges down triumphing over the need to rebuild Scotland's ageing water and sewerage infrastructure'.⁷⁵ The charging debate has allowed the WIC to be portrayed as being on the side of the customers,⁷⁶ reigning in the irresponsible spending plans of Scottish Water. Therefore if Scottish Water is unable to fulfil the ministerial objectives set for 2006-10 it is likely that there will be more calls for private sector solutions to perceived public sector 'inefficiency'.

It is true that the Scottish Executive has been under increasing political pressure since 2003 to keep bills down, for both domestic and small business customers. It is also clear that Scottish Water has therefore been constrained in its budgetary options. Given the concerns raised over the very tight budget set by the WIC over making badly needed improvements to infrastructure, in which to redress Scottish Water's unenviable tag as the 'leakiest' water company in the UK⁷⁷, it may well be that the

⁷¹ 'Builders blame Scottish Water for delays in New homes' *The Herald*', February 22 2006

⁷² "Inadequate Water supplies are threatening the flow of new homes in Scotland" *The Sunday Times* December 18th, 2005,

⁷³ Letter from Geoff Aitkenhead, Asset Management Director at Scottish Water, to Colin McLaren, Drinking Water Quality Regulator for Scotland, titled 'Strategic Review of Charges 2006-2010 Final Determination –Water Quality Programme, 25th January 2006, document released under the Freedom of Information Act.

⁷⁴ Young, A., "Get more pay less target may not be achievable", *The Sunday Herald*, October 16 2005

⁷⁵ STUC Water Campaign Research Brief

⁷⁶ 'Water cash leak plugged at last', *The Daily Record*, 1 December 2005, Comment, p8

⁷⁷ 'Scottish Water, Leakiest in the UK as 1 billion litres lost every year'. *The Evening News*, June 17th 2006,

Scottish Executive could and should prioritise funding for water much more. This would ensure that all objectives were met whilst still keeping as low as possible, the politically contentious question of, prices.

The dispute also highlighted the power of the WIC and their foremost preoccupation with cost, and the propensity of the Executive to back the WIC ahead of Scottish Water. This was illustrated by correspondence between the WIC, Scottish Water and the Minister uncovered through FOI documentation. Ross Finnie, when asking the regulators to examine the rebuttal by Scottish Water of the regulators concerns over their business plan, said ‘Ministers place great store in the views of the regulators’.⁷⁸ The WIC wrote to Ministers saying that they still believed that Scottish Water is ‘retreating from taking responsibility on development constraints and maintaining asset serviceability...and of a delayed investment scenario extending beyond 2010’.⁷⁹ Conversely, Scottish Water hinted at confusion over what plan, the draft or final one, was actually being considered. As Alan Alexander said ‘I was surprised by many of the comments made by the WIC and SEPA as they did not appear to the delivery plan that I submitted to you (Ross Finnie) on 1 February’.⁸⁰ Moreover, he responds to the WIC statement that the Scottish Water delivery plan ‘falls short’ by saying ‘none of the commission’s listed issues relates to the targets specified in the ministerial directions; rather they all relate to additional targets set by the commission beyond those specified in the directions’⁸¹. This seems to be saying that the WIC is adding further work for Scottish Water to do, but within the existing budget. Alan Alexander however, did state that they addressed ‘every concern raised by the regulators’.⁸² The WIC disagreed stating that the ‘WIC sees no reason to change its view that the delivery plan falls short of the requirements of the Final Determination in a number of material aspects’.⁸³ Given that Alan Alexander resigned on February 20, 2006 over what Ross Finnie said was a ‘fundamental disagreement’⁸⁴ it is difficult not to conclude that the Scottish Executive sided with the WIC.

However Alan Alexander’s successor, Ronnie Mercer, claimed subsequently that:

Scottish Water is delivering a far better deal for customers. These massive efficiency savings and significant service improvements are good news for customers and good news for Scotland...Four years ago, when Scottish Water was created, the industry was way behind the private companies in England and Wales. We’ve now closed that gap on many measures... The results delivered by Scottish Water’s employees give me great confidence that we

⁷⁸ Scottish Executive Document uncovered by Freedom of Information, Letter from Ross Finnie to Sir Ian Byatt, 14th February 2006.

⁷⁹ WIC Document uncovered by Freedom of Information, Letter from Sir Ian Byatt to Deputy Minister Rhona Brankin 7th February 2006a

⁸⁰ Scottish Water Document uncovered by Freedom of Information, Letter from Alan Alexander to Ross Finnie 10th February 2006

⁸¹ ibid

⁸² ibid

⁸³ WIC Document uncovered by Freedom Of Information, Letter from Sir Ian Byatt to Ross Finnie 13 February 2006

⁸⁴ Lessware, J, ‘Did these letters open the floodgates for the Chairman?’, *The Scotsman*, 24 February 2006, p47

will continue to deliver further vital improvements for our customers over the next four years.⁸⁵

He does not categorically state, however, that the Ministerial Objectives for the next four years will definitely be achieved. Neither does the WIC who say merely that they ‘should’ be achieved.⁸⁶

⁸⁵ ‘Scottish Water Beats Efficiency Targets’, Scottish Water.co.uk
http://www.scottishwater.co.uk/portal/page?_pageid=219,4804148&_dad=portal&_schema=PORTAL)
⁸⁶ WIC Annual Report 2005/2006, p12

The Drift to Privatisation: Restructuring of the Industry

Thus far we have set out a case that the system is moving towards increasing involvement of the private sector in Scottish Water, most notably through Scottish Water Solutions and the consequent familiarising by the private sector of the vagaries and complexities of the Scottish Water Industry.

One of the key means by which the private sector has assumed a greater role in the water industry in Scotland has been through commercial relationships with Scottish Water. Scottish Water was allowed to enter into contractual arrangements with external partners, in practice private providers, by the Water Industry (Scotland) Act, 2002. The act states 'Scottish Water may engage in any activity (whether in Scotland or elsewhere) which it considers is not inconsistent with the economic, efficient and effective exercise of its core functions'.⁸⁷ Scottish Water may do anything which it considers necessary or expedient for the purpose of or in connection with its functions'.⁸⁸

The power in subsection 2 includes in particular the power to...form or promote (whether alone or with others) companies within the companies act 1985...To form partnerships, enter into arrangements or agreements and co-operate in any way with any person...[and to]...enter into a contract with any person for the provision or making available of assets or services, or both (whether or not together with goods) whether by Scottish Water or by that person.⁸⁹

According to SWS their main aim is to deliver ‘better value for money and a superior service’ for Scottish Water’s five million customers as well as environmental improvements to Scotland’s rivers and coastlines. SWS is a limited company within a publicly owned organisation. Its enthusiasts argue that SWS brings global best practices from each partner to the Scottish Water industry, particularly in the fields of asset management, engineering, programme management and construction.’

SWS is in effect a joint venture partnership, bringing together eight different corporate partners (see Appendix 3). Scottish Water is the majority owner with a 51% shareholding in SWS. The balance is shared equally by two consortia: UUGM Limited led by United Utilities with their construction partners Galliford Try and Morgan Est and Stirling Water Limited led by Thames Water with their construction partners Gleeson, KBR and Alfred McAlpine. As part of the second Quality and Standards programme Scottish Water Solutions will deliver around 2,300 projects with an estimated value of £1bn.⁹⁰ The increasing involvement of the private sector in the water sector is understandable given the volume and value of business available. The entry of the private sector has been accompanied by a campaign to convince policy makers to move more decisively towards privatisation.

⁸⁷ Water Industry (Scotland) Act (2002)Part 3, section 25, subsection 1

⁸⁸ Water Industry (Scotland) Act (2002)Part 3, section 25, subsection (2). Subsection 3 (a)

⁸⁹ Water Industry (Scotland) Act (2002)Part 3, section 25, subsection 3 (d) (e)

⁹⁰ ‘About Us’, Scottish Water Solutions

(http://www.scottishwatersolutions.co.uk/portal/page?_pageid=545.914196&_dad=portal&_schema=PORTAL)

Part 2 Scottish Water and the Private sector: Where we are going

The Campaign to privatise Scottish Water

The promotion of alternatives to the public service model under which Scottish Water currently operates, especially mutualisation and privatisation, has been a feature of recent debate about the water sector in Scotland. The current discourse and debate pertaining to water services in Scotland is being dominated and framed by those who advocate either privatisation or mutualisation. For instance, *The Scotsman* newspaper and the market fundamentalist think tank, the Policy Institute have both taken a pro privatisation stance. *The Scotsman* has regularly reported 'bad' news stories about Scottish Water, largely in the context of the necessity for privatisations.⁹¹. Professor Colin Robinson published a paper, through the policy institute, advocating the privatisation of Scottish Water⁹² as did Donald McKay (another board member of the PI) in a recent co-authored report.⁹³ Another influential think tank on the Scottish scene, the Fraser of Allander also recommended a switch from the public sector model. In a widely reported intervention the economist, Jo Armstrong⁹⁴, had a paper co-published by the Fraser Allander Institute and Scottish Council Foundation, which argued that Scottish Water was a drain on Scottish Executive resources and leached funds that could better be directed to what were termed 'essential services'. This does beg the question as to what could be more essential than clean water? That said, it has been said by Jim Cuthbert amongst others that this argument is 'nonsense' and that even if the block grant was cut Scottish Water would still be able to continue giving enough loans in order to meet their current investment plans.⁹⁵

Other strands of Scottish life supportive of the privatisation of Scottish Water have included the CBI,⁹⁶, and other newspapers like the *Daily Mail*⁹⁷ and the Sunday Times⁹⁸. A leading Scottish Corporate Financier, Frank Malcolm, unsurprisingly enough, also called for the privatisation of Scottish Water in 2006 as did John Blundell of the Institute of Economic Affairs.⁹⁹ It is clear that the business lobby is circling around the guaranteed profits of the Scottish water industry. Perhaps the most concerning person and organisation advocating changes to the governance structures of Scottish Water is Sir Ian Byatt and the WIC. Byatt said he believes that Scottish Water should be turned into a mutual model, thus freeing it from state ownership. Moreover, he and Alan Sutherland have put in place a detailed blueprint for doing

⁹¹ For the full list of the stories run by the Scotsman on Scottish Water see (<http://news.scotsman.com/topics.cfm?tid=512>)

⁹² Robinson, C, 'Reviving the Scottish Water Industry', *Policy Institute Paper*, March 2005

⁹³ Bell, D and Mackay, D, 'The Political Economy of Devolution', *Policy Institute Paper*, (2006), (<http://www.policyinstitute.info/AIIPDFs/BellMackaySep06.pdf>)

⁹⁴ Armstrong, J. 'Raising the return: Scotland's public assets', Published by the *Fraser Allander Institute and the Scottish Council Foundation*, (2006)

Jo Armstrong was formerly an adviser to former Finance Minister Angus Mackay and various other Executive Ministers

⁹⁵ Jim Cuthbert Interview with one of the authors

⁹⁶ 'CBI backs calls for water privatisation', *The Scotsman*, June 17th 2006, , p38

⁹⁷ 'Dripping Scandal; Soaring bills, poor quality and massive waste. Why its time to end Scottish Water's Monopoly', *The Daily Mail*, July 11, 2006, 'Section ED SC1; p,12

⁹⁸ 'Taking Water Private is not just a pipe dream', *Sunday Times*, (February 5th 2006), , p,2

⁹⁹ 'Fresh Calls for Scottish Water to be Privatised', *Scotland on Sunday*, (May 7th 2006), p,2

so.¹⁰⁰ This intervention by Sir Ian Byatt was arguably way out of his remit, nonetheless it sparked much debate amongst leading Politicians in Scotland regarding the future governance of water in Scotland. See below for a discussion on this debate.

The public agenda has tended to be dominated by those pressing for change to the governance structures of Scottish Water, due to either its perceived ineffectiveness or/and its inability to address developmental constraints. The framing of the debate in this way places water as a purely economic resource, rather than as a social resource, public good, or even a natural resource that needs to be sustained for future generations. In addition, there is little mention of successful community run and publicly owned models for the management of water resources. Throughout this debate there is little mention of the decrease in manpower within Scottish Water itself and the simultaneous increased involvement of the private sector in the provision of water services in Scotland today. The tenor of public debate about water in Scotland stands in marked contrast to experiences elsewhere: much of the evidence from other countries points to the failure of private models of water ownership and delivery. One is left to conclude that much of the public debate in Scotland relating to Scottish Water is based more on ideology and dogmatism than comparative evidence.

In parallel to this public discourse there has been considerable behind the scenes lobbying on behalf of two of the main stakeholders, Scottish Water and the WIC. It is as yet unclear what the precise purpose of this activity might be as details of the relationships between Scottish Water, the WIC and their retained commercial lobbying firms might be. It is however legitimate to question if this is a worthy use of public money.¹⁰¹

Political Context

Aside from the Conservatives no political party has openly declared itself in favour of the full privatisation of Scotland's water industry. In fact the major parties said little in relation to water in their manifestos for the last Scottish election in 2003. Yet the two coalition parties in the Scottish Executive, Labour and the Liberal Democrats, introduced the Water Services (Scotland) Act in 2004 without signalling their intention to do so during the election. When one considers that this legislation effectively transferred power over the budgetary process to the WIC it is perhaps surprising that this was not put to the electorate during the previous years Scottish Election. Despite the volume of recent water legislation in Scotland the pressure for more changes to the governance structures of Scottish Water continues. Whether this will be legitimised by an electoral test or referendum remains to be seen. If the water industry in Scotland is privatised 'by the back door', or moved away from the public sector through some form of mutualisation, then serious questions about the nature of devolved decision making and the sharing of power between the people and Parliament must be raised.

¹⁰⁰ 'Free Scottish Water from state to avoid surge in bills, ministers told', *The Scotsman*, 8th June 2006, p.5

¹⁰¹ The WIC employs the lobbyists Greenhaus Communications. There is no mention of this relationship either in the main body of their annual report or in their financial accounts. However through Freedom of Information we have discovered that the WIC paid Greenhaus £27,500 over a 9 month period from when their contract began in March 2005. 'WIC Document uncovered by FO, e-mail between Chris Winslow (Greenhaus) and Katherine Russell, (Corporate Affairs at the WIC) March 7th, 2006. Scottish Water employs the lobby firm Fleishman Hillard

Ross Finnie Minister for the Environment and Rural Development refused to discount the possibility of mutualisation in the future, arguing that it would be a 'foolish politician who ruled out change'¹⁰². This was despite his assurances during the Holyrood debate in 2004 over the Water Services bill that the Executive 'would defend public sector water provision in Scotland'¹⁰³. Finnie has recently insisted that 'there are no plans to privatise Scottish Water '¹⁰⁴. However, many people involved in the water sector divine an increasing role for the private sector in Scotland's water, through the ongoing use of PPPs and joint ventures with private industry in delivering water infrastructure and the persistent floating of mutualisation as a new model for Scottish Water.

As mentioned above, the Chairman of the WIC, Sir Ian Byatt, sparked some debate in the Labour Party by advocating a new ownership and control model for Scottish Water. This prompted First Minister Jack McConnell to claim 'There are no current plans to change our position' though he failed to rule out proposals from MSPs linked to the Co-op movement which recommended a mutual model should be considered. There has been some confusion over the exact model of mutualisation being proposed.

McConnell said: 'I am sure there will be a debate within the Labour Party over the next 12 months as we consider our manifesto for the next Scottish election, and views on both sides will be expressed.'¹⁰⁵ While clearly not embracing the WIC's model of mutualisation, the First Minister expressly did not discount it. There has also been speculation that the UK Treasury is considering selling off Scottish Water.¹⁰⁶ If this was proved to be the case then this would provoke questions relating to the devolution settlement itself, given that water in Scotland and its governance is a devolved matter.

¹⁰² MacMahon, P., 'Finnie refuses to rule out Scottish Water Mutual plan' *The Scotsman*, June 9th 2006

¹⁰³ 'Water legislation under twin attack for protecting monopoly and opening up market' *The Scotsman*, November 18th 2004,

¹⁰⁴, 'Executive is not about to Privatise Scottish Water insists Finnie' *The Scotsman*, March 23rd 2006

¹⁰⁵ 'Water ownership debate begins; First minister faces call give industry mutual status' *The Herald*, 9th June 2006,

¹⁰⁶ 'Row Brews over £2billion plan to float Scottish Water', *Daily Telegraph*, March 20th 2006, p,1

The English Experience and the RCV method

We have argued that the Scottish Water regulatory framework is akin to the English model. In this section, we will consider some of the accounting techniques used by the English economic regulator, OFWAT to deal with the problems thrown up by regulating private monopolies.

When publicly owned monopolies are privatised there is the real danger that the private owners will charge monopolistic (very high) prices. The majority of formerly state owned monopolies provided *essential* goods and services (gas, electricity, water and so on) to corporations as well as to individuals. The fear of monopolistic pricing lay behind the government's introduction of regulators of privatised monopolies. Regulators (like OFWAT) are typically charged with the responsibility of ensuring that privatised monopolies make a "fair" return but not monopoly profits. OFWAT itself has publicly stated that one of its duties is 'to secure that companies are able (in particular by securing reasonable returns on their capital) to finance the proper carrying out of the functions of such undertakers.'¹⁰⁷ ¹⁰⁸

Economic regulators are therefore faced with a complex task. They have typically addressed this by taking guidance from a neoclassical economic framework which states that assets (for example, pipes, water treatment plants, pumping stations and so on) should provide an economic rent (or financial return) to investors. Put simply, if the assets of a newly privatised water company are valued at (say) £100 million and a fair rate of return (or economic rent) is (say) 10%, then the company should be able to charge prices at a level which would ensure that the profits are £10 million. This simple example belies the complexity which regulators face in valuing the assets of a company. It is beyond the scope of this report to explore this issue. However, addressing a few key questions highlights some of the technical issues. Should one value be placed upon the whole water network? Should each individual unit (eg pumping station, treatment plant etc) be valued separately and then added together? Should the assets be valued at the amount they initially cost (historic cost), the amount they are worth today (market value), the amount it would cost to replace them (replacement cost) or some other cost? Research has shown that the particular valuation method used by OFWAT ensures that privatised water companies make vast rates of return¹⁰⁹.

¹⁰⁷ OFWAT, 'Financial Performance and Expenditure of the Water Companies in England and Wales' 2005

¹⁰⁸ In effect this means that water companies can legally justify price increases as necessary to offset the costs of upgrading infrastructure. On the face of it this might seem reasonable. However, 'market' values tell us nothing about the overall social worth of investments. In other words, a simple monetary amount tells us nothing about the investment choices being made. Does the investment help to protect existing supplies? Does the investment improve pollution control? Does the investment simply move the water shortage problem to another area? Evidence from England and Wales suggests that in the decade following privatisation companies did not reinvest in the infrastructure claiming that profitability would be compromised. Consumers saw their rates increase by 102% (46% in real terms). OFWAT Memorandum, 18 March, 1998 from the House of Commons Research paper 98/117 December 1998. cited in Lobina, E., "UK Water Privatization: a Briefing" *Public Services International*, University of Greenwich, February 2001, p 7)

¹⁰⁹ Cuthbert, J.R, 'How the RCV Method Implies Excessive Returns on Capital Expenditure'. Response to OFWAT/OFGEM discussion document on 'Financing Networks', published on [OFGEM website](#): (August 2006).

Ofwat uses a fairly complex formula (see below) to calculate the value of each privatised water company. The result of this formula is called Regulatory Capital Value (RCV).¹¹⁰ RCV is the starting point to work out the return (or profit) for each water company. *It should be pointed out at this stage that there can be few examples of other private companies throughout the world which have a regulator to ensure that they receive a set rate of return on their investment.* This is essentially a form of corporate welfare.

Clearly the regulation of privatised monopolies is difficult (not least because of the technicalities of valuing them in the first place). But, how successful has regulation been in England?¹¹¹ Research suggests that regulation and legislation have failed to address concerns about the behaviour of the privatised water companies, particularly the pursuit of profit at the expense of customers, aggressive pricing, lack of reinvestment and higher dividends awarded to shareholders and owners.¹¹² Profit margins in the privatised UK water industry far exceed those of the rest of the world.¹¹³ The activities of the water companies in England and Wales, and their regulatory system, have been criticised for their lack of transparency.¹¹⁴ Many argue that British privatised water companies have lost sight of the notion that water is more than a commodity -- it is a basic human right to have access to clean water.

Regulatory Capital Value (RCV)

Accounting information or to be more specific, *regulatory accounting* is one of the keys to understanding two central (and controversial) features of the water industry. These are

- 1 Water pricing, and
- 2 Investment in infrastructure.

Of course these two are closely connected. Ofwat ensure that if a company invests money in new infrastructure it is allowed to increase prices in order to earn a return on the new infrastructure. Underpinning the accounting numbers used in regulatory accounts are some questionable assumptions. These are

Cuthbert, J.R., Cuthbert, M.: 'Water: The Birth of a Cash Cow. Why water privatisation in Scotland is inevitable unless we rethink the basis of utility pricing'.

Talk given at conference on "Neo-liberal Scotland: Rethinking Scotland in a Global Context", at the University of Strathclyde, 20th May 2006.

¹¹⁰ When companies were first privatized, RCV was based upon the share prices plus the companies borrowings, thus it took a market value approach.

¹¹¹ eg the 1983 and 1989 Water Acts, the Water Industry Act 1991 which brought together sewerage legislation, the Competition and Services (Utilities) Act 1992, which applied to the regulatory bodies dealing with privatized utilities, such as Ofwat; the Environment Act 1995 placed a duty on the companies to promote the efficient use of water by customers.

¹¹² Lobina, E., and Hall, D. 'Public Sector Alternatives to Water Supply and Sewerage Privatisation: Case Studies', *PSIRU Report*, 1999, p,11, Lobina and Hall; UK Water Privatisation – A briefing, 2001

¹¹³ Lobina, E., and Hall, D. 'Public Sector Alternatives to Water Supply and Sewerage Privatisation: Case Studies', *PSIRU Report*, 1999, p,11

¹¹⁴ The meetings of companies and regulators are not public and this has meant that decision-making lost some of its perceived transparency. See Lobina and Hall; UK Water Privatisation – A briefing, 2001, Ofwat, 2005.

1 that the most 'correct' value is the market value. Thus the values used in water accounts are not 'social values' or 'environmental values'. For example, they do not begin to address questions such as 'what is the value of having a sustainable water system in Scotland in the 21st century?'

2 That efficiency means market economic efficiency. This is very different to what customers and the public might understand as efficient. A reduced workforce is seen as economically efficient, even though there is ample anecdotal evidence that response times to leaks and service problems are increasing, so customers experience Scottish Water as increasingly *inefficient*. Whilst Scottish Water has won customer service awards and is improving in the sphere of Overall Performance Assessment (OPA)¹¹⁵ there are also numerous current examples of how Scottish Water is stretched to the limit and not fulfilling standard customer obligations throughout Scotland. This suggests that the draft determination of charges, given how tight the budgets are, might not be enough to meet all the social and environmental obligations that the Scottish Executive set, but also that which their customers expect. For instance, there have been examples of hundreds of houses not being built in the Highlands, which Highland Council believes may be as a result of urban areas taking priority over rural areas¹¹⁶. There have been recent examples of Sewage discharges in Dingwall¹¹⁷ and Nairn¹¹⁸, resulting in fines for Scottish Water. There were sewage leaks and odors in places as far apart as Glasgow¹¹⁹, Burntisland¹²⁰, Gourock¹²¹, Pathhead in Fife¹²², South Queensferry¹²³, Eyemouth¹²⁴ and Cellardyke in Fife¹²⁵. Moreover, many of these have taken a long time to be repaired or sorted, despite the associated health risk. There are also recent examples of water quality being less than customers expect in Lerwick¹²⁶, Inverclyde¹²⁷ and in Scotland generally as the DWQR reported water quality down on the previous year¹²⁸.

¹¹⁵ WIC Annual Report 2005/2006, p,24

¹¹⁶ 'Homes 'held up' by water supplies', *BBC News*, Friday, 18 August 2006, (http://news.bbc.co.uk/1/hi/scotland/highlands_and_islands/5262398.stm)

¹¹⁷, 'Agency in hot water after pollution probe', *Highland News*, 24th August 2006 (http://www.highland-news.co.uk/news/fullstory.php/aid/403/Agency_in_hot_water_after_pollution_probe.html)

¹¹⁸ 'Games linked to sewage incident', *BBC News*, 17th August 2006, (http://news.bbc.co.uk/1/hi/scotland/highlands_and_islands/5260376.stm)

¹¹⁹ 'Sewage spill nightmare for mother', *BBC News*, 18th August 2006, (http://news.bbc.co.uk/1/hi/scotland/glasgow_and_west/5262556.stm)

¹²⁰ 'We're sick of raw sewage pouring down flooded street', *Fife today* , 24th August 2006, (<http://www.fifenow.co.uk/ViewArticle2.aspx?SectionID=1015&ArticleID=1717395>)

¹²¹ 'Scottish Water Forced to Clean Up its Act', *Greenock Telegraph*, 3rd August 2006, (<http://www.greenocktelegraph.co.uk/readstory.php?id=7492>)

¹²² 'What do we have to do to get rid of this pong?', *Fife today* 3rd August 2006 (<http://www.fifenow.co.uk/ViewArticle2.aspx?SectionID=1015&ArticleID=1670496>)

¹²³ 'Sewage saga causing a stink', *The Scotsman*, 29th August 2006 (<http://news.scotsman.com/edinburgh.cfm?id=1274642006>)

¹²⁴ 'Smell frustrates Eyemouth residents', *Berwickshire today*, 3rd August 2006, (<http://www.berwickshiretoday.co.uk/ViewArticle2.aspx?SectionID=972&ArticleID=1667531>)

¹²⁵, 'Water chiefs told: your service stinks!', *Fife Today*, 30th August 2006 (<http://www.fifenow.co.uk/ViewArticle2.aspx?SectionID=1015&ArticleID=1727631>)

¹²⁶ 'Water filthy Mess'!, *Shetland Today* 11/08/06 (http://www.shetlandtoday.co.uk/Shetlandtimes/content_details.asp?ContentID=19884)

Economic efficiency is concerned with lowering costs so that a company can increase its profits. Recent studies have shown that many employed in the water industry have taken redundancies or have lost their jobs through the pursuit of increased efficiency.¹²⁹ The efficiency measures in regulatory accounts cannot be understood as measures of social efficiency.

In England and Wales, the RCV starts with a direct measure of value placed on each company's capital and debt by the financial markets following privatisation.¹³⁰ The RCV is a value placed on a company's asset base, on which it should earn a return. It is adjusted for additions and depreciation. Additions affect the price cap by increasing the RCV. As the rate of return remains constant (it is a percentage of the RCV) any increase in the RCV increases the amount of return allowed in the revenue requirement and increases prices.

The infrastructure renewals charge (IRC) is an explicit component of the company's revenue requirement. The regulator ensures that customers do not pay for the same investment again through the RCV. The IRC is therefore subtracted from the RCV.

Example given by the Scottish Regulator¹³¹

In this example, it is important to understand that prices are set to ensure that water companies receive a rate of return for their previous investment *and* for any investment which they plan to make in the coming period. Suppose that the regulator has allowed £10m in the revenue requirement for infrastructure expenditure. If the company actually spends £12m there may be a case for allowing the company to recover a further £2m. The regulator can do this by adding £2m to the RCV. The company will then recover £12m, £10m through the IRC and £2m through the RCV. Suppose that the regulator has allowed £10m but the company has actually spent only £8m. The regulator must claw back £2m to ensure that customers are not paying for investment that has not been made. The regulator can do this by deducting £2m from the RCV.

The RCV is computed as follows

Closing RCV (previous year)

¹²⁷ 'Water Chiefs told to keep it clean', *Greenock Telegraph*, 11th August 2006, (<http://www.greenocktelegraph.co.uk/readstory.php?id=7523>)

¹²⁸ Levels of bacterial pollution in Scotland's drinking water have risen over the past year, according to Scottish water watchdog's annual report. (http://www.edie.net/news/news_story.asp?id=11854&channel=0)

¹²⁹ Lobina, E., and Hall, D. 'Public Sector Alternatives to Water Supply and Sewerage Privatisation: Case Studies', *PSIRU Report*, 1999.

¹³⁰ The initial RCV was calculated as the average of the market value of each company for the first 200 days for which the shares were listed plus the total debt at privatisation. It is adjusted by the increase in the Retail Price Index. In Scotland the Modern Equivalent Asset (MEA) value is used. MEA is a measure of the cost to replace an old asset with a technically up-to-date new asset with the same service capability, allowing for any difference both in the quality of output and in operating costs.

¹³¹ (http://www.watercommissioner.co.uk/Documents/src2006/volume3/VOL3_COMPLETE.pdf#search=%22example%20scottish%20sutherland%20rcv%20infrastructure%20expenditure.%20%22

+

 Indexation
 +

 Capital expenditure (excluding IRE)
 +

 Infrastructure renewal expenditure (IRE)
 -

 Infrastructure renewals charges (IRC)
 -

 Grants and contributions
 -

 Depreciation
 -

 Disposals
 =

 Closing RCV

Cuthbert and Cuthbert's research has highlighted many significant problems with the RCV model as it is used by OFWAT. Two problems will be highlighted here.

- 1 the RCV model's treatment of money spent by water companies repairing pipes to stop leaks creates a disincentive for companies to repair pipes, and
- 2 the RCV model's use of current value accounting means that when prices are rising, water companies will make excess profits.

Accounting typically distinguishes between two types of expenditure – “operating expenditure” and “capital expenditure”. Operating Expenditure could be described as everyday running expenses, whereas Capital Expenditure is money spent on new assets. So for example, the purchase of a new car is capital expenditure but money spent on fuel is operating expenditure. According to the RCV model, money spent on fixing pipes to stop leaks (infrastructure renewal) counts as “operating expenditure”. Operating expenditure is not added to the RCV and so doesn't attract a rate of return through the model.

The RCV model used by OFWAT is indexed such that it contains “current” rather than “historic” values. So if a water company invests in an asset which costs £10 and the inflation index is 3%, at the end of the year, the assets RCV will be £10.30. The company will be able to make a return on the £10.30, even though the cost of the asset was only £10. Cuthbert and Cuthbert have demonstrated that if inflation (or the indexing) is as low as 2.5% pa and the rate of interest is 5%, that companies will make almost 50% *additional* profit over a 30 year period simply because of the accounting techniques used by OFWAT.¹³²

¹³² Cuthbert, J.R., ‘How the RCV Method Implies Excessive Returns on Capital Expenditure’. Response to OFWAT/OFGEM discussion document on ‘Financing Networks’, published on [OFGEM website](#): (August 2006).

Cuthbert, J.R., Cuthbert, M.: ‘Water: The Birth of a Cash Cow. Why water privatisation in Scotland is inevitable unless we rethink the basis of utility pricing’.

Talk given at conference on "Neo-liberal Scotland: Rethinking Scotland in a Global Context", at the University of Strathclyde, 20th May 2006.

So far we have simply stated that the water companies are allowed by the regulator through the pricing mechanism to earn a 'rate of return'. Who determines what this rate should be? Traditional finance theory suggests that there is a risk/return tradeoff. This means that companies which invest in 'risky' investments can expect greater returns than for investing in safe ones. Yet, the state sanctioned guarantee of a certain margin of profitability on all investments minimises the risk to the private water companies. Yet the returns of water companies are relatively high. Indeed the social risk of the failure to have a cheap plentiful supply of water is borne by the state. If there is (for example) an E. coli contamination of drinking water, the subsequent health care and other costs would be borne by the state and not the private water company concerned.

In summary, it could be argued that regulation is a 'good thing', because the regulator ensures that water companies do not hike their prices to unreasonable levels (which as monopoly suppliers of an essential service they could easily do). However, what the regulator does in effect is to ensure that the Regulatory Capital Value (a proxy for the market value of the company) is used to ensure that a 'fair' return is given to the investors in water companies. While the regulatory model could be said to 'encourage' much needed investment in the water industry, in practice, it contains serious flaws. These flaws mean that expenditure on repairs is disincentivised while companies which invest in capital projects (new fixed assets) can earn excess profits. Moreover, there is no transparency or public debate about what should be invested in from a broader social perspective. This is an accountability issue. The hidden costs of privatisation are simply not captured by regulatory accounts. Some of the "hidden" costs of privatisation are discussed next.

Policy Options: The Hidden Costs of Privatisation

It is clear that in England and Wales, and in Scotland, regulatory accounts cannot capture the social costs and social values of a water system. In the context of increasing private sector participation in the water industry there are many unseen or hidden costs of privatisation which should be considered.

1 Accountability

Water companies are legally accountable to their shareholders and not to the general public. This means that the general public have no say in where or what water companies invest in or whether private companies should invest at all. Under privatisation investment decisions are 'private decisions' which pertain to capital by virtue of its property rights. However much the welfare of the majority will be affected by them. The nature of our economic system and its relentless drive to profits means that we cannot be provided with information by the regulatory or by the individual private company accounts with which to make socially effective and efficient decisions. Any analysis of public effects of economic action requires information that individual companies do not provide. Because they produce unregulated and unplanned social effects, capitalist markets create enormous social inefficiencies.¹³³

Arguably, some accountability issues could be dealt with by setting up regulatory bodies to oversee the activities of private companies. However, this can remove another important layer of accountability – the accountability of elected representatives. Again, developments in Scotland suggest this is a real concern with the drift in water policy since devolution. Recent changes to the regulatory powers in Scotland under which executive statutory powers to determine charges were handed over to the WIC. This significant change takes accountability for charging away from elected representatives and ministers.

2 Private Financing (or loans) cost more than Government Financing

There is a perception that although Victorian water systems are in desperate need of replacement that the government is unable to borrow the large sums of money to replace them. The solution is to shift the burden from the public to the private sector. However, since governments are very low risk when it comes to borrowing, banks will loan money to governments at lower rates of interest than to companies. This means that if the task of replacing outdated water systems is transferred to the private sector then it is likely that banks will receive additional interest. Of course in the long run, this increased expense is met by water consumers.

If additional costs of dividends and executive salaries are added to the higher rates of interest, it is difficult to see how water consumers will benefit from this. A report published by the Public Service International Research Unit (PSIRU) comparing the Swedish publicly owned water system with the

¹³³ See for example. Hahnel, R., and M Albert, *Quiet Revolution in Welfare Economics*, Princeton: Princeton University Press, 1990, p 218

privatised system in England and Wales found that the Swedish system had lower operating and maintenance costs, and that customers paid less for their water. In England and Wales, both the operating costs and customer rates were more than double those in Sweden.¹³⁴

3 *Privatisation leads to job losses*

In England and Wales, the number of employees in water and wastewater was reduced by almost 10,000 over a 10 year period.¹³⁵ There will be a social as well as a financial cost to this. It is unlikely that all 10,000 people found another job straight away. It is likely therefore that they would be paid social security benefits. There would also be the costs of additional health care requirements because of stress and so on. Redundancies reduce a jurisdiction's tax revenues because people without jobs do not generally earn taxable income and don't spend as much. One hard-to-calculate cost of redundancy is the effect on the morale of remaining workers. Those in charge of water companies are often incentivised to cut operating costs. In effect this means that director's remuneration is likely to increase the more efficiencies through redundancy are made. As mentioned above Scottish Water has lost over a third of its workforce since its creation in 2002.

4 *Consultants, Reports and Legal Fees*

Privatisation programmes have been organised and directed by an 'influential technocracy of economists and accountants'.¹³⁶ Privatisation consultants and advisors, drawn predominately from the ranks of Big Four accountancy firms and investment banks, became central figures in the 'neo-liberal alliance'¹³⁷ that implemented privatisation ideology. Their activities range from advising governments on how to 'reform' public sectors, to performing valuations of state-owned enterprises, to designing privatisation plans, to overseeing tender offers, negotiated sales, stock floatation's, joint ventures, management-employee buyouts and a myriad of other types of privatisations.

Accounting firms have been at the heart of government policy development for lucrative PPP/PFI or privatisation contracts. Their secondees work in government departments that devise, negotiate, and drive privatisation policy.¹³⁸ For example, in 1997 the Treasury created a Taskforce to encourage PFI. This was led by a merchant banker supported by a small team of experts from the private sector. These experts included personnel from leading accountancy firms, who briefed civil servants and provided 'in-depth training

¹³⁴ Lobina, E., 'UK Water Privatization: a Briefing' *Public Services International*, University of Greenwich, February 2001 (<http://www.psiru.org/reports/2001-02-W-UK-over.doc>)

¹³⁵ ibid

¹³⁶ Arnold and Cooper, A Tale of Two Classes: The Privatisation of Medway Ports', [Critical Perspectives on Accounting](#), Volume 10, Number 2, April 1999, pp. 127-152(26); [Academic Press](#); Martin 1993: 2.

¹³⁷ Martin, 1993: 6

¹³⁸ 'A web of private interest: how the Big Five accountancy firms influence and profit from privatisation policy' UNISON, June, 2002, <http://www.unison.org.uk/acrobat/B362.pdf>

in privatisation and more recently in Private Finance Initiative (PFI) project management, project finance and negotiating skills'.¹³⁹

The major accounting firms train civil servants in 'accounting evaluations techniques and methodologies' and have helped introduce commercial investment appraisal to the public sector. They devise and run so-called value for money calculations, which in effect often obscure the essential but difficult to measure social costs of the implementation of privatisation. Thus, for privatisation development and evaluation the government has relied on firms with a direct commercial interest in these policies.

5 *The Costs of the Regulator*

The office of the Water Industry Commission for Scotland had total expenditures of over £3.8 million in the year to April 2006, with £1.28 million spent on staff remuneration, £421,241 on general operating costs, £702,770 on the strategic review of charges, £881,388 on licensing, and £232,785 on consultancy projects.¹⁴⁰ As indicated above much of the latter expenditures will have been on professional consultancy fees for lawyers and accountants. In this accounting period the WIC actually recorded a net deficit of £130,061.

An important issue for utility regulators is that of transfer pricing. Clearly all organisations (public and private) should be audited. In the case of privatised water companies, they are audited twice. Once by the normal accounting firm who will sign off their accounts to say that they show a true and fair view of the company. However, because of things like transfer pricing, privatised utilities will have to be audited by the public regulator. The following example explains why.

The regulator is concerned with the regulated part of any private company. So let us suppose that Company A is a privatised water company. Company A decides to set up an insurance division. The regulator will only be concerned with the water division of the business not the insurance part. Suppose that Company A's best quote for insuring its infrastructure is £100. Now that Company A has its own insurance business it decides to go 'in-house' to provide insurance cover. Company A is aware that it is under the scrutiny of the regulator and it is also aware that it is ensured a guaranteed rate of return on its water business. The smart thing for it to do would be to charge itself (say) £10,000 for insurance that would normally cost its water arm £100. The company can then make huge profits (unregulated) in its insurance business while making the maximum return allowed by the regulator in its water business.

The job of the regulator in such a scenario would be difficult. How much time should the regulator spend checking all of the inter-company transactions? Clearly in a privatised situation, this regulation and scrutiny of transfer prices would be necessary (but also very costly). In a public sector setting incentives

¹³⁹ ibid.

¹⁴⁰ Water Industry Commission for Scotland (2006) Annual Report, SE 2006 / 84, June, p. 36. (<http://www.watercommissioner.co.uk/Documents/Publications/Annual%20Report%202005-06.pdf>)

to (ab)use transfer pricing could be entirely removed therefore making the costs of regulation much cheaper.

6 *Other potential human costs*

In other industries, privatisation has produced the following 'human' problems:

- Private firms routinely under-staff facilities.¹⁴¹
- Private firms boost profits by paying inferior wages
- Privatisation often jeopardises high quality services. The goal of profit maximisation isn't the same as providing the best service.
- The lower wages and benefits that private firms offer lead to less-qualified staff and lower employee retention rates.
- Privatisation erodes living standards in the local community.

7 *Privatisation leads to loss of flexibility*

Under privatisation expertise in running the water industry is passed to the private sector. When consumers complain about a contracted service, the government becomes a 'middleman' who can often do little more than complain in turn to the contractor or enter into costly contract renegotiations or termination proceedings.

After a few years, government will only have the option of offering the contract to another private company: 'in-house' public sector expertise will have been lost. This can also lead to the erosion of a 'public service' ethos in the privatised water sector. Moreover, the water market in a mature economy like Scotland's is very attractive to transnational corporations (TNC's). This can often mean less investment and higher prices plus the flight of the dividends overseas.

8 *The Burden of Risk*

Private companies seek to minimise risk. This partially explains the popularity of Public Private partnerships (PPPs) and models of mutualisation. Experiences across the world have demonstrated the ability of private companies to negotiate tight contracts with guaranteed revenue but with the ultimate risk lying with the owners, usually either the state or members/customers. The risk bearer of last resort in a key sector like water will always be the government, given the inelasticity of demand for water and associated essential services.

This section has briefly considered some of the hidden costs of privatisation. For those who wish to imagine other options, the next sections discuss various policies.

¹⁴¹ Cooper and Taylor, "Independently Verified Reductionism: Prison Privatization in Scotland", Human Relations, April 2005. pp 467 - 522

Policy Options: Mutualisation

The concept of a mutual water company has attracted much attention and some support in Scotland in recent years. There appears to be a notion that mutualisation is a modern panacea to the issues facing the Scottish water sector, and that mutualisation offers a policy compromise between the alleged inefficiency of the public sector and the worst aspects of unfettered privatisation.

Most of the debate on the merits of mutualisation for the water industry in Scotland has been characterised by a conspicuous lack of detail on what such a policy would mean in practice. For instance, one MSP recently remarked that at a meeting on water services in Glasgow that 'not...all mutualisation corresponds to privatisation. If done properly it can mean mutual investment in mutual assets'¹⁴²

The key questions that arise from this kind of argument are who has the resources and capacity to invest in *mutual assets*, how would this investment be subscribed, and how would the governance and management of a mutual organisation deliver high quality water services at reasonable prices to Scottish water users? Attached to this are critical questions about the governance and accountability of a mutual water company in Scotland.

A core issue is that of investment. The only obvious sources of funding for investment in a mutual water company in Scotland are from public funds or the private sector. Essentially, the devolution settlement allows the Scottish Executive to spend the block grant from the UK Treasury as it chooses. But there are many competing calls on this funding. The Scotland Act (1998) does allow the Executive to raise taxes by 3%. But heretofore the Executive has strongly resisted calls to raise taxes and it is highly unlikely that it would choose to do so, even to support important public services like water. The devolution settlement means that the Scottish Executive is not allowed to borrow money.¹⁴³ So, with no possibility of borrowing, very little chance of tax rises, and scant appetite to push up water prices to pay for mutualisation we are left with the likelihood that only the private sector will be in a position to invest in

¹⁴² Ballard, M, 'Water privatisation' (2006). <http://www.markballard.org.uk/index.php?/archives/11-Water-Privatisation.html#extended>.

¹⁴³ Scottish Ministers have no powers to raise extra resources by borrowing or sanctioning borrowing. They may borrow sums from the Secretary of State for Scotland in accordance with section 66 of the Scotland Act 1998 but only to meet temporary shortfalls of cash, or to provide a working balance in the Scottish Consolidated Fund (SCF). Scottish Ministers may borrow money only under this power or under powers conferred by separate Acts of the UK Parliament. Section 67 of the Scotland Act makes provision for HM Treasury to issue sums by way of a loan to the Secretary of State out of the National Loans Fund (NLF) in order to make loans to Scottish Ministers. Repayments from Scottish Ministers to the Secretary of State are a charge on the SCF and are not therefore subject to authorisation by the Parliament.

Under the *Statement of Funding Policy*, which defines the financial relationships between the devolved administrations and the UK Government, Scottish Ministers may sanction borrowing for capital investment by local authorities and other public bodies. However, this borrowing, excluding short-term borrowing (ie less than a year), counts towards the United Kingdom Public Sector Net Cash Requirement (PSNCR) and hence is included within the Scottish Administration's Assigned Budget each year as a control mechanism so that any increases in borrowing must be offset by reductions in other spending. Scottish Ministers also possess powers to lend money
<http://www.scotland.gov.uk/Topics/Government/Finance/spfm/borrowingetc>

mutualisation. Then the conditions of the investment would have to be such to allow a return on investment, or profits, which is precisely what a mutual model is meant to avoid.

As Unison has argued:

Mutualisation for the capital intensive Scottish water and sewage industry is simply a smokescreen for privatisation. The mutual body would in effect be owned by the financial institutions that provided (the more expensive) capital funds. To minimise financial risk they would insist that all services be provided by private contractors... Therefore the so-called mutual option is in reality a token representation for customers on a board overseeing a wholly privatised Scottish Water.¹⁴⁴

In an ideal world a consumer mutual would give ownership and control of core monopoly assets to those users and communities dependent upon the service provided.¹⁴⁵ Membership of the mutual would extend to customers (domestic and non-domestic in the case of water) and employees. There would be no separate shareholders on whose behalf manager's act. Theoretically, mutual's are open and democratic. Members are entitled to receive information and meaningfully participate in the governance of the organisation, leading to enhanced openness and accountability. As such mutualisation offers the possibility of a more participative form of democracy.¹⁴⁶ Despite government rhetoric in support of more diverse forms of participation in decision-making, real progress appears very limited. These rather intangible benefits of mutualisation have been endorsed by the Prime Minister:

Common ownership and management of the water industry would represent a bold move in building relationships based on mutual understanding and equal treatment and creating 'social capital', what the Prime Minister has summarised as 'the capacity to get things done, to co-operate, the magic ingredient that makes all the difference'.¹⁴⁷

Governance of a mutual is critical to realising the magic of co-operation. The literature on mutuals suggest that such organisations should be led by a board of highly skilled and credit-worthy individuals, who would be directly accountable to members, and responsible for daily operations. Operational control of the mutual would focus on the provision of quality water and sewerage services at the lowest possible cost, aided by the 'rapid introduction of new technology, a permanent lifelong learning programme to upgrade'.¹⁴⁸

The highly capital intensive water industry means that funds, other than those generated through surplus from charges, have to be raised via long-term debt rather

¹⁴⁴ UNISON Water Brief, <http://www.unison-scotland.org.uk/water/waterbrief.html>

¹⁴⁵ 'What Future for Scotland's Water? The Mutual Answer', Scottish Co-operative and Mutual Forum, Forum Focus (Issue 2)

¹⁴⁶ 'Scottish Water The Case For a Peoples Company with Mutual Ownership and Management', Social Enterprise Institute , June 2001

¹⁴⁷ As quoted in Hargreaves, I. 'New Mutualism in from the Cold', London, Co-operative Press Ltd. 1999, p. 12

¹⁴⁸ Social Enterprise Institute, ibid.

than equity, which is characteristic of privatised water companies. Such debt is secured against assets. The mutual would not diversify into other areas of the industry.

Whilst the possibility of a customer co-operative was considered by the Scottish Parliament¹⁴⁹ it was rejected in favour of the formation of Scottish Water from the amalgamation of the three regional water authorities. The recent calls for privatisation and the legislated introduction of competition in water services for non-domestic customers have reopened discussion around the model upon which water services could be provided in Scotland.

Model Mutualisation? Welsh Water

There are no examples of successful water mutual's in the UK. A few years ago Yorkshire Water considered the possibility of mutualisation, though the benefits arising from this scheme were to flow to private investors, who were expected to benefit by £2.5bn. The Lex column of the *Financial Times* noted 'from the shareholders' point of view, spinning the water and waste assets into a mutual, financed entirely by debt, is all gravy'¹⁵⁰ while 'Kelda [the parent company of Yorkshire Water] would realise £2.4bn – more than five times the 1989 purchase price – from the sale of the water business's assets built up by generations of taxpayers and consumers'.

Kelda's proposal was rejected by the then Director General of Water Services, Sir Ian Byatt (Chair of the Water Industry Commission for Scotland). Byatt made clear he was not opposed in principle the separation of ownership of assets and operation of services. He added that these new ownership forms could be accepted if the customer would benefit through increased competition, increasing choice, and/or through the lowering of prices.

Welsh Water is the mutual model most cited in discussion of water policy options in Scotland. In response to a series of regulator imposed price cuts Welsh Water proposed the acquisition of its assets by a new not-for-profit, Glas Cymru. The latter company was established through securitisation, where debt finance is secured against the assets to ensure ownership and control of Welsh Water in 'the best interests of Welsh Water, its customers and the environment'.¹⁵¹ OFWAT approved the sale of Welsh Water's assets to the not-for-profit company,¹⁵² encouraged by support from the devolved Welsh Assembly. This sell-off raised £2billion on the bond market.

The new asset-owning company was limited by guarantee, with no shareholders seeking dividends from operational surpluses. Instead any surplus was retained, and

¹⁴⁹ Birchall, J. 'A Mutual Trend: How to run water and rail in the public interest' 2002, p.10

¹⁵⁰ Lex Column, 'Water into wine', *Financial Times* , 15 June 2001

¹⁵¹ 'Clas Cymru plans for Welsh Water'

(<http://www.dwrcymru.com/English/library/Reports/companyreports/glascymru/plans/plansforww.pdf>)

¹⁵² The sale was approved on the following conditions: there would be effective regulation by the Drinking Water Inspectorate and the Environment Agency; the company was committed to reducing customer's bills, activities of the new company were limited to water and sewerage services; 'objective measures of performance' on the quality and levels of customers' bills; and the company would focus on commercial success

possibly returned, to benefit the customers of Welsh Water,¹⁵³ which amounted to a customer dividend of £19 in 2006. Put simply, Glas Cymru was established to own, finance and manage Welsh Water; the latter was charged with carrying out the day-to-day activities via special contract partners employed by Welsh Water following a competitive procurement process. Welsh Water only employs 152 people directly, whilst being ‘at the heart of an ‘Asset Management Alliance’ with approximately 3,000 people from 15 different organisations.¹⁵⁴

Under this new corporate form Welsh Water’s capital investment programmes are financed by bonds and retained financial surpluses. Additional savings have funded some discretionary investment in service improvements. However, to date financial efficiency savings have largely been used to build up reserves to insulate Welsh Water and its customers from any unexpected costs in the future, and to improve its credit rating to keep the costs of future financing as low as possible.

Membership of Glas Cymru extends beyond the Directors of the company. Presently there are 57 members. Rather than being democratically elected, as recommended by the theory of mutualisation, members are selected according to process overseen by an Independent Membership Selection Panel that is required to maintain a balanced and diverse membership. Glas Cymru is under pressure from the National Assembly for Wales to develop a more democratic constitution.

The experience in Wales suggests models of ‘mutualisation’ do not simply translate into common ownership by customers and employees. A recent review of the policy options surrounding ‘mutualisation’ emphasises the importance of stakeholder representation and democratic accountability. In particular, the legal form and the key features of membership rights are crucial to understanding how mutualisation actually works. So too are the definitions of membership and representation mechanisms open to stakeholders in the governance structure.¹⁵⁵

The Scottish Parliament rejected the idea of a single-stakeholder mutual for Scottish Water because they were not convinced that consumers would want to participate in the long term.¹⁵⁶ The extension of the statutory powers of WaterWatch Scotland has been seen as a way of seeking to safeguard customer interests.

Mutual membership could be offered to customers, given they represent a relatively stable and homogeneous group. Such a scheme would most likely be implemented by issuing shares to existing customers. However, the weighting of such an offer could favour business customers’ over domestic customers, given the formers greater use of the business. Shareholders could then vote representatives on to the board and participation costs would be low since information-distribution and voting could be linked to billing.

¹⁵³ Glas Cymru (<http://www.dwrcymru.com/English/Company/Glascymru/index.asp>)

¹⁵⁴ Glas Cymru (2006), *Report and Accounts 2006*, p. 15

¹⁵⁵ The options are non-member non-profit; single stakeholder non-profit; single stakeholder mutual; multi-stakeholder non-profit; multi-stakeholder mutual. For more detail see Birchall, J. (2002) *A Mutual Trend: How to run water and rail in the public interest*

¹⁵⁶ Ibid p.10

The key problems associated with this model arise from the need to develop a continuing strategy for the board and management that would involve members and avoid capture by a particular interest group. All interests would not be represented if only customers, as a single stakeholder group, were to form the body of members. For instance, how would workers and environmental interests be represented? Also, any financial surpluses could be divided among customers possibly leading to conflicts between different types of users.

Currently, Scottish Water remains in the public sector in terms of ownership and strategic direction. The capital investment programme it undertakes and the services it provides have, or are on the verge, of being opened up to private sector interests seeking to profit from a relatively captive and stable group of customers. There is considerable pressure for profit and economic efficiency within the industry prompted by the economic regulator. However, the issue of financing the investment required in the industry remains. Debt financing is more attractive for 'mutualised' companies. However financing from government bonds is still cheaper. Given that water and wastewater services are crucial for public health and socio-economic development, is it better to develop an organisation which can fund investment through the cheapest means possible and where multiple interests are represented? To ensure democratic accountability the organisation should remain in the public sector where other interests can be represented through Parliament. Water is not simply about customers seeking the cheapest possible water services. Water users are also citizens who may be concerned with social equity and environmental justice. Mutualisation can make such objectives more difficult to achieve in practice.

Reviewing the lessons from privatisation of water in England and Wales Shaoul points to the 'unviability' of the policy. There are clear warnings that mutualisation is not a solution to privatisation:

'If the regulator allows prices to rise...this in turn would generate the political outcry that the regulation was supposed to prevent...Thus the turn to mutualisation, far from representing a return to a form of public ownership, represents an exit strategy for the infrastructure industries and a mechanism for evading price regulation, at the expense of the consumers'.¹⁵⁷

While local communities should have the right to choose how their water is delivered, the reality is that the range of choices continues to be narrowed by factors outside local control. Any further reorganisation of the Scottish water sector should prioritise the following:

- accountability – through information and openness to public participation regarding financing, safe water (public health), environmental protection
- public involvement throughout operation and investment
- acceptance of the political nature of water discussions and that political support is necessary for the public sector model to develop and flourish
- Charging
 - Charge on volume of water used
 - Subsidies for the poor

¹⁵⁷ Shaoul, J. 'Tapping into Mutuals', *Public Finance*, (2000)

- Need highly educated technical experts in the public authority
- Sense of shared responsibility for the common good

Policy Options: Democratising Scottish Water

There appears to be a general erosion of the public sector ethos of common ownership across key sections of Scottish public life. Pundits, experts and other assorted commentators repeat the mantra of 'public bad, private good' in many different spheres of policy. In the water sector this can be seen as leading to a gradual acceptance of the commodification of water. The encroachment of the private sector on Scottish Water can be seen at many different levels. For example the skills base within the public arm of the water industry is being downsized and out-sourced. This loss of expertise inevitably makes Scottish Water increasingly dependent on private companies. This also begs the question as to whether a public service should be run by managers incentivised to produce efficiency savings, which is often a euphemism for redundancies. Whether customers of Scottish Water would see the reduced workforce, and persistent problems with leaks, repairs and service, as evidence of a more 'efficient' industry is not something that Scottish Water or the WIC have much to say about.

Financing is a key challenge for every community wanting to ensure water for all. The day-to-day running of a water utility comes at a cost and expanding access to water requires investment. There are principally two ways to pay for public water delivery: taxes or user fees; charges for operations and taxes for capital investment. Overcoming financial obstacles to the expansion of water delivery can be done by reducing operational costs and increasing efficiency. By ambitiously taking on leakages and improving billing, lower shares of non-revenue water can be achieved and financial viability of the utility can be improved. Delete??

Citizen participation can help the financial health of the water utility. They are not only empowered by the government to prioritise the allocation of public funds, but are also involved in monitoring implementation of decisions and projects. Close and continuous scrutiny of water utilities and of external contractors has helped to reduce costs of new construction projects. It is clear that Scotland has much to learn from other parts of the world on how water services can be made more accountable and efficient. We would argue strongly that real accountability and efficiency are intimately linked.¹⁵⁸

Case Study: Stockholm Vatten

Public water and sanitation utilities have traditionally been managed by the 290 municipalities in Sweden.¹⁵⁹ Municipal water supply and sewerage works (MWSW) are separate accounting administrations, which are not allowed under law to be operated by a profit margin and are solely funded by connection fees and operation charges. MWSWs are seen to be a societal concern, under the municipality's responsibility for health protection.

¹⁵⁸ W. Dinan, C. Malcolm, D. Miller and A. Watterson 'Openness in Scottish Water: A review of Consultation, customer relations and communications in the Scottish Water industry' Water Customer Consultation Panels (WCCPS), (2003)

¹⁵⁹ Gustafsson, 'Public Water Utilities and Privatisation in Scottish Water eden', Working Paper, presented EPSU Public Service Conference, Brussels, 12 December 2001

The city council sets requirements for water and wastewater services, these objectives relate to operations alongside financial and economic objectives¹⁶⁰. The City Executive Board is also responsible for implementing the resolutions. Stockholms Stadhus AB is a special division of Stockholm City's Executive Office¹⁶¹, which has a central and strategic role in the government of Stockholm and is responsible for the control, follow-up and development of the City's activities. In addition, the Executive Office makes sure the political decisions are implemented. Stockholm Vatten AB is owned directly by the City of Stockholm (7%), by Stockholms Stadhus AB (91%) and by the municipality of Huddinge (2%). The Stockholm Water Company (aka 'Stockholm Vatten'), founded in 1990, is owned by Stockholm City and Huddinge municipality.

The Stockholms Stadhus AB group is the parent company for Stockholm City's companies. Stockholm City Council approves the companies' articles of associations, appoints their board members, and issues directives for the company. The City Council also determines the bases of the fees to be levied by the company for such services as water supply and wastewater treatment. The parent company is responsible for the Group's overall development and strategic planning as well as the management of the Group's economic and financial resources¹⁶². The Board is composed of the ordinary members and trade union representatives, whose professions and memberships to political parties, trade unions and of other boards is outlined.

Stockholm Vatten (also known as Stockholm Water Company) produce and deliver drinking water to approximately one million people in Stockholm, Huddinge and nine neighbouring municipalities; alongside the management and treatment of wastewater from Stockholm, Huddinge and six neighbouring municipalities. SWC will ensure supplies of good-quality drinking water to households and enterprises in Stockholm and treat the wastewater produced in the area in accordance with stringent safety and environmental standards.¹⁶³

Despite having a monopoly position SWC and no competition the company states it 'must operate in a rational and customer-orientated manner and maintain high quality standards so that our services provide good value for money'. The company states it is making every effort to reduce resource utilization and increase cost-effectiveness, for example, by increasing the percentage of operations put out to public tender. Such activities, gives some indication of the commercialisation of activities within the public sector model. To evaluate performance and give an indication of where improvements can be made, SWC uses key indicators for prices, quality and quantity with other companies in Sweden and the Nordic countries.

¹⁶⁰ Stenroos, M. and Katko, T.S.) *WaterTime case study – Stockholm Sweden (PSIRU)* (2005) (www.watertime.net/docs/WP2/D38_Stockholm.doc)

¹⁶¹ The City of Stockholm's Executive Office is one of two administrative bodies staffed by civil servants and is part of the City Executive Board which is "Stockholm's government". (Stockholm Stad) (http://www2.stockholm.se/english/pdf/F_engelsk.pdf#search=%22stockholm%3A%20democracy%20in%20images%20and%20words%22)

¹⁶² The City of Stockholm, (<http://www2.stockholm.se/english/>)

¹⁶³ 'Stockholm Vatten, 'A year with the Stockholm Water Company and a century with Norsborg waterworks', *Environmental and Annual Report 2004*.

Charges for Water and Sewage Services (from 1 January 2006)¹⁶⁴

According to Swedish law, SV is a non-profit public company. Business activities are funded from rates charges levied for drinking water, sewage treatment and other services, which are calculated in accordance with the cost price principle under the Public Water Supply and Wastewater Systems Act¹⁶⁵. Specifically, the municipal council establishes principles for the system of rates and the Board of SV, consisting of Ordinary members and Trade Union representatives, fixes the scale of rates. Charges are not subsidised from taxes in any other way. Charges are classified into the following categories and include variable, fixed and storm-water charges¹⁶⁶ including 25% Value Added Tax:

- detached houses and other small buildings
- residential buildings and non-residential buildings
- industrial and other property

Financial Issues

In 1995, SWC underwent a major reorganisation aimed to enhance operating efficiency and long-term sustainable development, through cost recovery rather than profit maximisation. Financial transactions were centralised under, and financial risks largely taken over by, Stockholm City in 2000. These risks include the different companies', within the Stockholm Stadhus AB Group financing risk and the credit risks, counterparty risks and liquidity risks associated with financial transactions. The interest rate risk is borne by the companies themselves, whilst all significant currency risks are to be eliminated by the use of derivative instruments. Such risks are connected to the company's financial viability is based on the stability of the operating conditions which are generally characteristic of water supply and sewerage.¹⁶⁷ In addition SWC must comply with various statutory and administrative instruments which are monitored by different agencies¹⁶⁸.

¹⁶⁴ Stockholm Vatten (2006) *Charges: Water and Sewage Services in Stockholm and Huddinge from 1 January 2006 (Summary)* http://www.stockholmvatten.se/pdf_arkiv/charges.pdf

¹⁶⁵ Stockholm Vatten (2004: 33)

¹⁶⁶ This is an environmental charge paid by customers who use the Stockholm Vatten pipe system for diverting rainwater and water from melting snow from the property. Stockholm Vatten encourages property owners to handle storm-water locally on the premises. Thus if the storm-water can be dealt with inside the site boundary, property owners can apply for a 50 or 100 percent reduction of the charge (Stockholm Vatten, 2006: 3).

¹⁶⁷ As quoted in Lobina, E., and Hall, D. 'Public Sector Alternatives to Water Supply and Sewerage Privatisation: Case Studies', *PSIRU Report*, (1999: 9)

¹⁶⁸ SWC must comply with statutory and administrative instruments, from national legislation as well as being influenced by the EU Water Framework Directive and Urban Wastewater Directive. The Stockholm Environmental and Health Administration and corresponding departments in other municipalities are responsible for external supervision and inspections of drinking water, as well as monitoring the impact of SWC's activities on the water environment. The Swedish Environmental Protection Agency formulates Sweden's national environmental objectives, whilst the environmental courts establish the requirements concerning the environmental results of wastewater treatments. Finally, the Stockholm County Administrative Board supervised the company's compliance with the treatment requirements. Noticeably, an economic regulator is missing from this regulatory framework possibly due to the financial limits and directives laid down with Stockholm City Council. Stockholm Vatten (2004: 7)

The Swedish municipal service seems quite competitive with reference to statistics from IWSA (International Service Water Association).¹⁶⁹ The average price or 200 cubic metres drinking water was less than half the price of most other European cities (some comparative prices are outlined below in Table 1). The low water charges are available despite Sweden lacking scale advantages given its small population sparsely populated around the country.

City	Euro
Amsterdam	153
Geneva	322
Helsinki	174
London	140
Marseille	256
Gothenburg	80
Swedish average	105

Average prices for 200 m³ drinking water in some EU cities

There is further evidence of the advantages of the Swedish model (based on a study by consultancy firm ITT in 1995).¹⁷⁰ The study surveyed the economic performance indicators in three public works in Sweden and six private water supply works in England and Wales. Some of the key measures are reproduced below:

City	Cost to customer	Cost of operation	Capital Maintenance	Return on Capital
Stockholm	0.28	0.17	0.03	0.09
Manchester	0.91	0.40	0.20	0.31
Bristol	0.83	0.48	0.19	0.15
Gothenburg	0.38	0.11	0.05	0.21
Kirklees	0.99	0.52	0.31	0.15
Hartlepool	0.73	0.35	0.08	0.29
Helsingborg	0.42	0.42	0.05	-0.05
Waverly	0.82	0.48	0.22	0.12
Wrexham	1.25	0.57	0.35	0.32
Average – Sweden	0.36	0.23	0.04	0.08
Average – UK	0.93	0.48	0.20	0.23

Table 1: Comparison of economic performance indicators of public and private water supply works/companies in some Swedish and English cities. Cost per cubic meter of water delivered in USD.

Scotland & Ireland

Gustafsson, J-E. ‘Public Water Utilities and Privatisation in Scottish Water Eden’, Working Paper, presented EPSU Public Service Conference, Brussels, 12 December 2001, p,3

¹⁷⁰ ibid: 4

When considering alternatives to the present governance structure of Scottish Water it is easy to slip into comparators with the most obvious comparison, which is of course England and Wales, but why do the WIC and the Scottish Executive not even attempt to look elsewhere for new models? Why do we look to England and Wales almost exclusively? Perhaps it is to do with proximity, both culturally and geographically, but a more persuasive view might be that the model of privatisation in England, or Wales, is the model that is the ultimate goal for the WIC and the Scottish Executive.

Another model that is geographically close is that of Ireland's water supply. Politically and organisationally, however, it seems very far away indeed. In Ireland, like in Scotland, there are European directives to be adhered to, but unlike in Scotland the managing of the water supply is accomplished by local authorities. The Irish are devolving this responsibility to locales themselves with local knowledge being utilised in the process. Moreover, it is funded through general taxation, albeit with major assistance from EU structural funds. This seems to be placing water very much as a fundamental human right. It is also anathema to current political thinking in Scotland, whereby the investment and operation of water is funded predominately from the water user and to a lesser extent from Scottish Executive loans.

Conclusions

The Scottish Water industry has been set up in a governance context and regulatory framework, which inevitably tends towards privatisation. This is predominantly because of the following factors:

1. The international financial and governance context creates pressures for market based solutions.
2. The devolution settlement constrains the Scottish Executive raising revenue to invest in infrastructure.
3. The governance model for the industry treats Scottish Water as if it was a private company
4. The financial accounting methods used by the WIC (the RCV method) lock Scottish Water into a model which enables returns to private investors

The trend towards privatisation is supported by campaigns from political parties, think tanks and other pro business lobbyists. The Scottish water industry is part of a global water industry. It is the governance and regulation system which inevitably pushes the water industry in a direction which makes privatisation seem a rational, least worst (or profitable) policy option.

But in fact on every major index, privatisation of water across the world has been a failure in terms of its value for money, the accountability of the service, sustainability and water quality and efficiency. There is every reason to suppose that the same would be the case in Scotland.

The major potential alternative to privatisation is mutualisation. Some critics have denounced this as privatisation by the back door and it is our view, based on evidence assembled for this report, that such a view is justified in relation to Scottish Water. This is predominantly because there is currently only one likely source for investment finance in a mutual model: the private sector. In practice financial institutions would have the whip hand in the governance system and in practical decision making in the Scottish water sector.

The only way to ensure that Scottish Water is saved from privatisation is by turning away from the current market model towards a democratisation of the industry. This is also the only way to ensure an efficient, sustainable and equitable water system in Scotland.

Key characteristics of a democratised water industry

While local communities should have the right to choose how their water is delivered, the reality is that the range of choices continues to be narrowed by factors outside local control. Any further reorganisation of the Scottish water sector should prioritise the following:

- accountability – through information and openness to public participation regarding financing, safe water (public health), environmental protection
- public involvement throughout operation and investment
- enable cross-subsidy of public services

- public awareness and reluctance to privatise communicated through campaigns and media
- acceptance of the political nature of water discussions and that political support is necessary for the public sector model to develop and flourish
- Charging
 - Charge on volume of water used
 - Subsidies for the poor
 - Association with cost of operation and maintenance in particular locations – a political decision needs to be made
 - Need highly educated technical experts in the public authority
 - Sense of shared responsibility for the common good

In many respects political support for public water is a priority:

The need for local public authorities to be given support in their efforts towards establishing an innovative, participatory, democratic system of public water management that is efficient, transparent and regulated and that respects the objectives of sustainable development in order to meet the population's needs.¹⁷¹

Scottish Water could be democratised. This requires that it is put firmly into public ownership, meaning that Scottish Water operates not as if it was a private corporation, but as a public service. It would not be required to prioritise market efficiency over social or environmental efficiency. The investment needed could be most efficiently achieved by cutting out the profit guaranteed to the financial markets and the other hidden costs of a market or privatised model. Most importantly the control over decisions in the delivery of safe, sustainable water would rest not at the whim of the market but with the people of Scotland.

¹⁷¹ Balanyá, B, Brennan, B, Hoedeman, O, Kishimoto, S and Terhorst, P (eds), 'Reclaiming Public Water Achievements, Struggles and Visions from Around the World', Transnational Institute and Corporate Europe Observatory, January 2005 (1rst edition) March 2005 (2nd edition)

Appendix 1

Some Key Facts about Scottish Water¹⁷²

Assets	Thousands of assets are operated and maintained - over 46,000 kilometres of water pipes, 48,000 kilometres of sewer pipes, 1807 waste water treatment works (including 1274 septic tanks) and 368 water treatment works plus pumping stations, sludge treatment centres, reservoirs.
Customers	Scottish Water has around 5 million customers in 2.2million households. Business customers number 133,000, the majority being small to medium businesses with 490 large industrial and commercial users.
Water Quality	Over 800 water samples are taken every day from a combination of customer taps, water treatment works and service reservoirs. Between January to December 2003 over 306,000 regulatory tests were carried out to ensure water quality is maintained to rigorous drinking water quality standards.
Volumes	2.5 billion litres of water is provided every day and nearly 1 billion litres of waste water is taken away and treated before being returned to the rivers and seas.
Coastline	Scottish Water is the sole provider of water and waste water services to an area of 78,000 square kilometres (over 30,000 square miles), a third of the area of Britain. And Scotland has a longer coastline - almost 10,000 kilometres (over 6,200 miles) - with a small and relatively dispersed population which requires a large number of small water and waste water treatment works.
Ranking and Turnover	Scottish Water is the fourth largest water and wastewater services provider in the UK and at £1bn it is in Scotland's list of top 20 businesses by turnover ¹⁷³ .

¹⁷² 'Key Facts about Scottish Water', Scottish Water.co.uk, (http://www.scottishwater.co.uk/portal/page?_pageid=225,483607&_dad=portal&_schema=PORTAL)

Appendix 2

How the water industry in Scotland is run¹⁷⁴

<u>The Scottish Parliament</u>	<u>Scottish Water</u>	<u>Water Industry Commission for Scotland</u>
Holds Scottish Water and Ministers to account and regularly calls executives to its committees to give progress updates. Scottish Ministers Set the objectives and appoint the Chair and Non-executive Directors	Responsible for providing water and waste water services to household and business customers. Delivers the investment priorities of Ministers within the funding allowed by the Water Industry Commission for Scotland.	Economic regulator. Sets charges and reports on costs and performance.
<u>Drinking Water Quality Regulator</u> Responsible for protecting public health by ensuring compliance with drinking water quality regulations.	<u>Scottish Environment Protection Agency (SEPA)</u> Responsible for environmental protection and improvement.	<u>Waterwatch Scotland</u> Responsible for representing the interests of customers

¹⁷⁴ Scottish Water Annual Report 2005/2006, ‘The First Four Years’, (http://www.scottishwater.co.uk/pls/portal/docs/PAGE/SWE_PGP_NEWS/0606%20-%20JUNE%202006/SWE_NEWS_AREPORT06/PRINTED%20ANNUAL%20REPORT.PDF)

Appendix 3

Ownership structure of Scottish Water Solutions¹⁷⁵



¹⁷⁵ Scottish Water Solutions Annual Report 2005/2006, p39,
http://www.scottishwater.co.uk/pls/portal/docs/PAGE/SWS_PUB_ABOUT_US/SWSE_PG_ABOUT_US/SWS%20_ANN REP05-06_72.PDF

Appendix 4

Water Knowledge Center 10 Reasons Why ... Public Utilities Should Be Regulated¹⁷⁶

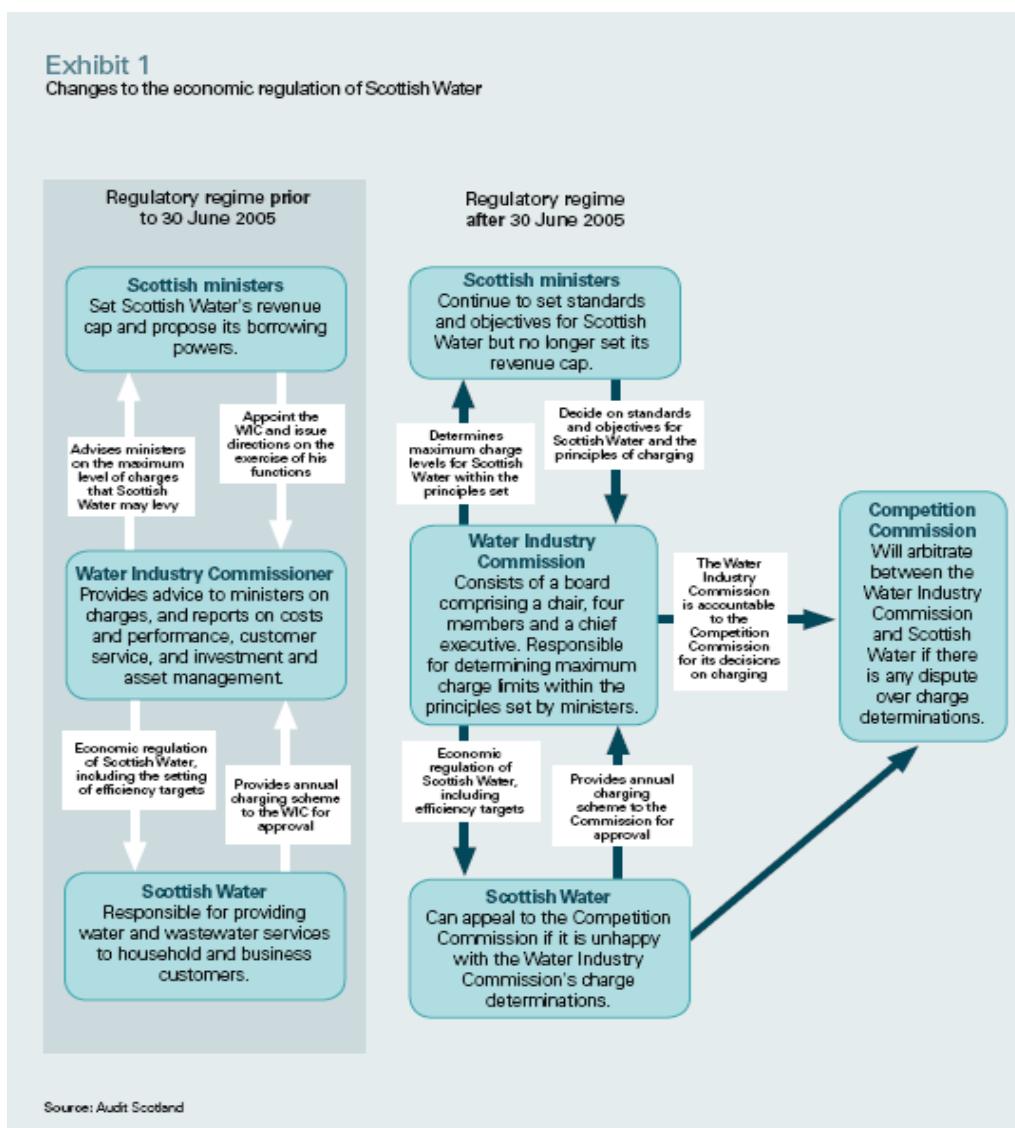
‘Water professionals involved in regulation talked about what their work has taught them about regulation. Here are their thoughts on why regulation should extend to public utilities’.

- A regulator will act as a proxy competitor, forcing the utility to operate efficiently
- A regulator can motivate a utility to act on consumer complaints
- A regulator can be blamed, instead of politicians, if tariffs are raised
- A regulator can prevent monopoly abuse
- A regulator can act as a referee between a frustrated public and defensive utility
- A regulator motivates utilities to conduct themselves professionally and upgrading their skills in order to present sound reasoning and defend their operations to the regulator
- A regulator can ensure utility sustainability
- A regulator creates employment
- A regulator can ensure that utilities make good on their promises, such as better service levels
- A regulator can set realistic limits to ambitious goals of utilities, while at the same time expand the public’s sustainability horizon further than 3 months at a time

¹⁷⁶ ‘10 Reasons why public utilities should be regulated’, Asian Development Bank (<http://www.adb.org/Water/Knowledge-Center/top10-publications.asp>)

Appendix 5

Illustration of the regulatory role of the WIC¹⁷⁷



¹⁷⁷ 'Changes to the Economic Regulation of Scottish Water', Audit Scotland Report 'Overview of the Water Industry in Scotland', p,13
(<http://www.audit-scotland.gov.uk/publications/pdf/2005/05pf07ag.pdf>)

Appendix 6

Profile of the WIC¹⁷⁸

SIR IAN BYATT, CHAIRMAN Sir Ian Byatt was Director General of the Office of Water Services (Ofwat) between 1989 and 2000. In that role he was responsible for independent economic regulation of the water companies in England & Wales. From 1978 to 1989 he served in HM Treasury as Deputy Chief Economic Adviser. Since 2000 he has advised the World Bank and governments around the world on matters relating to the water industry. Sir Ian, who was an adviser to the Water Industry Commissioner from 2002, was knighted in 2000.	PROFESSOR JOHN K BANYARD OBE Professor Banyard is a chartered engineer who retired in December 2004 as an Executive Director of Severn Trent Plc following a career in the water industry. His particular areas of responsibility were the design and management of the capital programme, the day-to-day operation of the company's infrastructure, and R&D. He also acted as an adviser to the Water Industry Commissioner for Scotland from January 2005.	PROFESSOR DAVID SIMPSON, DEPUTY CHAIRMAN Professor Simpson was economic adviser to Standard Life from 1988 to 2001. He was the founding Director of the Fraser of Allander Institute at the University of Strathclyde and is a Trustee of the David Hume Institute. Professor Simpson acted as an adviser to the former Water Industry Commissioner for Scotland from 2002.
DR MIKE BROOKER Dr Brooker is a scientist who recently retired as Chief Executive of Welsh Water following a career in the water industry in Wales. During his career he was Chief Scientist and subsequently	ALAN SUTHERLAND, CHIEF EXECUTIVE Alan Sutherland was the Water Industry Commissioner from November 1999, when the position was created. During that time, he developed a framework for	CHARLES COULTHARD Charles Coulthard retired recently as Managing Director of Ofgem (the Gas and Electricity regulator) in Scotland. He served as Deputy Director of the Office for the

¹⁷⁸ WIC annual report 2005/2006, P6
(<http://www.watercommission.co.uk/Documents/Publications/Annual%20Report%202005-06.pdf>)

<p>Divisional Operations Director of Welsh Water before becoming Managing Director in 1996.</p>	<p>economic regulation of Scottish Water. He has extensive experience in management consultancy and in the investment banking industry, being a former management consultant with Bain and Company and before that a Manager with Robert Fleming and Company. More recently he was a Managing Director of Wolverine CIS Ltd, a division of Wolverine World Wide.</p>	<p>Regulation of Electricity and Gas in Northern Ireland between 1992 and 1999. He is also currently the Chair of the Gas and Electricity Consumers Council in Scotland.</p>
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