P.01357

PRIME MINISTER

Water Authorities: the Strategic Issues

(E(NI)(84)7 and 10)

BACKGROUND

The Regional Water Authorities (RWAs) are relatively recent creations. Until the mid-1970s, when the RWAs were set up in England and Wales, water and sewerage were regarded as largely local authority responsibilities, as they still are in Scotland. Despite a further reorganisation under the Water Act 1983 to make the RWAs more commercial, they still retain features of the local government system: in particular, the great majority of domestic consumers pay water charges based not on their consumption but on the rateable value of the property they occupy. It was only last year that the RWAs were brought under the same control regime as the other nationalised industries.

FLAG F

2. The proposals in the joint memorandum by the Secretary of State for the Environment and the Secretary of State for Wales (E(NI)(84)7) reflect that background to some extent. The proposals are as follows.

(i) That investment in water services should increase by at least 5 per cent a year in real terms over the next five years, and more if resources permit, so as to make progress towards environmental aims.

(ii) A real rate of return on new investment in water services lower than that required of the other nationalised industries (3 per cent as against 5 per cent) should be accepted; and existing assets should be required to earn only 1 per cent in real terms.

(iii) Part of the surpluses generated by a charging policy consistent with (ii) above should be put into a Water Environment Fund (WEF), to be used for environmental improvements rather than taken for the benefit of public finances generally.

(iv) Officials should report on the possibility of a capital restructuring to provide a mechanism for recovering part of the surplus (presumably the amount not paid into the WEF) and to remove inconsistencies between authorities.

FLAG G 3. The memorandum by the Chief Secretary, Treasury (E(NI)(84)10) opposes all these proposals except the last.

(i) The Chief Secretary opposes any commitment to the proposed increase in investment; by implication, he regards present levels of investment as adequate for at least the next five years.

(ii) He argues that the RWAs should be treated like other nationalised industries and required to earn 5 per cent in real terms on their assets, though he accepts that a move to this level would have to be phased over 10 to 15 years. He suggests that a charging policy based on this approach would provide substantial savings for the Public Expenditure Survey.

(iii) He argues against the establishment of a WEF because it would add to public expenditure.

The Chief Secretary suggests that he should seek to agree with Mr Jenkin and Mr Edwards on specific financial targets and investment figures in the early Autumn (ie. after more progress has been made with the nationalised industries Investment and Financing Review(IFR)).

MAIN ISSUES

4. The specific issues before the Sub-Committee are as follows.

(i) What provision should be made for capital investment by the RWAs?

(ii) What is the desirable rate of return on the assets of the RWAs, bearing in mind the consequences of the decision for water charges?

(iii) Should a WEF be set up?

(iv) Should officials be asked to report on a capital restructuring of the water authorities?

5. Although no operational decision on the point is needed, the Sub-Committee's conclusions on the questions in the preceding paragraph are likely to be coloured by the view they take of the nature of the RWAs: should they be assimilated as closely as possible to the nationalised industries, or treated as special? Clearly there is force in the points that the RWAs have substantial responsibilities affecting the environment and public health; and that charges to domestic consumers are largely unrelated to consumption. On the other hand, there is a risk that the RWAs will, in effect, be allowed to pick out the favourable aspects of different financial regimes. One of the justifications for controlling nationalised industries through

their external financing limits (EFLs) is that their charges are not like taxation but reflect market demand. If water charges are to be regarded as analogous to taxes, the logic is that the whole of their capital expenditure should be treated as public expenditure, as with the capital programmes of central and local government, and be subject to similar disciplines.

Capital Investment

6. The RWAs have said that present levels of investment are adequate for five years to maintain present standards and deal with the needs foreseen for new housing and industrial development. Paragraph 7 of E(NI)(84)7 implies that more investment will be needed over a period of 10 to 15 years to replace assets. It is not clear whether the implication is that present levels of investment will not after all be adequate for the next five years.

7. Paragraph 8 of E(NI)(84)7 also bids for substantial additional investment: a minimum of 5 per cent a year in real terms. Ministers will need to consider whether they wish to give this expenditure, and the development of water and environmental services which is its objective, priority.

Rate of Return and Charging Policy

8. Their decision will be influenced by the view the Sub-Committee take of charging policy. If additional capital expenditure by the water authorities is not covered by additional revenue, it self-evidently adds to the EFLs, the public expenditure planning total and the PSBR; and if it is not required to produce an economic return it requires a clear social justification.

9. Paragraphs 4, 13 and 14 of E(NI)(84)7 set out the considerations which Mr Jenkin and Mr Edwards suggest provide such a justification. In essence, they are as follows.

(a) Water authorities have substantial social and environmental responsibilities. For this reason, and because the financial risk in the water industry is low, RWAs should be asked to earn only about 3 per cent in real terms on new assets rather than the 5 per cent required of other nationalised industries.

(b) Water charges, at least to domestic consumers, are more akin to taxation than to prices.

(c) High water charges would have an inflationary effect.

(d) Substantially higher charges would generate large financial surpluses, which would be attacked by consumers as clear evidence of abuse of a monopoly position.

(e) The accounting basis is not sufficiently strong to bear a large immediate increase in charges.

10. The last of these arguments does not seem relevant, since Mr Rees is proposing only a gradual move towards securing an economic rate of return. For the rest, the Sub-Committee will wish to consider the following points on the other side.

(a) The required rate of return of 5 per cent does not reflect financial risk, as suggested in paragraph 14(a) of E(NI)(84)7: it is a measure of the opportunity cost of capital. (However, if Ministers considered that investment in water produced substantially larger social benefits than investment in either the other nationalised industries or the private sector, this would justify accepting a lower financial return).

(b) The more the RWAs are treated as levying taxes rather than charging market prices, the less the justification for treating them as nationalised industries when their investment programmes are considered.

(c) It is contrary to Government policy to keep nationalised industry charges below an economic level in the supposed interests of reducing inflation: the immediate effects on the retail prices index are outweighed by the general inflationary effects of the higher borrowing or taxation required.

(d) The justification for the proposal in E(NI)(84)7 to seek a lower return on existing assets than on new assets is far from clear.

Specific Financial Targets and Investment figures

11. The Sub-Committee will probably wish to invite the Secretary of State for the Environment, the Secretary of State for Wales and the Chief Secretary, Treasury to reach agreement on specific financial targets and investment figures in the light of their views on the general questions discussed above.

Water Environment Fund

12. Whether the Sub-Committee favour in principle the proposal to set up a WEF will depend on two main considerations.

(i) Whether Ministers accept the view clearly favoured by the Chief Secretary that surpluses on investment in the water industry should be regarded, as with surpluses in other nationalised industries, as a return on public investment to which the taxpayer is entitled, or whether at least part of the surplus should be regarded as hypothecated to the industry. Presumably the justification for raising this part of the surplus, rather than simply keeping charges down, would be that it is necessary for current consumers to make some sort of advance payment for later environmental benefits.

(ii) Whether setting up a WEF would generate irresistible pressures for other hypothecated funds (a Road Fund and a North Sea Oil Fund to benefit Scotland are both well-known suggstions).

13. If the Sub-Committee should in principle favour the establishment of a WEF, they will probably wish to invite the Secretary of State for the Environment and the Secretary of State for Wales to bring forward detailed proposals.

Capital Restructuring

14. The Sub-Committee seem likely to accept the proposal, favoured by all three Ministers, for a study by officials of a possible restructuring of the capital of the water authorities to provide, among other things, a mechanism for the recovery of part of any surpluses.

HANDLING

15. You will wish to ask the Secretary of State for the Environment, the Secretary of State for Wales, and the Chief Secretary, Treasury to introduce their memoranda. All members of the Sub-Committee are likely to wish to comment from the standpoint of nationalised industry policy. The Secretary of State for Scotland may have comments on the implications for the water industry in Scotland, which is organised quite differently from that in England and Wales. The Secretary of State for Trade and Industry may have views on the implications for water charges to industry.

CONCLUSIONS

16. You will wish the Sub-Committee to reach conclusions on the following.

(i) What broad level of investment in water services should be accepted as reasonable over the next five years?

(ii) What rate of return should be required from the RWAs

(a) on new assets; 3%.

(b) on existing assets? 1%.

How quickly should the water authorities be required to move to earning that rate of return, bearing in mind the implications for water charges?

The Sub-Committee will probably wish to invite the Secretary of State for the Environment, the Secretary of State for Wales and the Chief Secretary, Treasury to discuss the detailed implications of their conclusions on these questions as part of the nationalised industries IFR.

(iii) Do the Sub-Committee in principle favour the establishment of a Water Environment Fund on the lines described in paragraph 19(a) of E(NI)(84)7?

(iv) Should officials be instructed to examine the possibility of restructuring the capital of the water authorities as proposed in paragraph 19(b) of E(NI)(84)7?

£250 = charging
£1500 = 1 hour 1 10p a week 15p
£1000 = £1.80

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Cabinet Office.
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