

CONFIDENTIAL

MR TURNBULL

25 July 1984

WATER AUTHORITIES - E(NI) ON 26 JULY

1. The Problems

Both papers are disappointing, in that they either miss or treat lightly some key issues. We think E(NI) should consider:

- i. efficiency - of management, labour and use of capital; and with that the attraction of private capital and greater use of private contractors;
- ii. the absence, after 10 years, of an agreed rationale for setting financial targets for the Water Authorities;
- iii. the absence of service (eg water quality) objectives which customers can understand and which might provide a justification for investment.

The result of all this is a muddle of expectations as between ratepayers, water authority managers and central government; and uncertainty as to what mix of charges and EFLs should be used to pay for revenue costs and new investment.

2. Some key observations

Annex A sets out salient facts and figures about the water industry. The conclusions we draw from them are as follows:

- i. water industry costs are not quickly reducible. But steady pressure on efficiency is desirable. Uncertainty about the life of the authorities' assets and the way in which they might be replaced calls into question the replacement cost of £28 billion ascribed to them. Why put a replacement cost on assets for which the replacement intention is far from clear?
- ii. Since the water authorities exercise a near-perfect monopoly, they can achieve any given real rate of return simply by adjusting their charges. We doubt the effectiveness of an RRR technique for setting charges.

CONFIDENTIAL

3. The DoE and Treasury views

DoE want increasing investment in real terms, but with modest real rates of return - 3% on new works after April 1985, but existing rates (approximately 1%) on existing investment. Surpluses generated should go to a Water Environment Fund "which would be used to support worthwhile projects for environmental improvement within the Water Authorities' investment programmes". They also suggest an officials' study of restructuring the Authorities' capital.

Treasury are happy to investigate the restructuring of capital, but do not like either the Water Environment Fund, or the low real rates of return suggested by DoE. The Treasury long-term financial target, however, is surprisingly vague - the achievement of approximately 5% over 10 to 15 years, with an increase in water charges a little above the general rate of inflation. Treasury are not persuaded of the need for a 5% real terms increase in investment over the next five years. Their main target is the reduction of taxpayer subsidy (ie the EFL) in the PES period.

4. The Policy Unit view

We believe that DoE and Treasury each have points in their favour.

Treasury are right to be sceptical about the Water Environment Fund and about the need for a real increase in the rate of Water Authority investment. The first sounds like expensive do-gooding, while the second falls into the "NHS trap", ie the assumption that more money automatically means a better service, and that the service always needs to be better.

On the other hand, Environment are better attuned to the presentational difficulties of stiffer financial targets. A flat-footed increase of so many per cent above RPI year after year for more than a decade will produce rising discontent and incomprehension, especially if the underlying valuation of assets is open to suspicion.

We feel it would be useful to look at other mechanisms that might be used for regulating monopoly activities. The "RPI minus X" formula to be used for British Telecom in the future seems to us well worth exploring. It is intended to provide a check on rapacity, pressure towards efficiency, and the opportunity to adjust annually in the light of political sensitivities. Why not apply the same formula to the costs of each of the 10 Water Authorities - not to the

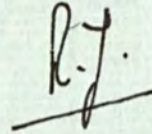
CONFIDENTIAL

industry as a whole - and couple the value of X to objective efficiency targets.

If E(NI) is content to have this explored further, we believe it would be useful to reassess at the same time whether rateable value should continue to be the basis for charging consumers for water services. Much ink has been flowed on this point in recent years. Surely mankind can now devise a better basis?

5. In summary we recommend that E(NI) should:

- i. reject DoE's request for a 5% real increase in investment over the next five years. Investment needs should follow on from precise and meaningful quality objectives, and even then will need to take account of public expenditure constraints;
- ii. reject the DoE proposal to establish a Water Environment Fund;
- iii. reject both Treasury and DoE targets expressed as real rates of return;
- iv. ask Treasury and DoE to explore the application of 'RPI-X', coupled with efficiency targets, to Water Authority costs.



ROBERT YOUNG

CONFIDENTIAL

Annex A

WATER AUTHORITIES IN ENGLAND AND WALES

1. In 1974 nine Water Authorities were established for England and one for Wales, each responsible for the whole water cycle from rainfall to disposal within "natural watershed" areas.
2. The Authorities raise revenue of around £2 billion per annum, and enjoy an EFL on top of around £300 million per annum. They invest around £800 million per annum. The largest element by far of their total costs (some 45%) is in financial charges - depreciation and debt-servicing. About 25% is manpower costs and the remaining 30% is largely in electricity, chemicals and other consumable materials. Although the Water Authorities have severed their connection with Local Authorities, their charges are still based on rateable values. The average bill to the domestic consumer is £75-80 per annum.
3. These are average figures which differ widely between Authorities. Thames is in surplus, and is paying off its debt, whereas the North West and Northumbria are bogged down in debt charges.
4. Independently of the Water Authorities, there exist 28 statutory water companies, which date back to the nineteenth century. Where it suits the Water Authorities, they exercise their statutory duty to supply by means of an agreement with the water companies.
5. On the whole, our climate ensures that we are not short of water. There is no obvious case for investing in major new storage or exploration schemes (the huge Kielder project is virtually surplus to requirements) and no case for a national water grid, which, capital costs apart, would entail enormous pumping costs. Although our water mains distribution system is leaky, and in some cases badly corroded, there is no objective evidence in support of a national spending spree. Interestingly, the CPRS reported in 1981 that only one-third of all water consumption in England and Wales comes via the Water Authorities or the statutory companies. Industry abstracts the remaining two thirds for non-drinking use.
6. Disposal (mainly sewerage) is, however, becoming financially more demanding. Sewer collapses are numerous - over 3,000 per year - but most are in small pipes and can be put right by local repair. The huge, highly publicised collapse is extremely rare. Virtually all the problems appear to be the result of hydraulic overloading rather than deterioration of

F. R.

CONFIDENTIAL

the sewer material. The implication is that network analysis, aimed at identifying the worst pressure points, will be more cost effective than wholesale replacement. Large parts of the nation's sewerage system are unmapped so it may even be necessary on occasions to wait for a collapse in order to locate it. The re-lining of short sections with modern materials is a developing technique.

7. Although a reduction in total water consumption and total disposal would help the finances of the industry, metering does not provide a satisfactory solution. It costs about £50 per household to install a meter, and we have 18 million households. And we would still not have a grip on the two-thirds of water consumption which would not flow through meters, but would require disposal.

h.j.

PRIME MINISTERWater Industry

Could I add one or two comments to Bob Young's note. This will be a difficult discussion to handle as two separate issues are intertwined.

- (i) The strategic decision on how the rate of return on the industry should be structured with the Treasury favouring a higher return on the total capital stock and DoE wanting a higher return to be applied only to new investment.
- (ii) Having decided the basis for setting the rate of return, what numbers should be set? This will have important implications for the industry's EFL.

You will want to avoid decisions being taken which pre-empt the Chief Secretary's efforts to secure from the water industry an adequate contribution to the savings which E(A) has agreed from the IFR.

On (i) the Treasury are not entirely candid about the impact of moving to a 5 per cent real return on total capital over 10-15 years. Over 10 years this would be RPI + 5 and over 15 years RPI + 3. I doubt if this could be described as "a little above the general rate of inflation". By contrast, Mr. Jenkin's proposal for 1 per cent on existing assets and 3 per cent on new investment is equivalent to about 3 per cent of the existing capital, the average rate of inflation would build up only slowly.

On the structure of the financial target, Policy Unit are sympathetic to DoE. One argument for adopting this

approach is that the higher return on new investment will provide a break on enthusiasm for a larger capital programme.

If Mr. Jenkin's proposals were adopted, it is doubtful whether the water industry would be providing an adequate contribution to the savings of

£1,142m	£1,830m	£2,315m
which E(A) agreed to seek. Mr. Jenkin is offering only to eliminate the excess over baseline of		
£64m	£105m	£107m.

Whatever is adopted for the structure of returns, the Chief Secretary must be left with freedom to ask for a bigger contribution, e.g. by arguing for a once and for all increase in the return on existing assets from 1 per cent to 2 per cent, with 3 per cent on new investment. This would add £280m for water industry revenues.

Changes are needed to the water industry capital structure as it will very soon have repaid all its debt to HMG. One possibility would be to give it some kind of public equity capital on which it is required to pay a dividend.

AT

ANDREW TURNBULL

25 July, 1984