Water UK

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Briefing Paper

A response to the Labour Party's consultation on 'Democratic Public Ownership'

Summary

In September 2018 the Labour Party published a document called *Clear Water*,[1] setting out how it would take the water companies of England into public ownership should it form a government.

It is the most detailed explanation so far of the broad commitment in the Party's general election manifesto of 2017. The Party's *Democratic Public Ownership*[2] paper also sets out some of the thinking behind *Clear Water*.

We note that there was no attempt to engage water companies or industry bodies in the development of the proposals. Instead of a return to public ownership, the Water UK board on behalf of the CEOs of water companies in England propose an alternative way forward, as set out in the recent *Public Interest Commitment*[3] Specifically, the English water companies commit to championing what it means to operate in the public interest, in line with leading socially-responsible businesses worldwide. Companies will retain the benefit of private sector investment and efficiency but be driven by statements of wider public purpose. We argue that more public value can be achieved by the existing private water companies if they remain in the private sector, rather than customers suffer the costs and disruption to services, severe financial constraint, and politically-driven mismanagement, that would inevitably result from being taken into public ownership. This document is Water UK's response to the *Democratic Public Ownership* consultation, in which we assess the *Clear Water* proposals.

It is important to explain that Water UK represents both private and public water companies operating right across the United Kingdom, with members operating under mutualised, listed, public sector, and privately-owned models. Regardless of ownership model, we take very seriously the responsibility of providing an essential public service, and our main concerns are ensuring that customers get the service they need, and that the environment is protected and improved.

It is against those concerns, rather than from any particular political or ideological standpoint, that we have considered Labour's proposals. We have sought to establish whether they provide the basis for delivering an equivalent or better service than that which is being delivered by the current industry model in England. Our conclusion is that they do not, and that they are

[1] Labour Party, *Clear Water,* 2018: https://www.labour.org.uk/wp-content/uploads/2018/09/Conference-2018-Water-pamphlet-FINAL.pdf

[2] Labour Party, *Democratic Public Ownership*, 2018: https://labour.org.uk/wp-content/uploads/2018/09/Democratic-public-ownership-consulation.pdf

[3] Water UK, *Public Interest Commitment*: https://www.water.org.uk/news-item/water-industry-reaffirms-pledge-to-work-in-the-public-interest

fundamentally flawed. The proposals will not deliver an equivalent or better service and create the significant risk of a return to the poor performance of the English water industry when it was last owned and run by the government.

Clear Water stops far short of explaining how the big challenges faced by the water and sewerage industry – like climate change and an increasing population – would be addressed by its substantial reorganisation of structures and ownership. It makes no attempt to acknowledge the many improvements made since privatisation in 1989 – let alone the further benefits, such as falling bills, improved services, and increased investment – that companies have set out for future years.

Our view is that, if implemented, *Clear Water* could seriously damage the provision and quality of water and sewerage services in England.

It could create a future where decisions are driven primarily by short term political expediency rather than the needs of customers, and where the high levels of investment needed to improve services, enhance the natural environment and protect resources for the future in the face of big challenges like climate change and population growth are not sustained.

At least 67 UK pension funds are invested in the water industry, and the impact of the plan for a future government to take over the English water industry at well below market value[4] would have a detrimental effect on the pensions of nearly 6 million pensioners, including 4.1 million public sector workers. The pensioners who would lose out include; local authority workers in Greater Manchester, Merseyside, Lancashire and the West Midlands; shopworkers from Tesco and Marks and Spencer; and former miners.[5]

The impact of a cut-price nationalisation of the water industry would also have serious consequences for investment in the UK. According to analysts, a move to pay a fraction of the industry's true value would 'hurt the global standing of the UK in a post-Brexit world in which the UK is likely to rely on international partners for trade and investment'[6]

The result of these plans would harm customers, pensioners, the environment, and the economy. They could also create an unwelcome and unnecessary diversion of attention and funds from other critical government priorities. Alternatively – as experienced previously – the water and sewerage service would lose out on government funding to areas deemed by Ministers to be a higher priority.

The Big Problems

There are three fundamental problems with *Clear Water's* content, undermining its case and raising questions about its credibility.

1. **It presents a seriously misleading picture of the industry**.

The document's negative portrayal of English water companies since privatisation is based heavily on figures which are either inaccurate, partial or without explanatory context.

In addition, the document exclusively looks backwards, neglecting future planned

[4] I News, *John McDonnell puts price on renationalising the water industry*: https://inews.co.uk/news/politics/john-mcdonnell-puts-price-on-renationalising-the-water-industry

[5] Water UK, *Dramatic fall in support for water nationalisation after revelations on pensions cuts*: https://www.water.org.uk/news-item/dramatic-fall-in-support-for-water-nationalisation-after-revelations-on-pension-cuts

[6] Financial News, *Why Labour's nationalisation plans are a dead end*: https://www.fnlondon.com/articles/labours-water-nationalisation-plans-are-a-dead-end-20190510

improvements. It significantly miscalculates potential bill savings by making a series of errors [7], and the document makes no mention at all about improving services, cleaner water, or other outcomes that are important to customers.

Any credible proposals need to make clear how progress since privatisation would be protected and improved upon. An obvious challenge, for example, would be whether the Labour Party will guarantee to match the improvements planned by companies between now and 2025 - and if so, how that would be achieved given the immediate disruption, loss of investment and exodus of staff that would flow from these plans.

2. The proposals risk seriously weakening the funding of an essential service.

The *Clear Water* model relies on questionable assumptions about the availability of financing and at a decent price.

It fails to explain how future, publicly-financed investment in water would be a high enough priority to prevent a deterioration in services.

There is a real risk that it would lose out to other public spending priorities such as funding for teachers, nurses, doctors, schools and hospitals, resulting in higher long-term costs (or worse outcomes) through delayed repairs and interrupted programmes – just as happened in England before 1989.

Indeed, one of Water UK's publicly-owned members, Northern Ireland Water, is currently experiencing a significant gap between the £1.7 billion investment it identified as necessary and the £990M constrained investment plan which it was forced to submit, which was subsequently underfunded by a further 10%. This is having an impact on growth in Northern Ireland. When asked about the issue by the BBC, Northern Ireland's Department for Infrastructure said that funding for NI Water "has to be balanced against the needs of transport and other services", providing a current example of the problems caused by a constrained public funding pot for state-owned bodies.[8] In England, funding shortfalls of this kind would hurt customer service, leakage, growth, environmental protection, and investment against climate change.

The proposals are also based on questionable assumptions about the cost of borrowing – it would not be as low as the document suggests, and efficiency would be likely to fall.[9]

3. The proposals threaten to put short-term political expediency, rather than the needs of customers, at the heart of future decision making.

If implemented, proposals to remove water's independent economic regulator, combined with other governance changes, would give Government Ministers, local councillors and trades unions a much bigger say in how water companies are run in future.

The document does not consider how this would affect the responsiveness and operation of services for customers, or any safeguards to prevent counterproductive political interventions. It will become much easier to defer or reduce expenditure on vital infrastructure that will not be apparent for years into the future (such as the slow but crucial replacements of pipes), with investment

[7] First Economics, *Private vs Public Financing of Water Companies: A comparative assessment*: http://www.first-economics.com/privatepublicfinancing.pdf

[8] Belfast Telegraph, *Cuts at NI water could stifle housing developments:* https://www.belfasttelegraph.co.uk/news/northern-ireland/cuts-at-ni-water-could-stifle-housing-developments-37452324.html

[9] First Economics, *Private vs Public Ownership of Water and Sewerage Companies*: http://www.first-economics.com/privatepublicwater.pdf

instead diverted into less important areas that have faster or more obvious public impact.

More detailed information on each of these three problems with *Clear Water's* content is set out in the following sections.

It presents a seriously misleading picture of the industry

The document's negative portrayal of English water companies since privatisation is based heavily on figures which are either inaccurate, partial, or without explanatory context; and which only look backwards without also looking ahead to the industry's future plans.

The true performance of the English water industry before and since 1989 fundamentally undermines the document's premise of a broken industry needing a change to public ownership.

The document's claim that **investment** has decreased is simply untrue. It is a claim based on a highly selective choice of years to compare, and only includes investment in water services, excluding the substantial investment made by companies in sewerage services – which are (and would remain) a fundamental part of the water industry. Capital investment quickly doubled following privatisation, with, for example, new sewage treatment works built to address the legacy of the UK as the 'dirty man of Europe' when companies were last under local authority control (see Chart One in the annex). Levels of investment have been sustained at very high levels since, and the UK now has the highest level of water industry investment in Europe.[10]

Household bills have indeed risen 40% in real terms since privatisation, but the document fails to explain that this rise occurred primarily in the first few years to help deal with decades of under-investment when it the industry was in public ownership. Bills then stabilised: average bills are around the same now as they were 20 years ago in real terms, and between 2015-2025 they are projected to <u>fall</u> by around 9% in real terms (see Chart Two in the annex). The average water bill in England is little more than £1 per household per day. The independent financial regulator Ofwat has estimated that average bills are £120 less a year than they would have been without the combination of privatisation and tough independent regulation[11].

On **leakage,** the document fails to acknowledge that, according to Ofwat, the independent economic regulator, leakage is one-third lower than it was in the mid-1990s,[12] leaving the UK roughly middle-of-the-pack compared with EU countries.[13] Companies' have committed to further reductions, saving the equivalent of all the water used daily by all the homes in Birmingham, Manchester and Leeds. They will cut leakage by a further 16% between 2020 and 2025 - the most ambitious leakage programme in twenty years – and halve it by 2050 (see Chart Four in the annex).

The document fails to recognise the progress made by companies to achieve **customer satisfaction** levels for water and sewerage services of around 90%,[14] or the **improvement**

[10] EurEau, *Europe's Water in Figures: An Overview of the European Drinking Water and Waste Water Sectors*, 2018: http://www.eureau.org/resources/publications/1460-eureau-data-report-2017-1/file

[11] Ofwat, *Profit and Dividends:* https://www.ofwat.gov.uk/nonhouseholds/your-water-company/profits-and-dividends

[12] Ofwat, *Profits and Dividends*: https://www.ofwat.gov.uk/nonhouseholds/your-water-company/profits-and-dividends/

[13] EurEau (ibid).

[14] CC Water, *Water Matters,* 2016: https://www.ccwater.org.uk/research/water-matters-household-customers-views-on-their-water-and-sewerage-services-2016/

in key aspects of service, such as a five times reduction in supply interruptions, an eight times reduction in sewer flooding incidents and a 100-fold decrease in incidents of low water pressure.

Similarly, the document is silent on the **environmental improvements** delivered since privatisation, such as a 70% reduction in pollutants to rivers[15] and a big drop in the number of serious pollution incidents caused by water companies (see Chart Three in the annex for other environmental gains since privatisation).

Companies plan to reduce further the number of serious pollution incidents by 90% between 2020 and 2025, while also improving over 8,000km of rivers.

On **tax**, the document fails to mention that companies make a significant direct contribution to the Exchequer in the form of business rates, employers' National Insurance Contributions and any corporation tax that is due. Company corporation tax bills are ultimately paid by customers, so therefore companies legitimately claim significant capital allowances against corporation tax – as they (and companies in every other capital-intensive sector) have been encouraged to do by successive Governments, in order to encourage vital investment while keeping customer bills down.

On **dividends**, the figures used in the document are incorrect. The totals quoted by Labour confuse dividends paid to shareholders with other items, such as interest payments on loans. The document also fails to mention that Ofwat has challenged companies over the next investment period with the lowest-ever cost of capital for any regulated utility.[16] This is projected to cut dividends substantially and allowed returns will fall by a third to 2.4%.

Not only does *Clear Water* fail to properly to credit the sector for what it has achieved and is committed to deliver, it also offers no evidence for how its proposals will improve **key outcomes for customers or the environment**. For example, there is no mention of what the public can expect to see with regard to:

- helping vulnerable customers,[17] whether with fraud, interrupted supply, help with bills, or sorting out debt from missed payments. By 2025, water companies will almost double their support for customers who struggle to pay their bills.

- the long-term challenges of drought and climate change, and the changes to water supply, distribution and demand that are needed to meet them.[18] Water companies in England have committed to end their contribution toward climate change by going carbon neutral by 2030.

- the long-term vision for water quality for people, habitats, recreation and landscape.

- the approach to new threats, like micropollutants from pharmaceuticals and plastics, and how to get the right balance in tackling them between producers and water companies.

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[15] Environment Agency, *The State of the Environment: Water Quality*, 2018: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/709493/State_of_the_environment_water_quality_report.pdf

[16] Ofwat, *PN 32/17: Delivering a decade of lower bills and better service for water customers*, 2017: https://www.ofwat.gov.uk/pn-32-17-delivering-decade-lower-bills-better-service-water-customers/

[17] By contrast, see https://www.water.org.uk/news-water-uk/latest-news/water-and-energy-join-give-more-help-customers for one example of companies' programme of work on this

[18] See https://www.water.org.uk/water-resources-long-term-planning-framework for an example of companies' programme of work on this

- the sector's role in economic growth, and the contribution made to new housing and development, flood risk management, and strategic planning; and as a vital input into industries like agriculture, energy, and food and drink, each with their own supply and quality needs.

- broader water policy affecting consumers, such as putting in place water efficiency labelling of white goods, or standards in new or social homes.

All these issues are being addressed by water companies, including through substantial new investment - £50billion of which is planned by them for 2020-25.

To be credible, the *Clear Water* proposals should at least demonstrate how past improvements since privatisation can be protected and built on - and how those proposals would achieve the same improvements (or better) as those which companies have recently committed to as part of their 2020-25 business plans (summarised in Chart Five of the annex) and in their longer-term water resources management plans.

Clear Water risks seriously weakening the funding of an essential service

The document's central financial claim is that publicly-owned entities would be cheaper to run for two reasons: first, investors' shares in today's companies would be swapped for bonds in new publicly-owned entities; and second, companies existing debts would slowly be refinanced on more favourable terms. It claims this would release money for investment or to cut bills.

The idea that Governments can raise capital more cheaply than the private sector is not in dispute for situations where, overall, public sector finances are prudently managed. But the difference in borrowing costs is because the taxpayer is explicitly responsible for covering the costs of public water companies if they have insufficient funds themselves to repay loans when they are due. Under the current model, water company shareholders shoulder this risk, and this arrangement protects the taxpayer even if it means a small addition to the cost of borrowing.

But the key doubts raised by the proposals are whether *sufficient* capital would be available, and on what terms.

There is good reason to believe that the proposals in *Clear Water* would seriously weaken the financial health of the sector, to the detriment of customers and the environment.

The document fails to explain how future, publicly-financed, investment in water would be a high enough priority to prevent deterioration in services. The future capital needs of the sector in England could represent one-third of all Government capital spend,[19] yet there is a real risk that this would lose out to other public spending priorities such as health or education, resulting in higher long-term costs (and worse outcomes) through delayed repairs and interrupted programmes – just as happened with English Regional Water Authorities in the past until reversed by privatisation (see Chart One), and as Northern Ireland Water is currently experiencing.[20]

[19] Social Market Foundation, *The Cost of Nationalising the Water Industry in England,* 2018: http://www.smf.co.uk/wp-content/uploads/2018/02/The-cost-of-nationalising-the-water-industry-in-England.pdf

[20] Northern Ireland Water was given £990 million from the Northern Ireland public expenditure budget against their proposed investment requirement of £1.7 billion: https://www.niwater.com/annual-report.aspx.

The TfL model *Clear Water* chooses for comparison does not offer an obvious solution to the challenge of **constrained public funding**. Like all Government borrowing, TfL's bond issuance programme is capped explicitly by HM Treasury via the spending review process. TfL has to date issued less than £4billion of bonds in total – a fraction of the £10 billion water companies expect to spend each and every year (half of which, roughly, will be in capital). The more instructive lesson from TfL's financing model may be its annual deficit (now approaching £1bn), and the infrastructure upgrades that have been foregone as a result.

The scale of reduction in financing costs envisaged in the document is highly questionable. The document's claims rely on a 2017 analysis produced by the Public Services International Research Unit[21] (PSIRU), which receives funding from an international public sector trade union group that actively campaigns to reverse privatisation.[22] However, PSIRU's figures assume that company debt would be nationalised - something explicitly ruled-out in *Clear Water*, which instead talks of re-financing debt over an unspecified period of time. PSIRU also assumes publicly-owned companies would be no riskier than Government bonds, yet TfL (*Clear Water's* favoured model entity*)* raises capital at a materially higher price than Government (at spreads of between 50-100 basis points above Treasury gilts).

There are further reasons for questioning the document's claims about financing costs. For example, no account appears to be made of the commitments made by companies and the regulator towards lower dividend payments and decreasing returns (now set to be half those seen in e.g. energy equivalents);[23] nor of companies' use of innovative lower-cost debt like Green Bonds.

In addition, transferring ownership also means transferring financial and performance risk to the taxpayer - including the need for any future urgent investments (e.g. for major repairs due to storm damage or to address service failure). There are recent examples of investors putting large amounts of money into water companies because of operational need. If a government does not guarantee it will fulfil its responsibility as an owner to take on those risks (due to competing claims for public spending), then publicly-owned companies' credit ratings will weaken to reflect the unfunded liabilities – thereby increasing the cost of new investment.

This is further underlined by Ofwat recently asking owners to invest more equity into businesses to strengthen them against the unexpected. The taxpayer would have to bear the costs of matching that approach – costs that are not reflected in *Clear Water*.

Finally, if Government compensated existing shareholders with less than companies' market value (as the document suggests), then two things are likely to happen. First, the increase in perceived risk by investors is likely to further increase the costs to companies of raising new capital. Second, the investment funds that own companies would make significant losses, worth hundreds of pounds to the average household's pensions and savings.[24]

[21] Bayliss, K. and Hall, D., *Bringing Water into Public Ownership: Costs and Benefits*, 2017: https://gala.gre.ac.uk/17277/10/17277%20HALL_Bringing_Water_into_Public_Ownership_%28Rev%27d%29_2017.pdf.

[22] See PSI, *Privatisation:* http://www.world-psi.org/en/issue/privatisation

[23] Based on a Water UK analysis of forecast returns on regulated equity between 2020-25 compared with latest equivalent figures for energy network companies.

[24] See e.g. NERA, *The Impact of Nationalisation of Utilities on UK Households' Savings and Pensions, 2018.* This estimated that nationalisation at regulated capital value would result in a loss to UK pensions and savings of £8.4 billion, or around £310 per household; indirect effects could further increase this by hundreds more per household.

***Clear Water* threatens to weaken the current drivers to improve efficiency, further reducing the scope to sustain investment and/or reduce bills**. The document proposes to replace a proven model for stimulating efficiency through independent economic regulation with an untested approach. That proven model has seen companies improve productivity by 64% - better than the economy as a whole and significantly outperforming comparator sectors (see Chart Seven). This has kept bills £120 lower than they would otherwise have been,[25] with companies committing to further efficiency gains again in their 2020-25 business plans.

Clear Water's proposed increase in staffing levels will lead to higher bills. When combined with the substantial loss of experience from dismissing companies' senior managers (without any evidence for how either of these produce better outcomes), real questions are raised about what this model would mean for the future cost base and efficiency of water companies, and the levels of bills and investment that depend on continually improving both.

Clear Water threatens to put short-term political expediency, rather than the needs of customers, at the heart of future decision-making

Water companies score highly on customer satisfaction and on trust: research by ComRes in August 2018[26] showed that six in seven (86%) adults in Britain say they trust their water company overall. Yet proposals in *Clear Water* for transferring water companies into public ownership include changes to the oversight of water companies which threaten to reverse both the progress made underpinning these scores and the future ability of companies to build on them.

The proposals involve scrapping the independent economic regulator, Ofwat, and absorbing regulatory responsibility into Defra, in what is possibly the first known stripping-away of independent regulation of a utility sector, at least in the modern era.

For good reason, this is inconsistent with how UK publicly-owned water utilities (Scottish Water, for example) currently operate and creates the dangerous prospect of much greater national political intervention in the water sector than at present – with, for example, bill levels set to election rather than investment cycles, leaving companies with shortfalls affecting services and increasing long-term cost.

The document proposes that ownership of water companies would transfer to Regional Water Authorities (RWAs), with boards made up of representatives from local authorities, trades unions and other bodies.

Giving a greater say in decisions to local councillors and Government Ministers could have the unintended consequence of reducing the high levels of trust that people have in their water companies. Research shows two-thirds of the public trust their water company more than their local authority, and more than three-quarters of the public trust their company more than the Government (see Chart Six for details).

The document makes suggestions for transparency and public participation without

[25] Ofwat, Profits and dividends, https://www.ofwat.gov.uk/nonhouseholds/your-water-company/profits-and-dividends/

[26] ComRes interviewed 2,051 GB adults aged 18+ between 19th and 20th February 2018. Data were weighted to be demographically representative of all GB adults. ComRes is a member of the British Polling Council and abides by its rules

referring either to the extensive transparency data already published by companies,[27] the public engagement already happening, or by justifying why changes to further increase participation also need new ownership.

Companies have just finished consulting over five million customers in a major exercise about the improvements they should deliver in their 2020-25 plans, including detailed work with independent Customer Challenge Groups,[28] which typically include representatives from organisations like the Citizens Advice Bureau, social housing providers, councils and environmental bodies.

In addition, it appears that the consultation has been unable to consider the new *Public Interest Commitment* announced by the water industry in April 2019[29] which sets out how the industry will strengthen its ongoing commitment to working in the public interest and placing wider good at the heart of everything it does. The companies have agreed a series of pledges which complements their individual business plans by showing leadership at a national level.

The water industry will champion measures through which water companies can enshrine what it means to operate in the public interest within their business purpose, in line with best practice among leading socially-responsible businesses. This could include steps such as amending licences or Articles of Association.

As part of the Public Interest Commitment water companies have also agreed to work together towards five challenging goals:

- triple the rate of leakage reduction across the sector by 2030
- make bills affordable as a minimum for all households with water and sewerage bills which are more than 5% of their disposable income by 2030 and develop a strategy to end water poverty
- achieve net zero carbon emissions for the sector by 2030
- prevent the equivalent of 4 billion plastic bottles ending up as waste by 2030
- be the first sector to achieve 100% commitment to the Social Mobility Pledge

The *Public Interest Commitment* was created after feedback from communities and national stakeholders who helped frame the ambition for the sector to represent the best in responsible business practice. That means going beyond just regulatory compliance to demonstrate long term stewardship of the environment, deliver social good and give people a meaningful say as companies decide their priorities. This will reinforce the water industry's contract with society.

For more information please contact the Water UK corporate affairs team at comms@water.org.uk

[27] See www.discoverwater.co.uk

[28] See Ofwat, *Ofwat's customer engagement policy statement and expectations for PR19*, 2016: https://www.ofwat.gov.uk/wp-content/uploads/2015/12/pap_pos20160525w2020cust.pdf

[29] Water UK, *Water Industry reaffirms pledge to work in the public interest:* https://www.water.org.uk/news-item/water-industry-reaffirms-pledge-to-work-in-the-public-interest/

Annex: Illustrative Charts

Chart One: Capital investment by water companies

From the establishment of Regional Water Authorities (1974) to privatisation (1989) and beyond.

Sources: Historic data from Ofwat. Projected data from company business plans for 2020-25. Prices are 2016/17. Includes water and sewerage.

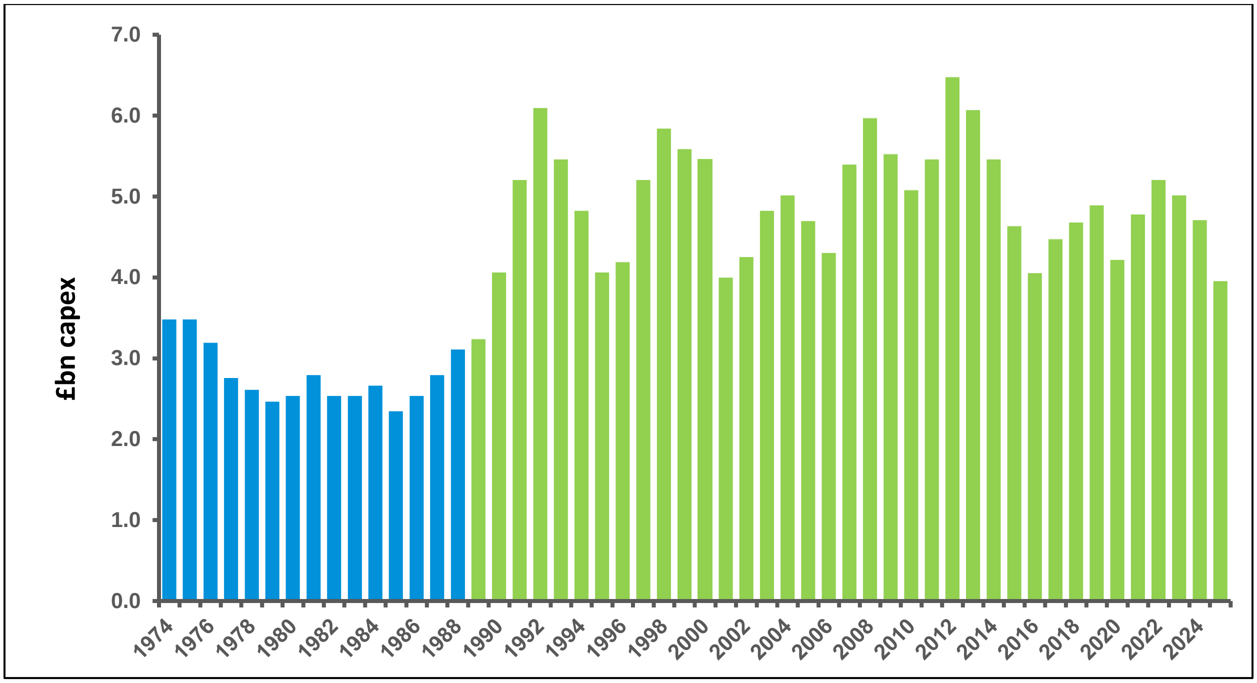


Chart Two: Water and sewerage bills 1989/90 to 2017/18

Price increased in the immediate post-privatisation era to correct an investment deficit.

Source: Ofwat data (actuals) and company business plans for 2020-2025 (projection). Combined bills, all in 2017/18 prices.

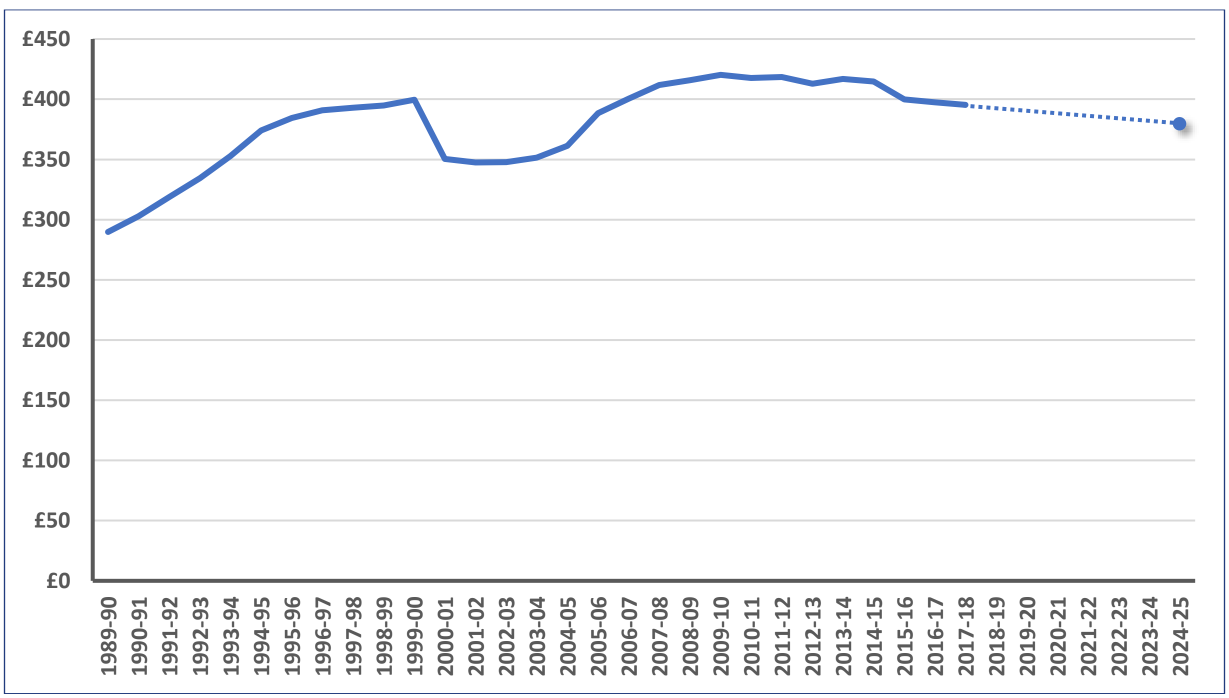


Chart Three: Environmental progress

Source: Green Alliance, *From Blue to Green: How to get the best for the environment from spending on water*, October 2018.
Starting year reflects the point at which data first became available.

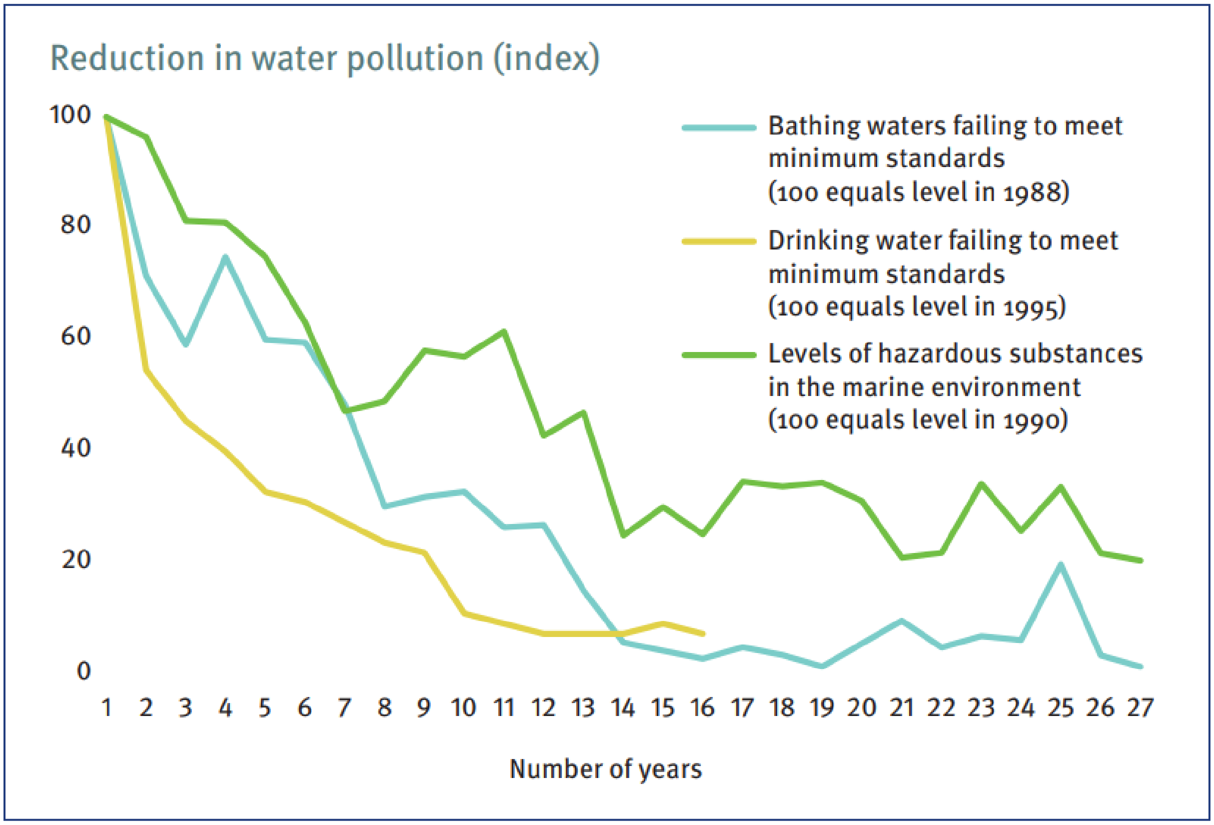


Chart Four: Leakage reduction (UK)

Source – adapted from WRc 2017 (Sustainable Economic Levels of Leakage), from water company draft business plans 2020-25 and Water UK.

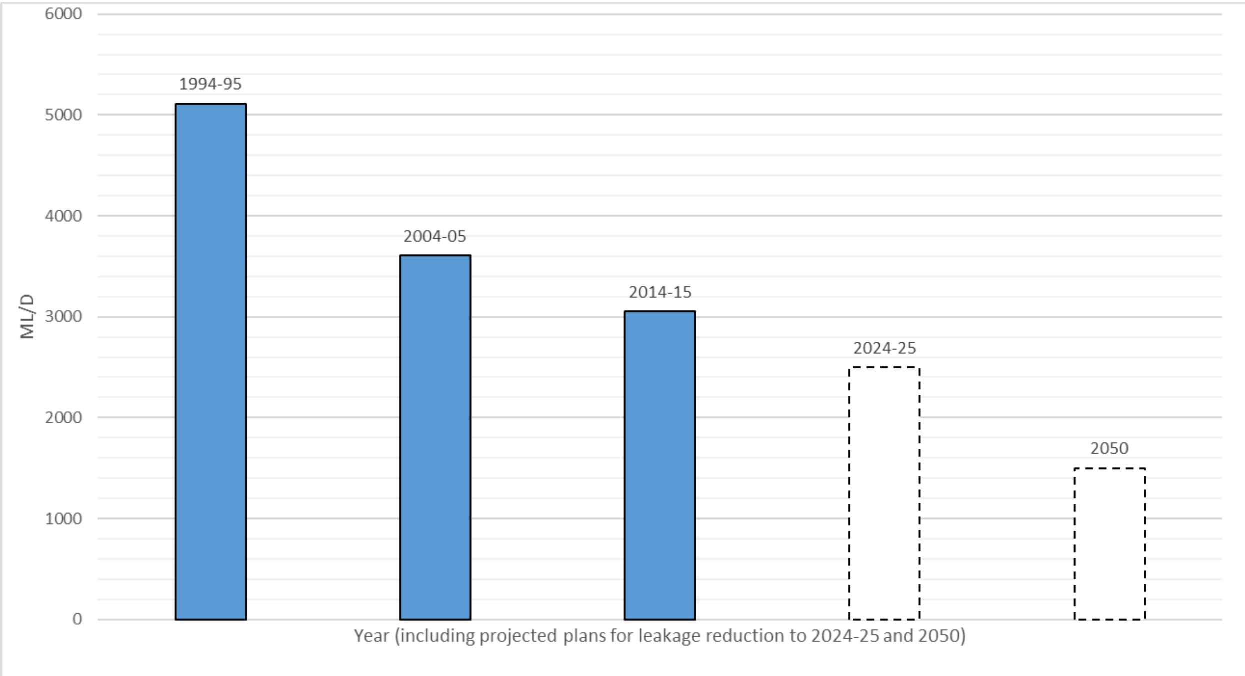


Chart Five: High-level summary of improvements proposed for 2020-25

Source: Water UK analysis of company business plans as submitted to Ofwat on 3 September 2018. Covers English companies (both water-only and water and sewerage). More detail from Water UK website.

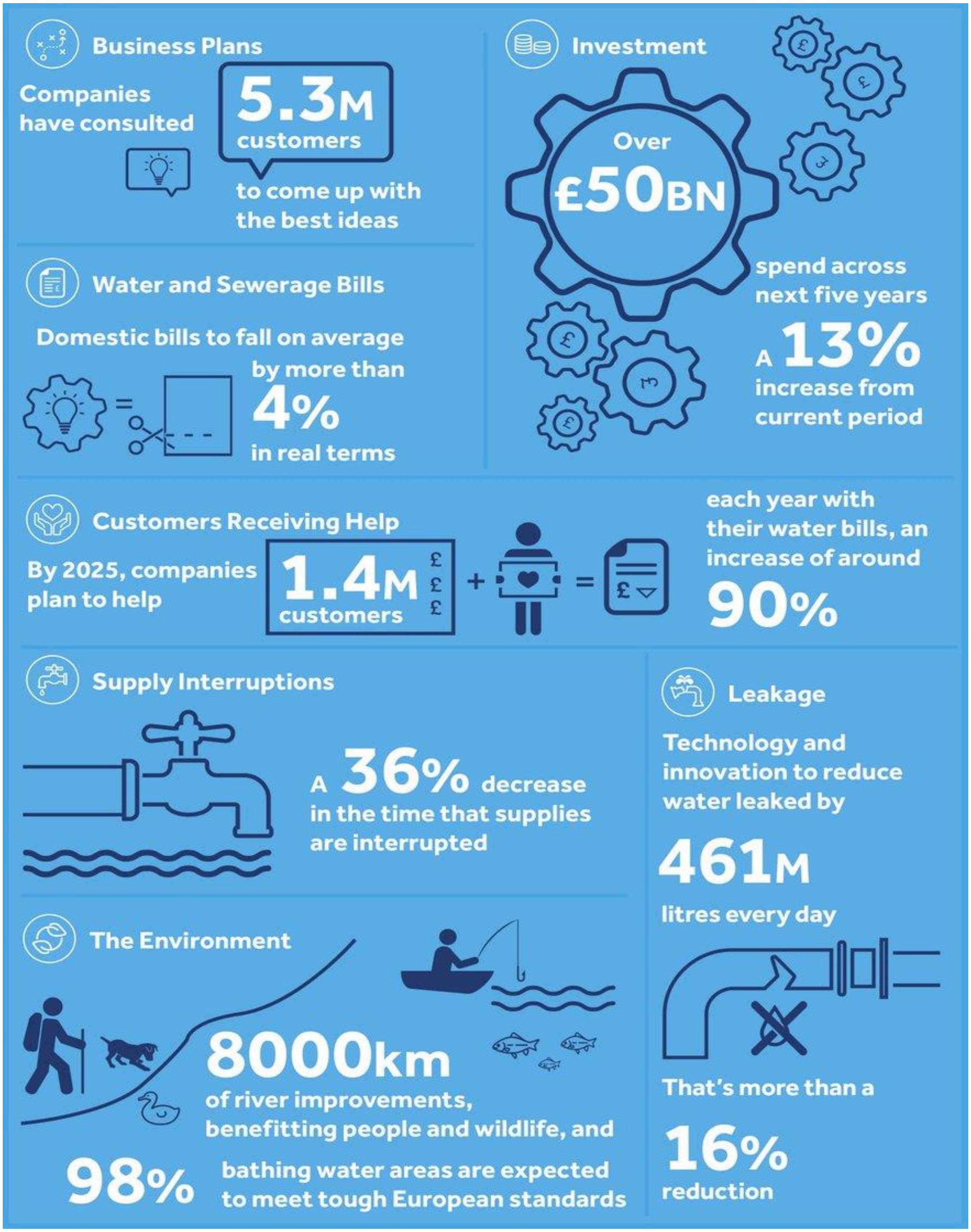
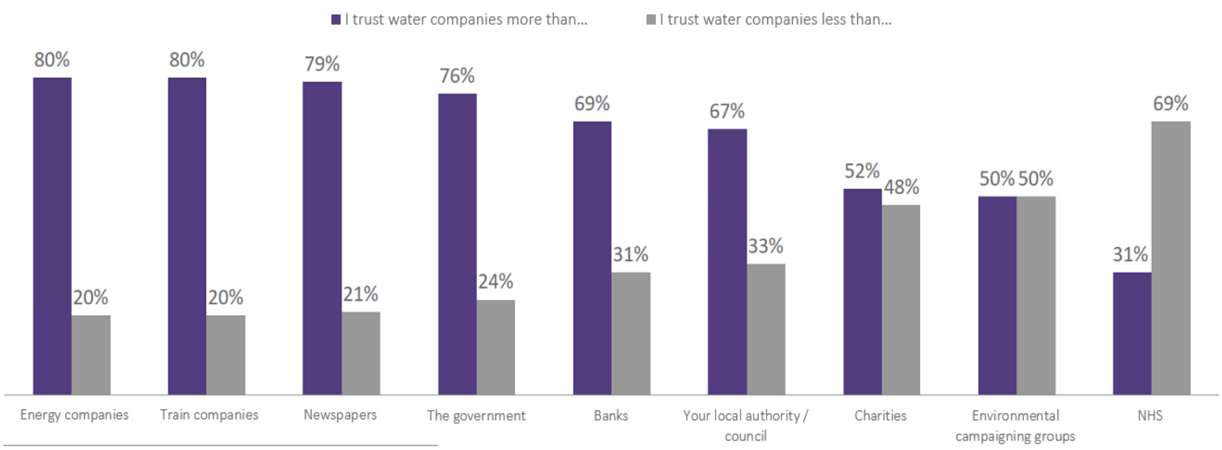


Chart Six: Trust in water companies



Methodology: ComRes interviewed 2,012 GB adults aged 18+ online between 8th – 12th June 2018. Data were weighted to be nationally representative of all GB adults by age, gender, region and social grade. ComRes is a member of the British Polling Council and abides by its rules.

Chart Seven: Productivity of water companies over time

Source: Frontier Economics (2017), '*Productivity Improvement in the Water and Sewerage Industry in England since Privatisation*'