Time to pull the plug on the water privatisation model

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There is a lot of truth in the old adage: "If it ain't broke, don't fix it". Well, it is broken, and it does need fixing, and not just with a lot of sticking plasters as the government proposes. After over 30 years, the privatisation model has run into the sands, and it now needs to be reset for the next 30 years, through to the mid-century and beyond. Fix it and we can have a reliant supply of clean drinking water, proper sewage treatment, and emergency-only sewage discharges.

None of this is beyond us, but without the reset, the water problems are going to go on and on. They will otherwise haunt the next election, and, whoever wins, action will be required after yet more damage has been done.

To find a pathway through all this, there are several obvious steps. First, the diagnosis, and a proper understanding and acknowledgement of what's gone so badly wrong. Second, to revisit the objectives and the requirements for a social licence to operate, and to rebuild trust. Third, a recognition that nationalisation is not the answer, either in the short or the long term. Fourth, a new planning for catchments and an integrated catchment approach. Fifth, a recasting of the regulation and the regulatory institutions to deliver the objectives on a catchment basis and to harness the ability of not just the water companies, but also many others, to contribute to the clean-up, and at lower costs.

The diagnosis of what has gone wrong

What has gone wrong? Pretty much all that could. There is too much pollution, too little investment, too high returns, and grossly excessive executive salaries. All this and no clear efficiency advances over most of the European public sector comparators.

It was not meant to be like this. Privatisation was advertised as the way to "unleash" private investment, outside the public sector borrowing requirement, with ungeared (strictly cash-positive) initial balance sheets to carry the investment so that current customers would not have to pay. It would be pay-when-delivered, rather than pay-as-you-go. The water industry was to be the poster example of the greatest efficiency, so that the efficiency gains would comfortably offset the higher returns that customers would pay for.

There are two versions of this privatisation prospectus: positively, that it would indeed be this wonderful improvement; and, negatively, that not to pursue this path would be to condemn the sector to a dystopian public sector, where it would be starved of investment and very badly managed.

The first version has not materialised. The second is a feeble defence of what has happened. It is not true that other countries have generally starved water companies of investment (though the water sector in Italy may indeed be a terrible example), but even if it was true, we could have had a properly regulated private sector, with: clear and accountable ownership structures; fairly paid executives; a lack of regulation-induced financial engineering; more investment utilising the balance sheets for what they were designed for; reasonable returns; and clear, honest and open environmental reporting, performance and delivery.

For all the talk of the need to recruit world-class managers and pay FTSE100 or indeed world corporate salaries and bonuses, the performance of many of the new privatised managers has been poor and, in some cases, dire – though of course with some notable exceptions. Diversifying into things that they had no knowledge of in the early days, trying to build global businesses, merging with energy networks, and becoming a merger and acquisition (M&A) pass-the-parcel exercise in maximising leverage, all have little to do with actually delivering the services that we, the public, and we, the customers, actually want. The water companies have not even been good at maintaining the assets and fixing the leaks.

The model is well and truly broken, even if it does limp on with regular trips to A&E. The water companies have lost public trust (if they ever had it) and no longer have a social licence to operate. So bad is the public regard, that most prefer re-nationalisation.

The objectives – what we want from the water sector

Surprising as it may seem, there really is no clear set of objectives for the industry. Pre-BREXIT, the UK outsourced the environmental side of this, notably mediated through the major EU directives, like the Water Framework Directive. This enabled the Department for Environment, Food and Rural Affairs (Defra) and its predecessors to avoid having to spell out precisely what government wanted.

The EU directives themselves are very general: they need flesh on the skeletons, and much is better described as aspiration. Games could be played. Claim that most of our beaches are not bathing beaches; and contract out monitoring and compliance to the companies; these are but a sample of the ways to get around EU enforcements, fines and the European Court of Justice.

Worse, the water company licences are vague and general. Try reading one of them, if you can find it. You will not find clear requirements, and hence it is hardly surprising that it has been all but impossible to take legal action against the companies.

With all this in mind, the first and obvious thing to do is to set out clear objectives, which are measurable and enforceable. These are distinct and separate from milestones and targets. For example, reducing storm overflows is an instrumental and intermediate target, not an objective. The objective is clean discharges and biodiverse rivers.

Once the objectives are set, these require detail. What exactly is going into our rivers? The water companies do not precisely measure what is in their discharges of treated water, let alone the raw stuff. Nor is there any baseline of what else is going into the rivers and was already there before the water companies' discharges.

There is also the question of supply. This is not just about clean drinking water, but also how secure the supply actually is. In electricity, there is a clear regulatory regime around security of supply, but not so in water. Only if the required level of security of supply is set can the leakage and the reservoir and other requirements be set. Furthermore, only if the point of supply is defined properly can the system be suitably maintained. It is the water that goes in your mouth that matters, and that involves household plumbing and pipes as well as mains pipes and treatment works.

Meeting this first requirement of a new model in a clear and unambiguous statement of these objectives would be a genuine first for governments and regulators.

Trust and the social licence to operate

It will be very hard to make progress in meeting these objectives unless there is trust and with it a social licence to operate. The model works only if people pay their bills, and vote and act on the basis that these bills are reasonable. It has always amazed me that, given the practical impossibilities of cutting off lots of customers if they do not pay, there is not a widespread strike on paying bills. It would take a matter of weeks to bring the industry to its knees.

Fortunately, there is no tradition in the UK of this sort of political action, but the current dismal public regard for the industry, and especially its management, has made this more likely if there is not serious progress.

The public is treated with disdain when the companies say that the executive bonuses and remuneration are a matter for shareholders. It is not that the amounts of money would make much difference spread over millions of customers. That is not the point. Rather, it is that paying a CEO of a water company £2 or £3 million a year is a *symbol* to everyone else of excess. When the medium income in the UK is around £34,000, £3,000,000 stands out. It is symbolic of greed rather than the pursuit of the public good. The fact that not all of the CEOs are paid at this scale is forgotten. It is the highest paid who hit the headlines.

The public might accept such a number for a major international company facing domestic and global competition. But it is patently absurd to claim that the CEOs of monopoly water companies, with regulators having a statutory duty to ensure that the companies can finance their functions, should be benchmarked against the leading CEOs of FTSE100 companies. Nor is it credible to claim that we have gained some of those apparently very rare international superstars who will change the fortunes of our customer experience and deliver what mere mortal managers cannot. Quite the contrary, we have ridiculously high pay for the top CEOs and too often poor general performance.

What makes all this worse is the escalator – the use of consultants and remuneration committees who decide that they must have (or want) upper-quartile managers. Who, for example, is going to say they want below average? So, each puts their CEO in the upper quartile, and quite soon there is a race to the top on salaries.

When a few CEOs recently voluntarily decided not to take their full bonuses, this is at least the first time that some responsibility is being taken. But on what basis? Minus a presumably temporary one-year halt on bonuses, what is the justification of the remaining just slightly less ridiculous pay package?

To see why this fails the test of public opinion, consider the CEO of Thames Water, Sarah Bentley. She is quoted in the *Financial Times* as saying that she is "heartbroken" over the "unacceptable" raw sewage discharges (and presumably her company's failure to properly report what it has been up to).[1] In any other business a bonus would be out of the question anyway, and should not have passed through a remuneration committee, and more likely such performance might lead to an instant resignation. In water it doesn't. No wonder the social licence to operate has wilted away.

How to get trust back and how to regain the social licence to operate? There are some obvious bits that encourage trust. These include: reasonable salaries and rewards; no financial engineering; simple corporate structures; transparent third-party reporting; and executive accountability of failures.

On salaries, the answer is to benchmark them against those of other comparable businesses – for example, Scottish Water, Network Rail, and the Highways Agency. On financial engineering and corporate structures, each company should be stand-alone without the mass of overlapping entities which describe how much of the industry is owned. Simple, transparent and straightforward: few trust complex structures and for good reasons. They suspect there are reasons for the complexity – hiding returns, dodging taxes and avoiding responsibilities. Third-party reporting is particularly important where trust has gone and incentives to cheat are high. Finally, as the debate on fines has demonstrated, there needs to be a clear line of responsibility. Simple

[1] *Financial Times* (2023), "I'm heartbroken by sewage spills, says Thames Water boss", 27th February.

structures make the responsibility line clearer, and corporate personal responsibility clarifies the incentives wonderfully. Imagine if the CEO of Thames Water was held personally responsible for the "unacceptable standards of service for our customers".[2] It is not hard to think this would radically change behaviours!

Nationalisation is not the answer

The public and the unions and several of the campaign groups and NGOs want renationalisation. Their argument combines matters of principle and matters of costs. On principles, the argument is that water is a public good which should be publicly owned and managed in the public rather than private interest of the shareholders. On costs, it is argued that the cost of capital is lower in the public sector, salaries are lower, and financial engineering circumscribed.

The trouble with these arguments is that the theory is based upon some dubious assumptions. Managers of publicly owned companies are not noticeably more publicly minded than those in private companies. Their behaviour is governed by the incentives they face, and in both cases it is all about regulation. There is also the political imperative for short-term outcomes (especially when it comes to short-term bills) over the medium and longer term. If this argument is indeed correct, it is hard to see why much of the economy should not be nationalised so that it is run in the public interest. Here history is not on the side of the nationalisers. Nationalisation is a means, not an end, and there is a conspicuous lack of detail as to how precisely, once nationalised, behaviour would change.

On costs, it is a bit more complicated. In the case of the cost of capital, there is the cost of debt and the cost of equity. In the case of debt, regulatory asset base (RAB)-based debt is not noticeably much more expensive than government index-linked bonds, not least because the utility debt is asset-backed. In times of crisis, it might actually be slightly cheaper. In terms of equity, the important point is that the equity risk does not go away in the public sector. It just goes somewhere else – to customers and to taxpayers.

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[2] Thames Water (2023), "Thames Water CEO to forgo annual bonus and LTIP payments".

The cost of capital is distinct from the excess returns that water companies have extracted. It is perfectly possible to design a regulatory system that handles the excess returns quite separately from the baseline cost of capital.

On costs and efficiency, it is important to bear in mind that most "works" in the water industry are not carried out by the companies themselves but contracted out. Provided there is competition for contracts, and the contracts are transparent and the benefits accrue to customers, there is no good reason to think that nationalised industries will be better or worse than private ones. In the proposed system regulation model discussed below, the power of competition for contracts is harnessed to drive down costs. Where the public ownership arguments come in is about the design, conduct and contract durations of such auctions to contractors and their monitoring and policing.

As an aside, the one objection to nationalisation which has little merit is that it would cost the government a lot. This is nonsense: it would primarily be swapping of RABs (which are protected by the duty to finance functions) for government bonds. Government would gain the assets and the RABs and swap utility debt for Treasury debt.

Planning on an integrated catchment basis

How well water companies perform needs to be measured against a plan, and a plan that reflects the objectives set by government.

The starting point in planning is to have one. In water there isn't a plan: there is just at best a series of targets – for example, the reduction of raw sewage spills. A plan has a timeframe, and it has to take account of the multiple parties who influence the outcomes. In water there has to be a catchment plan, and that has to include all the main sources of pollution where a key objective is to have biodiversity-rich rivers and hence to severely limit pollution. It is not to be confused with what the government and the Environment Agency (EA) claim when they talk about catchment management plans. It is altogether more serious.

It makes no sense to set environmental targets for water companies without taking account of agricultural pollution, run-off and pollution from other industries, from houses and from developments. Unless there is an integrated catchment plan, the costs are likely to be higher and the objectives may not be attained.

The integrated catchment plans are the way to achieve the objectives and to minimise the costs by finding the least-cost options. In most, if not all, catchments, the costs of any pollution standard are excessive precisely because the end-of-pipe solutions are forced on the water companies. Instead of stopping the pollution at source, and using natural capital ways of handling the effluence before the water reaches the main rivers and then the sewers, the UK approach is to leave the farmers as the one group who expect to be paid not to pollute and against whom enforcement is close to non-existent, and to allow developments without regard to the treatment of domestic wastes, and then wonder why the raw sewage that is released is so horrible, including lots of things like wet wipes and fats that should not enter the sewers in the first place. Similarly, with storm overflows, the focus should be on stopping rapid run-off by designing buildings, roads and other hard surfaces that absorb water, and by putting in place natural capital barriers, filters and trees in upper catchments.

The catchment plans have to be developed by some institution or body, and they have to be owned by that institution or body, which has to have a responsibility to ensure the objectives that the plan is designed to achieve actually are achieved. That requires a catchment planner.

In the catchment approach to regulation, the catchment planner has the licence obligations. It is its statutory duty to achieve them – not the duty of the water companies. This is the bit that should be in the public sector.

In an earlier paper I explain in considerable detail how the catchment regulation model works.[3] For our purposes here, it gets the works done by auctioning and negotiating contracts with the relevant parties – be they water companies, farmers, flood defence contractors and providers, and a host of other bodies, including environmental organisations and local parties. Water companies lose their monopolies and face

[3] Helm, D. (2019), "The systems regulation model", 12th February.

competition from others who may offer to provide the works at lower cost and better quality. They will also compete with each other across the different catchments.

The catchment regulator needs money to pay for these works. Instead of having multiple "buckets" of money – separately for farmers, for water customers from bills, developer contributions, monies for highways and road drainage, for flood defence and much else in catchments, and revenues from carbon offsets, and biodiversity net gain – the catchment regulator integrates these pots into a catchment funding model. It would be almost inconceivable that with this integrated funding mode, more could not be achieved for less. Put another way, it is hard to think of anything more inefficient than having a host of different funding silos, each with its own special interests, lobbyists and political linkages (notably in farming).

Recasting the regulatory architecture and Labour's plans

The Labour Party has flown a kite with leaked plans to merge OFWAT and the EA, minus the flood defence activities of the EA. This is better than the current situation, but it is just better sticking plaster.

Here are some obvious questions about Labour's plan. What about the other regulatory functions of the EA? Where does the EA's inspection and regulatory functions in respect of agriculture fit? Is this new regulator on a catchment or national basis? What will it do differently from now? Will the periodic review still persist on a five-year basis? Who will decide the customer bills? Who will be liable for failures?

Getting rid of OFWAT is almost certainly a good thing. It has not covered itself in glory, though many of its failings lie at the feet of government. Getting flood management out of the EA also has to be a good thing. The EA is not good at it, and it is not sensible to design flood defence spending in line with the Treasury's three-year comprehensive spending reviews. More importantly, Labour's plan gets operational works out of the EA's ambit, and hence the EA board can concentrate on environmental protection.

But this is not enough. The EA should become an Environmental Protection Agency (EPA), and in this new, slimmed-down format, it should probably be merged with the Office for Environmental Protection (OEP). It should enforce environmental legislation, inspecting, monitoring, advising, and fining where there are serious breaches. It should not keep water regulation, the legacy of the botched original Ridley plan for privatisation (via the earlier National Rivers Authority). These bits should go into the remit of the catchment regulators described above.

To summarise, OFWAT should be closed down. The EA should focus on environmental protection as an EPA. The OEP should then be merged into the EPA. That gets rid of two regulatory bodies. There should be new catchment regulators for the main catchments, empowered with the licence obligations transferred to them. They should integrate farming environmental land management scheme (ELMS) subsidies where appropriate. Flood defence works should be split off.

Changing the regulatory rules

It is inevitable that in this new model there will be quite a lot of residual monopoly, at least for some time. Water companies will have new opportunities, but also new competitive pressures. As a result, there will obviously need to be some regulation of the continuing water companies.

There are some obvious ways of doing this. First, as a condition of gaining contracts to do the works, the bidders could be required to meet certain standards of conduct. This could include reasonable remuneration, clear and transparent reporting and monitoring, and so on.

Winning large contracts for residual monopolies would almost certainly be negotiated in large part, at least initially. Negotiated contracts could include profit-sharing, so that there is no repeat of the excess returns. The companies could be required to be financially robust and resilient, and thus gearing could be limited and financial engineering greatly curtailed. Significant equity could be a requirement.

These bidder rules would in essence set out the criteria to be met for a responsible company that is entitled to a social licence to operate.

Note, too, that there would be no bundling of all the different elements into a simplistic five-year periodic review straitjacket. That would go out the window with OFWAT.

This new architecture would cost less to administer, would radically reduce the headcount for the EA (which should also digitalise its environmental protection functions), cut out the costs of OFWAT, and have the advantage of finally extracting some of the efficiency gains from competitive bidding. But most of all it would stop the waste of money from the silos.

Will Defra's plan actually work?

A good plan sets out how to achieve one or more objectives. The objectives are clearly defined, progress is measurable and there is a set of policies to meet the objectives, supported by institutions that are fit for the purposes of the plan.

Having reflected on Labour's plans, what of Defra's latest contribution: *Plan for Water: our integrated plan for delivering clean and plentiful water*[4]? It scores almost zero on all three counts. The objectives are vague and ill defined, the policies are not up to the tasks, they are not integrated, and the 16 organisations involved that are listed out in the annexes are mostly siloed. None is actually in charge of delivering the integrated catchment approach that Defra's "policy plan" claims to be pursuing.

In case you think this is harsh, keep in mind that the big "new" announcements in the document are that the government will legislate to remove the plastic in wet wipes (already promised twice before), increase the maximum fines (with lots of discretion as to how they are actually set), get OFWAT to link dividends to environmental performance, and make shareholders pay for the extraordinary salaries in the sector.

Given the sheer scale of the problems, Defra's plan boasts about the "new funding". Read between the lines, however, and the objectives and the "new" funding are miles apart. What is actually offered is an advance of already agreed spending by the water companies of £1.6 billion. This is not "new money". There is to be a water restoration fund, with moneys from fines for failures, so its income depends upon the plan not being

[4] Department for Food, the Environment and Rural Affairs (2003), "Plan for Water: our integrated plan for delivering clean and plentiful water", 4th April.

properly implemented, and then a £10 million Water Management Grant to fund on-farm reservoirs. Give or take the odd extra million here or there, that's it.

Well not quite, according to the plan the government is going to "unleash" private finance to help. When you see the word "unleash", don't get too excited: finance is money invested with the expectation of a return – i.e. an expectation that customers and taxpayers will pay the interest, the profits and the capital sums back again. Quite how this is going to work is predictably ignored, because nowhere in the plan is there any discussion about the implications for customer bills (or the taxpayer implications if and when they either can't or won't pay).

When it comes to the policies, the old and tired adage that the definition of madness is carrying on the same path in response to failure comes to mind. Why would anyone think that simply shouting out the mantra "integrated catchment plans" and repeating it louder and louder is going to deliver the outcome of integrated catchment plans, with the same regulators, officials and the voluntary stakeholder approach. Neither Labour nor Conservative plans yet add up to a decisive shift. Under Labour's plan the deckchairs may be moved on a bit, but the ship sails on.

The sheer scale of public anger is a once-in-a-30-year opportunity to put it right, reform properly and create a new model that lasts. This is what is not only needed, but practical. Time to pull the plug on the existing model, and move to a model that is fit-for-purpose.

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