



Prime Minister (2)
Ms 167

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:
Your ref:
16 July 1982

De Lee

PRIVATE SECTOR FINANCE FOR THE WATER INDUSTRY

There has been an exchange of correspondence, beginning with my letter of 19 November 1981 to Geoffrey Howe, about how to tackle the problem of cleaning up the Mersey. Under Tom King's direction we are now going to go ahead and approach the North West Water Authority to get their appraisal of the public and private sector costs, and the time scale, involved, both for the estuary and the upsteam part of the river. However, there is one basic point I want to raise again with you and, if necessary, with colleagues.

In your letter of 17 May you seem to assume that I have accepted that we should abandon the idea that a private consortium should build and operate a sewage treatment works on Merseyside. I have not. I am convinced that we should try to proceed in that way. Your position is that you are not against it in principle but you consider that there would be no advantages in practice. You were kind enough to set out your objections in some detail in your letter of 16 April. You said that there would be little scope for savings in construction; little scope for faster progress; little scope for savings from competition; little scope for labour savings in running costs; little scope for getting the public sector out of the project. Let us suppose you are right. All you have done is to acknowledge that to proceed in the conventional way and have the works built by the NWWA would have no advantages either. You are simply defending the established way of doing things and inhibiting any new approach. Everything depends on one's starting point. Yours is a little like that of a guard on the frontiers of the public sector. Mine is that the public sector should not do anything which the private sector can do equally well or better. If one begins by looking at the Merseyside problem with a fresh mind, there is no reason why the private sector should not build and operate a sewage treatment works. There are 28 statutory water companies which successfully meet about a quarter of the demand for water. I would like to see more of them, and in due time I hope to return to that theme.

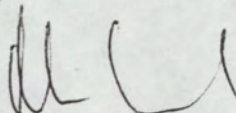
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Public
Guernsey
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In the particular case of Merseyside, there is an additional reason why I am sure that a private consortium would be the right answer. We are all agreed on the importance of discouraging excessive pay increases. We should do everything we can to create the conditions to make that work. A private consortium's wage negotiators' minds would be fixed on making a success of the building contract because the return on capital would be geared to construction costs. They would have no one to pass the costs on to. They would be resistant to irrelevant arguments about what is going on in the economy at

large. There would be the best conditions for the success of wages policy.

Merseyside has been damaged enough by public sector attitudes. I am quite ready to go to colleagues for their ruling on this, but I do urge you to change your mind.

I am copying this to the Prime Minister and Patrick Jenkin.

yes
mw


MICHAEL HESELTINE



local Govt

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Prime Minister

The Chief Secretary remains unconvinced that this is a suitable candidate for private finance.

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Michael Heseltine MP
Secretary of State
Department of the Environment
2 Marsham Street
London SW1

23 August 1982

Wm
24/8

D. Michael,

PRIVATE FINANCE FOR THE WATER INDUSTRY: SEWAGE TREATMENT IN MERSEYSIDE

Thank you for your letter of 16 July. The Chancellor and I have given a lot of thought to this, and to the papers from Ferdinand Mount and Alan Walters. I am afraid we still see problems with the particular proposals, but it is not for lack of enthusiasm for a new approach.

If it would cost the same to build a sewage treatment plant in Merseyside with private finance as with public finance, I should be for private finance every time. You do not need to persuade me that the public sector should not do anything which the private sector can do equally well or better.

But the public sector can raise money more cheaply than the private sector; and in the particular case of the Merseyside plant, I cannot see how private finance could bring savings sufficient to offset its extra cost. My worry is that it would be more expensive to clean up the Mersey with private finance than with public finance.

This follows not from any universal law, but from the physical characteristics of the specific scheme. The plant would be built by private contractors whoever finances it; and once built, it would be run by very few people. So it is difficult to see how private finance could make much difference to the non-financing costs of building or operation: yet on the financing side, it would cost more to raise the money privately than publicly.

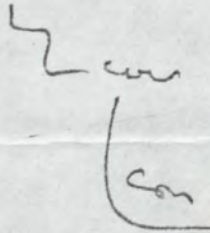
I am attracted by the new point you make that a private consortium would have an incentive to hold down pay. But the private contractors who would build the plant would have that incentive anyway: their contract would surely not be cost-plus.

I also see Ferdinand Mount's argument that, in principle, the private sector might be able to undertake "building-and-treatment" more cheaply than "construction alone". But as I say, building would be private anyway; and in this particular project, treatment would be little more than letting sewage settle in concrete tanks. There cannot be great scope for savings there.

We both want private finance promoted in general; and I am grateful to you for trying so energetically to find applications. But it would do immense damage to our shared objective if private finance came to be associated with higher costs; and I fear that is what would happen in the Merseyside case. It would be no favour to Merseyside consumers.

I am as sorry as you are to come to this conclusion. But this particular scheme really does not seem a good candidate for private finance. I would of course readily reconsider this if any fresh evidence came to light showing that private finance for this project would in fact be no more expensive.

I am sending copies of this letter to the Prime Minister, Patrick Jenkin, Ferdinand Mount and Alan Walters.

A handwritten signature in dark ink, appearing to read 'Leon Brittan', with a stylized flourish at the end.

LEON BRITTAN

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B. B. B.
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24. AUG 1982

Local
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bc: Mr. Mount

259

10 DOWNING STREET

From the Private Secretary

22 July 1982

PRIVATE SECTOR FINANCE FOR THE WATER INDUSTRY

The Prime Minister mentioned to the Chancellor this morning that she had received a paper from Ferdie Mount about the introduction of private sector finance into the water industry.

I attach a copy of this paper. The Prime Minister would be grateful if the Chancellor could give sympathetic consideration to these ideas.

I am sending a copy of this letter (but not enclosure) to Terry Mathews (Chief Secretary's Office, HM Treasury).

M. C. SCHOLAR

John Kerr, Esq.,
H.M. Treasury.

CONFIDENTIAL

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Prime Minister (2)

21 July 1982

Policy Unit

MS 21/7

PRIME MINISTER

PRIVATE SECTOR FINANCE FOR THE WATER INDUSTRY

Michael Heseltine's idea of a private consortium building and operating a sewage treatment works on Merseyside seems to me both imaginative and practical.

The Treasury argues, however, that such a project offers little scope for savings on construction, or faster progress or competition or labour savings on running costs; and that it could never be a genuinely private venture because it would have to maintain contractual arrangements with the water authority.

At worst, as Michael points out, if privatisation offers no advantages over the conventional public sector method, it offers no marked disadvantages either.

But I wonder whether Leon's dismissal of the potential merits of privatisation in this case may be a little hasty.

A private sector sewage treatment works would surely:

- (a) Create some downward pressure on wages in the industry, however slight. A small group of workers would be removed from the water authority negotiations and would have to bargain with private employers who would have a genuine self-interest in bargaining hard.
- (b) Provide an alternative model of providing sewage treatment facilities. The North-West Water Authority and other water authorities would be able to see whether the private sector arrangement did offer savings in construction or operation and, if so, would be encouraged to imitate it.
- (c) Attract private capital into the utilities. The Chief Secretary tends to regard this as a fudge, arguing that there is little real distinction between money so raised and ordinary government borrowing, because of the government guarantees, implicit or explicit, and because of the captive market enjoyed

by a monopoly public utility. But again, if the expenditure is justified at all (as it clearly is in the case of sewage treatment - and sewer construction and maintenance) there can at worst be no disadvantage in raising the money privately. And at best, there is more of an incentive to use the capital economically in order to maximise the return.

The sort of system we have in mind is as follows. The authorities would invite tenders for a sewage treatment plant with a specified minimum and maximum through-put. The tender would be not merely for building the plant, but also for operating it for a period of, say, 10 or 15 years. (The tenders could be split, but leave that aside for the time being.) The contract would specify a payment per cubic meter of sewage treated to a specified minimum standard. These payments could be fixed at the average cost of treatment of other public sewage plants in the area. (Or one might specify a discount of, say, 2% below those values.) Then after 10 or 15 years, the contract price per unit of treated sewage could be renegotiated.

If the "standard" price of treatment, as determined by the average cost of other plants, were considerably higher than the price at which a private operator felt he could deliver, then the bids for the building-and-treatment contracts might be below the bids made under the present-day system for construction alone. Then the Treasury would reap the benefits of the greater efficiency in the private sector.

If, on the other hand, the private sector bids for building and treatment were higher than the bids for construction alone plus the specified standard payment for treatment, then Leon's propositions would be established. It would then be best for the plant to remain in the public sector. But this certainly would provide a fair test.

In general, the Treasury seems to me to underestimate the dynamic, innovative effects of even the imperfect competition which may be achieved in such a situation.

If the water authorities begin to make a habit of privatising their sewage treatment facilities, more firms are likely to be attracted into the business and more ingenuity will be expended in ways of

building and running them more cheaply and effectively. The fact that minimum standards of design and maintenance will still have to be ensured by the authorities is no more of an argument for continued nationalisation than weights-and-measures or food-and-drugs laws are arguments for nationalising greengrocers.

I am copying this note to Leon Brittan, Michael Heseltine and Patrick Jenkin, who have seen the previous correspondence.

fm

FERDINAND MOUNT



Local Govt

10 DOWNING STREET

From the Private Secretary

19 July, 1982.

Private Sector Finance for the Water Industry

The Prime Minister has seen a copy of your Secretary of State's letter to the Chief Secretary dated 16 July.

Mrs. Thatcher notes your Secretary of State's view that there is no reason why the private sector should not build and operate a sewage treatment works. She has commented that, if this really were to be done by the private sector, there would have to be no public guarantee.

I am sending copies of this letter to Jonathan Spencer (Department of Industry). and Terry Mathews (Chief Secretary's Office, HM Treasury).

M. C. SCHOLAR

David Edmonds, Esq.,
Department of the Environment.

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