



10 DOWNING STREET

Prime Minister

There are bound to be  
press reports of this meeting.

Water is a reasonable  
candidate for privatisation.  
But water and sewers are  
very emotive. In view of  
the growing unease about  
the privatisation programme  
it seems to me important  
that there should be  
clear conclusions on the need  
for a fully adequate  
regulatory framework. What  
that means can be argued  
about separately.

DSV  
18/11

PRIME MINISTER

PRIVATISATION OF THE WATER AUTHORITIES : E(A)

E(A) will consider privatisation of the water authorities tomorrow. We had a seat on the official committee at DoE which examined the issue. The proposals in the paper from Kenneth Baker, Nicholas Edwards and Michael Jopling are:

a) that the water authorities should become public limited companies and should be privatised as they stand, without boundary changes and without separating out the regulatory functions, because the principle of one authority handling the supply of water and the sewerage in each river-basin catchment area has proved successful and is the envy of overseas water experts;

b) that the water authorities should be economically regulated by price, because this gives water authorities, which will be local monopolies, the biggest incentive to keep operations efficient and costs down;

c) that Ministers will keep their responsibility for environmental policies to do with water supply and sewers, and will have power to see that water authorities carry those policies out, because, although water supply can and should be done privately, water is bound to remain an issue of political interest.

Water is a good candidate for privatisation because:

\* many, though not all, of the water authorities are already in good shape for private ownership and do not need a long period of elaborate restructuring;

\* the water authorities, between them, own substantial assets and employ more than 50,000 people, so they will make a big contribution to the privatisation programme;

\* the water authorities say they need to invest in renewing their assets faster than Treasury constraints permit, and privatisation would free them from those constraints and allow them to borrow from the private market for future investment, yielding more spending on Britain's now-fashionable "infrastructure" without any adverse effects on the PSBR;

\* We would not be selling off a national monopoly (like BT) because the performance of each of the 10 water authorities can be measured against that of the others, introducing an element of competition at the margin not unlike that of the four regional groupings of railway companies before nationalisation;

\* the general advantages of privatisation, such as wider share ownership by the public and employees, removal of State interference, and realisation of assets, apply with full force.

You may get some arguments against water privatisation on the grounds that it is not worth the hassle, that it will not yield much to the Exchequer or that the legislative programme for 1986/7 is going to be too crowded.

We think you should meet such arguments by saying that water privatisation is certainly worthwhile, that it will yield substantial sums to the Exchequer (the Treasury have calculated that the net present value could be worth up to £9bn); and that many

of the water authorities are themselves keen to be privatised so  
that they can speed up their investment in renewal of assets and  
serve the customers better.

Water authorities should be a firm part of the privatisation  
programme, and the scheme recommended by DoE/Wales/Agriculture is  
sound.



CHRISTOPHER MONCKTON

18 November, 1985.



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PRIME MINISTER

E(A) (85) 22nd Meeting:  
Privatisation of Water Authorities  
(E(A) (85) 64)

## BACKGROUND

There has so far been no specific commitment to privatisation of the water industry. There is, however, a general expectation that it is an early candidate on the government's list and Mr Hattersley singled this out for particular criticism in the Debate on the Address on 13 November.

2. The Government's public position is as follows. On 7 February 1985 the then Minister of State, Department of the Environment, Mr Gow, said in the House that he would 'be examining the possibility of a measure of privatisation in the water industry'. Following this the Department of the Environment issued a consultation paper in April, to which the water authorities, trade unions and industrial interests concerned, and others responded. This was followed by an interdepartmental official study, on which the Secretaries of State for the Environment and Wales and the Minister of Agriculture have now drawn in putting forward their paper.

Nature of Water Industry

3. In addition to the primary public service tasks of the supply of water and the provision of sewerage facilities, water authorities are responsible for water resource planning and control; river water quality and pollution control; fisheries, navigation, recreation and conservation; environmental improvements; and land drainage and flood defence. These latter functions account for only about five per cent of water authorities' total costs, but the activities, and the charges made for some of them, can have an important impact on particular individuals and businesses as well as on the environment more generally.



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Case for Privatisation

4. The balance of considerations to be weighed up in reaching a decision on the privatisation of the water authorities was summarised as follows in the report by officials:

"The benefits of privatisation are of a general character - freeing the water authorities from state control, motivating management and employees with a spirit of enterprise, increasing share ownership, and reducing the size of the public sector. But it must be noted that given the monopoly character of the water authorities in providing basic services, the scope for genuine competition does not exist except at the fringe; nor is there great scope for further efficiency improvement in most water authority operations, except where this is the result of cost - saving investment.

The difficulties inherent in privatisation stem essentially from the need to deal satisfactorily with the whole range of public good and regulatory functions which go to the heart of the authorities' activities, and from the present financial situation of some of the authorities, particularly North West, South West and Wessex. The authorities' public good and regulatory functions have until now always been in the hands of accountable public bodies; the choice lies between retaining these functions in the public sector and so losing the advantages of integrated river basin management, or leaving them with the authorities when privatised, but controlled by a system of licensing and regulation which because of the scale and range of activities to be covered would inevitably be complex. For privately owned corporations to be responsible under licence for making and enforcing public policy would be to break new ground. The need to demonstrate that the public interest was being properly safeguarded points to a strong regulatory mechanism."



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Proposals

5. The specific proposals put forward by the three Ministers may be summarised as follows:

(a) each of the present water authorities in England and Wales should be privatised in its entirety as a separate Water Service Public Limited Company (WSPLC);

(b) a body analogous with OFTEL should be created to regulate the WSPLCs by means of a licence. Charges to consumers would be regulated by means of some kind of RPI minus x formula; with the exception of flood defence and land drainage, the WSPLCs would retain all their present powers and functions;

(c) Ministerial responsibility for water environment policy would be retained. WSPLCs would need to seek Ministerial approval for their water resource plans, and for their own abstractions from the discharges into rivers, while a right of appeal to Ministers against the companies' decisions on abstractions, discharges, pollution charges, etc would be retained;

(d) to end the present statutory presumption that district councils will act as water authority agents for sewerage;

(e) to establish new Regional Land Drainage Committees to finance and coordinate flood defence and land drainage, with the work being contracted out as appropriate to WSPLCs or others.

6. On timetable, E(A)(85)64 proposes:

(a) a White Paper before Christmas as a basis for further consultation;

(b) legislation in the 1986-87 Session;



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(c) incorporation of all water authorities as WSPLCs as soon as possible after Royal Assent; and

(d) sequenced flotation of all authorities, with one or more (in whole or part) within six months of Royal Assent.

#### MAIN ISSUE

7. The essential issue is whether or not to go forward with plans for the privatisation of the water authorities on the basis proposed by the three Ministers.

8. Privatisation of the water authorities is a different, and in some respects more complex, exercise than the privatisation of, say, Telecom or BGC. Partly this reflects the fact that there are ten water authorities, whose problems and activities differ widely. More substantially, however, it reflects the fact that, unlike Gas and Telecom, the water authorities are not engaged exclusively in providing a particular commodity or service to their customers on terms which reflect the customers' use of that commodity or service. Although the provision of water is closely analogous to that of gas, only a small minority of domestic consumers pay a metered charge for their water rather than what is in effect still a surcharge on local rates. The analogy is even less close for sewerage (where domestic charges are all based on local rates), and there is no real parallel between the wide range of 'public good' functions water authorities undertake, and the activities of the other privatised utilities.

9. As an alternative to privatising the water authorities as they stand, the official study also examined the possibility of restricting privatisation to the main operational functions of water supply, sewerage and sewage disposal. Under this arrangement the existing water authorities would be retained to undertake the policy and regulatory functions which may appear to be more naturally at home in the public sector, while being required to franchise out the operational activities.



Officials recommended against this, however, on the grounds that it would mean giving up the benefits of integrated river basin management, and would require an upheaval in water authority organisation which would delay privatisation for a considerable period.

### Regulation

10. This is perhaps the most difficult and complex issue. Control of water and sewerage charges presents many of the same problems as control of gas or telephone charges, and the price regulation will need to incorporate a stimulus to efficiency while at the same time generating sufficient profit to support a large and expanding investment programme. Decisions will also be needed, however, on the extent of the financial regulator's responsibilities in the environmental area. The licence will require the companies to continue to fulfil the public policy functions now undertaken by the water authorities; and the question will arise how far the financial regulator should monitor their performance, given that the Government will continue to be the ultimate environmental regulator. The financial regulator will also need to be involved in determining equitable arrangements whereby the companies can recover the costs of those of their operations which do not involve the direct provision of services to consumers. Assurances will be needed that the companies will discharge their wider responsibilities (eg through pollution controls and charges) in the interests of the specified policy objectives (water quality, environmental protection, etc) rather than in the interests of their own shareholders.

### Financial implications

11. The current cost value of the water authorities' assets is put at £30 billion. The authorities are currently investing £850 to £900 million a year, and an ambitious programme is under way to increase the real returns they earn on their assets, which will require substantial real increases in charges phased over a period of years. From 1987-88 onwards, current Government plans provide for the water authorities as a whole to be self financing (ie they would earn sufficient profits



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to finance an annual investment programme of about £1 billion without any further borrowing). Overall there is little scope for increases in the volume of the business, or in the productivity of its assets; but there remains a large need for replacement and cost-saving investment, given the great age of much of the present infrastructure.

12. Preliminary merchant bank advice is that the WSPLCs, with these characteristics and prospects, would need to be marketed as public utility stock guaranteeing a steady real return rather than as exciting equity stocks with growth prospects. On this basis Schrodgers estimate the net proceeds at about £5½ billion, after allowing for meeting unfunded pension liabilities. They see the stock as yielding a premium of about 3 per cent over indexed gilts (ie a real yield of about 6 per cent a year). There must be some question about the rate at which the market would be ready to absorb stock of this kind; in the case of BGC, Rothschilds' advice has been that only 50 per cent of the shares could be sold, and at a relatively low price, if there were close price regulation over all BGC's sales. On the other hand, there is no doubt considerable scope to encourage individual householders to take up small stakes in the privatised water authorities.

13. Although no decisions need to be taken now, further consideration will need to be given to the outlook for water charges after privatisation. One possibility might be to go for less ambitious improvements in real returns on assets, and smaller increases in prices; but this would mean a continuing need for external finance, and a substantial reduction in the potential proceeds. The eventual regulatory price formula will determine the outcome.

#### Statutory Water Companies

14. A quarter of the population of England and Wales receive their water supplies from 30 statutory companies (which have always been in the private sector, and which were effectively under the direction of the water authorities). It would be natural for these companies to be absorbed by the WSPLCs; but seeking to achieve this through the



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privatisation Bill would almost certainly present problems of hybridity. The three Ministers therefore conclude that this problem will have to be dealt with later.

#### Sewerage

15. Local authorities had responsibility for sewerage prior to 1974, and would like it to be returned to them on privatisation. In most cases sewers, though owned by water authorities, are maintained and operated by district councils on an agency basis. E(A)(85)64 recommends that WSPLCs should be free to employ local authority agents or other franchises as they choose; in practice, local authorities will no doubt continue to be employed, but they are likely to oppose this aspect of privatisation.

#### Consumer Consultative Committees

16. New arrangements are proposed to make these Committees independent of the water authorities who currently appoint them. A careful course will need to be steered to provide sufficient reassurance to consumers without upsetting potential investors.

#### The balance of the argument

17. As paragraph 2 of the annex to E(A)(85)64 makes clear, the case for privatisation rests on the reduction of the size of the public sector, the removal of Government constraints on the way the business is run, the greater incentive within the business for efficiency, and the scope for wider share ownership. Privatisation of the water authorities, however, raises a number of new issues; it would be novel to make private companies responsible for public policy functions not directly connected with the services provided to customers, and assurances would be needed that environmental objectives would be as well secured as under the present arrangements and that adequate protection would be given to industrial and farming interests against unreasonable behaviour by the privatised companies. This is likely to mean rather

complex regulation, with a substantial economic regulatory apparatus combined with a greater detailed involvement by the Department of the Environment than hitherto. Arrangements for water charges will also need to reflect the Government's decisions on changes in the financing of local authorities, whose practices the water authorities have hitherto followed. Finally, privatisation will not remove the problem that the costs of infrastructure renewal will require continuing relatively high charges; this may have some implications for the wider public perception of the impact of privatisation.

#### HANDLING

18. You will wish to invite the Secretary of State for the Environment to introduce E(A)(85)64. Thereafter the Secretary of State for Wales and the Minister of State for Agriculture may wish to add their comments. The Financial Secretary, Treasury will wish to speak from the standpoint of the privatisation programme as a whole, and the Secretary of State for Trade and Industry will wish to give his views on the regulatory protection of domestic and industrial consumers. You might wish to ask what was to be done in Scotland, where all the water authority functions still remain with the local authorities. The Lord President of the Council, the Chancellor of the Duchy of Lancaster, and the Lord Privy Seal may all wish to speak on the political and Parliamentary aspects of the proposals.

#### CONCLUSIONS

19. You will wish the Sub-Committee to reach conclusions on the following matters:

1. Whether to press ahead with plans to privatise the water authorities broadly in the way and within the time scale proposed in E(A)(85)64; and
2. Whether any further specific guidance should at this stage be given for the follow-up work on -



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- (a) the discharge of continuing Ministerial responsibility for water environment policy;
- (b) the retention of flood defence and land drainage as direct public sector responsibilities;
- (c) the role of district councils in relation to sewerage;
- (d) aspects of economic and environmental regulation; and
- (e) questions related to the financial structure of the privatised companies and the terms of the offer for sale.

J B UNWIN  
Cabinet Office.  
18 November, 1985



PRIME MINISTER

THE PRIVITISATION PROGRAMME

I have read E(A) (85)26 in which the Chancellor reviews the present state of the privatisation programme. Unfortunately, I am unable to attend the meeting at which the paper will be discussed.

I am writing to draw attention to one aspect which causes me some concern, namely the suggestion (in paragraph 3) that we are now in a position to "firmly endorse" the inclusion of the water industry in the privatisation programme. The present position is reflected in the inclusion of 'Water Authorities' in the list (B) of Major Candidates Not Yet in Current Plans. The note (B6) on the Water Authorities draws attention to the work of an inter-Departmental group which has been set up to study the issues involved and we shall not be in a position to take a discussion on the inclusion of the water industry in the privatisation programme until we have considered the group's report.

From my own knowledge of the Welsh Wter Authority I anticipate that privatisation will not be straightforward. For this and other reasons I submit that we are not yet in a position to "firmly endorse" inclusion of water authorities in the privatisation programme.

... I am copying this minute to the Chancellor of the Exchequer, to members of E(A) and Sir Robert Armstrong.

14 May 1985

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R N E

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