P. 01400

PRIME MINISTER

Flag A+B

Water Strategy
(E(NI)(84)13 and 15)

BACKGROUND

Until the mid-1970s, when the Regional Water Authorities (RWAs) were set up in England and Wales, water and sewerage were regarded as largely local authority responsibilities, as they still are in Scotland. They still retain features of the local government system: in particular, the great majority of domestic consumers pay water charges based, not on their consumption, but on the rateable value of the property they occupy. It was only last year that the RWAs were brought under the same control regime as the other nationalised industries.

Flag C

2. The Sub-Committee discussed strategic issues for the industry in July (E(NI)(84)4th Meeting, Item 3). The Secretaries of State for the Environment and Wales proposed then:

i. that investment in water services should increase to a level 5 per cent above the present level over five years so as to make progress towards environmental aims.

ii. A real rate of return on new investment in water services lower than that required of the other nationalised industries should be accepted (3 per cent, as against 5 per cent); and existing assets should be required to earn only 1 per cent in real terms.

3. The Chief Secretary, Treasury (in E(NI)(84)10), opposed these proposals. He argued, in particular, that the RWAs,

like other nationalised industries, should be required to earn 5 per cent in real terms on their assets, though he accepted that a move to this level would have to be phased over ten to fifteen years. He suggested that a charging policy based on this approach would provide substantial savings for the Public Expenditure Survey.

4. The Sub-Committee decided in July:

i. that RWAs should be required to earn a rate of return of 5 per cent on new capital assets; and

ii. that they should return to discuss the other issues (raised in E(NI)(84)7 and 10) in September on the basis of a study of the implications of a general introduction, over a suitable period, of water metering. The study was to include cost, implications for financing the industry and for charges; and incentives to consumers and others to encourage a move towards general water metering.

5. These remits are dealt with by the Secretaries of State for the Environment and for Wales in E(NI)(84)13. The Chief Secretary, Treasury's views are in E(NI)(84)15.

MAIN ISSUES

6. Main issues are:

i. what should be decided about issues still outstanding from July, namely:

a. what provision should be made for capital investment by the RWAs?

b. What is the desirable rate of return on the existing assets of the RWAs, bearing in mind the consequences of the decision for water charges?

ii. What further action should be taken on metering?

Investment

7. The proposals by the Secretaries of State for the Environment and for Wales in paragraphs 6-10 of E(NI)(84)13 call for greatly increased levels of investment compared with those they proposed in July - an increase over five years to levels 20 per cent higher than current ones (the increase they proposed in July was 5 per cent over the period, although they did suggest that more investment might be undertaken if resources permitted). On the face of it, this increase seems too great to be explained by the new factors at paragraph 8 of E(NI)(84)13: in July the RWAs said that current levels of investment were adequate to maintain present standards for five years. The increase now proposed would mean in effect that the full amount raised by requiring a rate of return of 5 per cent on new assets from 1985 would go to water investment; and not, as earlier proposed by the Chief Secretary, Treasury, as a benefit to public expenditure generally.

8. The Chief Secretary, Treasury proposes EFL savings as set out in paragraph 6 of E(NI(84)15. He is prepared for these EFL reductions to be accompanied by increased investment either at the levels now proposed in E(NI)(84)13 (ie 5 per cent growth a year) or at the lower level proposed by the sponsoring Secretaries of State in July (1 per cent a year). The difference comes out in charges to consumers, the effects on which of the various options under discusssion are shown in the Annex to E(NI)8(4)15. The higher level of investment would involve a 4.5 per cent real increase in charges next year; the lower level a 3 per cent real increase.

9. Charges, together with operational needs and the priority they should be afforded, given the need for public expenditure savings, will thus be key factors in deciding levels of investment and the EFL levels which should be set along with them. On the one hand, as the Chief Secretary, Treasury, says, the effect of higher charges

on individual consumers is small. On the other, water bills, perhaps because they are not closely related to consumption and are perceived as akin to domestic rates, may be disproportionately contentious; and it may be argued that consumer reistance would be stiffened if, in the aggregate, large financial surpluses were generated in excess of the amounts reinvested. There is an obvious attraction in being able to explain increased water charges in real terms at least in part by reference to increased investment.

Financial targets

10. As in July, the Secretaries of State for the Environment and for Wales argue that the return on water authority assets existing at 1 April 1985 should be kept at about 1 per cent of their current valuation. They argue that RWAs have substantial social and environmental responsibilities. For this reason, and because of the long life and low risk of the investment, a lower rate than that required of other nationalised industries is justified. Moreover, large increases in charges which would occur if a higher rate of return were required would be inflationary and would be misunderstood and disliked both by the industry and by consumers.

11. The counter-arguments also remain the same, in essentials, as in July. The Chief Secretary, Treasury, argues that the same 5 per cent rate of return should be required as of nationalised industries, though he recognises that the effects of the change would require it to be phased over up to fifteen years. He points out that the required rate of return of 5 per cent does not reflect financial risk but is a measure of the opportunity costs of capital; and argues that the cash and Retail Price Index effects of the increases in charges claled for by his proposals would be almost negligible.

How to proceed

12. You will not want to spend time on a theoretical discussion on the rate of return on existing water industry assets which might eventually be achieved in the year 2000. There is agreement on a 5 per cent rate of return on new assets. A decision on how far and how

fast the rate of return on existing assets might be increased could perhaps be left until it becomes clearer whether widespread metering (see below) would be feasible, since this would provide a better link between charges and the demand for water services. The immediate requirement is to agree on a path of investment and charges over the next three years which is both politically acceptable and consistent with the need to restrain public expenditure. Is it agreed that there should be some increased investment and some real increase in charges over the next three years? If so, what real increase in charges would be politically tolerable? Having set that constraint the Sub-Committee would then leave it to the Chief Secretary, Treasury and the two water industry Ministers to settle the details of the EFL, reconciling the desire for more water industry investment with the need to restrain public expenditure.

Metering

13. The report by officials at Annex A to E(NI)(84)13 points up a number of considerations which prevent clear conclusions from being drawn on the basis of earlier work about the technical, financial and other implications of a move to metering. The Secretaries of State for the Environment and Wales propose a full feasibility study followed by a further report to the Sub-Committee. The Chief Secretary, Treasury, is content to proceed in this way. As time will be short, you may wish simply to record the Sub-Committee's agreement to the work proposed and establish how long it is likely to take.

HANDLING

14. You will wish to ask the Minister of State, Department of the Environment, and the representative of the Secretary of State for Wales to introduce the discussion. The Chief Secretary, Treasury will wish to respond. The Secretaries of State for Trade and Industry, Energy and Transport may have comments as Ministers sponsoring other nationalised industries. The Secretary of State for Scotland may have comments on the implications for the water industry in Scotland, which is organised quite differently from that in England and Wales. The Secretary of State for Trade and Industry may have views on the implications for water charges to industry.

CONCLUSIONS

15. You will wish to reach conclusions on the following:

i. what should be the path of water charges and investment over the next three years;

ii. what, if anything, should be said to the water industry at this stage about the rate of return to be achieved on its existing assets;

iii. whether there should be a full-scale feasibility study of metering.

PLG

P L GREGSON

2 October 1984