Evaluating the Privatisation of the English and Welsh Water Industry

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Abstract

The privatisation of the ten large water authorities in England and Wales is assessed in terms of some of its costs and benefits. Particular attention is paid to claims that privatisation would lead to less regulation, more competition and improved water services for consumers. The conclusions are that privatisation of water services was costly to tax payers, led to more economic regulation and inadequate environmental regulation and did not significantly increase competition in the provision of water services.

1. Introduction

The water industry internationally is confronting the same reform issues as it is in Australia. These include preserving the water environment while improving the economic efficiency of the industry, and improving the quality of its services. The priority in reform in the countries where the most radical reform has taken place, like the United Kingdom has been the achievement of economic efficiency through reorganising existing institutions. This paper will assess the case of England and Wales, to review

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https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

its effectiveness. The benefits in terms of gains in economic efficiency, improvements in water services quality or higher environmental standards are not yet, as we will show, readily apparent, indicating a number of important lessons for similar reform strategies if they are adopted in Australia.

Privatisation of public sector activities was a key component of the Conservative Government's reform programme in the United Kingdom in the 1980s. The disposal of public sector assets to private investors, generated £77 billion of revenue from sales from 1979 to 1991 and was a central element in the government's overall economic and social policy package designed to reduce the size and scope of government activities; provide the resources to reduce and redistribute the incidence of taxation; stimulate competition and private sector activity and more broadly switch macroeconomic management from a fiscal (and regulatory) to a monetary (and market oriented) focus (Whitefield, 1990, p. 181). A measured assessment of all the possible economic and social consequences of the privatisation was, however, not a feature of the preparation for the privatisation programme in Britain. The programme was driven by political imperatives that ranged from the desire for the immediate realisation of the market ideology of the leadership of the Conservative Government; to the the urgent necessity of generating resources to pay for the cuts in taxation and other elements of their reform package. The resulting process of privatisation of the water industry in England and Wales, and its consequences, indicate some of the costs and benefits for taxpayers, water consumers and the population more generally from privatisation.

2. The Structure of the Industry

With the introduction of the Water Act of 1973 the 1,395 separate sewerage authorities, 157 different water supply utilities and 29 river authorities in England and Wales were amalgamated into 10 integrated water authorities with water and sewerage service functions and water environment regulatory responsibility. Water service provision in Northern Ireland was, and continues to be undertaken by the Department of Environment and in Scotland by regional local governments. In addition to the ten major authorities, the industry in England included 29 privately owned water supply companies, like Cambridge Water, that continue to account for a quarter of England's water supply (although there are now only 27 of these companies as two have been absorbed by others). The advantages of the amalgamation of the industry in 1973 were perceived to be the benefits of achieving economies of scale on costs and prices, enhanced central government control to improve the economic and social returns from the

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

authorities and the benefits for resource management and the environment of integrated river basin management of water resources.

The size and scope of operations of the companies water authorities created in 1973 varied greatly. The areas covered by each authority, population served and services supplied vary widely as a result of different geography, climate, population distribution and industrial composition of each region and the degree of overlap with the operations of the private water supply companies. Cross comparisons between the utilities in terms of their costs or efficiency, for example in terms of total output per worker is difficult, as some, for example Northumbrian, supply 40 per cent of the water to six industrial water users, while others have more sewerage than water customers. The services are provided using stocks of infrastructure that differ widely in age and composition between authorities. Revenues are, in the main, generated by water rates based on property valuations, although meters have been introduced in some areas (See Water Services Assn, 1990)

During the 1980s government control of the water utilities was rationalised through the reorganisation and reduction in the size of boards of directors and the appointment of the directors from the private sector. These measures were accompanied by the imposition of three measures to force improvements in the economic efficiency of the organisations. These measures included maintaining caps on rate increases, reduction of the borrowing limits of authorities (and introduction of programmes to repay existing debt) and increases in the rate of return targets (that were based on the historical cost of capital). The results were reductions in authorities' debt, cuts on operating costs and increasing rate of return. The rates of return for the typical authority in mid 1980s rose to over 40 per cent of turnover. (Midland Jaws, 1988, p. 4-12). The total number of employees of authorities fell from 53,524 in 1985 to 46,728 in 1989, a drop of 13 per cent (Ogden, 1991, p. 13). As a result, the partial productivity indicators of output and revenue per worker rose, but there were a number of accumulating costs for water service consumers and the public from these measures designed to improve short run economic returns because as a result of them, investment in the industry fell.

In a typical authority, Severn Trent, from 1982/83 to 1986/87, investment in water supply fell 25 per cent and sewerage services by 11 per cent. By 1986/87 over one-sixth of Severn Trent's mains piping system had over 50 per cent of its cross sectional area closed, there were 4,500 pollution incidents in a year and its water quality met no recognised standards. A problem was created from the drive for economic efficiency, then, of a physically disintegrating British water industry, that could have been addressed by increasing water charges, relaxing borrowing limits or lowering rates of returns accompanied by the monitored increase in investment. The desirable changes were introduced, but not through direct changes to the control mechanisms as they affected public authorities made by the politicians and bureaucrats responsible for the industry, but through the privatisation of the water authorities.

3. The Question of Privatisation

Water industry management, financial markets and a minority of consumers were receptive to arguments for privatisation, as the industry manifestly was not delivering services effectively and its environmental costs were rising. The issues were also of concern to the majority of the population who did not want water privatised (Harris and Gallup Polls of 1989 reported in Ogden, 1991, p. 22). The problems of the industry meant that it could be argued by the Conservative Government that private sector management and private capital market disciplines would rectify the problems of the industry. Alongside physical deterioration of the infrastructure of the industry, rates of return on capital (which was run down) were also high in the industry and therefore profits could be guaranteed to potential investors, to ensure a successful float of the authorities on the capital market. This was an important ingredient for making privatisation a success after earlier privatisation difficulties, for example with British Petroleum (BP) where the government had to intervene at the float to buy shares, a scenario for water that the government was keen to avoid. The management of the authorities, after initial questioning, also supported privatisation, as measures to buy their support and mechanisms to ensure the financial health of the industry were put in place. These mechanisms included ensuring the industry's investment needs were guaranteed; the management was given a pay rise prior to privatisation and senior management were assigned shares options at privatisation to ensure their commitment to the process. However, the employees of the organisations and the public had doubts about the effects of the privatisation of an industry providing a basic commodity that met an essential human need; and concern at the fact that the authorities were and would remain monopoly suppliers and require regulation (see Nalgo, 1987, WIUC, 1986, 1987, 1988, Labour Research Department, 1990).

The proposals for the privatisation of the ten water authorities were put forward by government in an April 1983 discussion paper. A number of objections to the 1983 proposals were made and pointed to the lack of consideration of necessary regulatory arrangements. The original proposal had retained the regulatory role of the public authorities in the privatised companies and it was pointed out that the notion of a combined water service supplier and water regulator might by appropriate for a publicly owned authority open to public accountability, but was not appropriate to a private profit maximising company accountable to its shareholders (see for example, JITUWC, undated). The results of the objections was a second set of privatisation proposals put forward in 1986 in a White Paper (in February), followed by a consultation document on changes to the laws regulating the industry (March) and a Green Paper on the environment (April). With the announcement of a British election in 1987 and growing public resistance to the privatisation plans, the privatisation of the water industry was postponed. With the Thatcher Government back in office, the ten authorities were transformed through corporatisation into publicly listed companies and then floated on the stock exchange in November 1989.

The arguments for privatisation of the water authorities were articulated in a number of different ways. At a political level it was put by the Minister responsible for the industry (Michael Howard), that privatisation would impose the discipline of the market place on the water authorities; that there would be gains for consumers in lower prices and enhanced quality of services and the public would benefit through the rewards of share ownership (Howard, 1988). At the political and Treasury levels there were the perceived benefits of reducing the public borrowing requirement and total public sector debt, while generating revenues for other purposes. There was also the expected generation of increased competition in the economy with a concomitant reduction in costs and prices and the reduction of the perceived power of trade unions to maintain inflexible practices in the industry (See Ogden, 1991, p. 25). At the authority level there were also a number of benefits perceived. There was for example, the claim by one authority chairperson, that privatisation of the industry would bring simple objectives to replace complex ones; bureaucratic and political interference and objective setting would be reduced; unnecessary information would no longer be required and collected; investment would not be forced and customers would be better looked after (Bellak, 1988).

Those, like the trade unions, who objected to privatisation, suggested the beneficial effects of public debt reduction from the sales would at best be neutral on the costs and availability of capital in Britain. The reason was that the country's level of total debt would not be reduced by it and governments could borrow more cheaply than the private sector; that the privatisation process itself would have excessive costs and that more state regulatory intervention in the industry would be necessary. It was also pointed out that the water companies were improving their efficiency

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

quickly before privatisation and they did not need to be sold off to continue doing so and that trade unions were becoming more involved in encouraging positive workplace change and were not obstacles to it . Finally it was suggested that the broad-based petty capitalist class of shareholders that privatisation was designed to create would not last long, while worker shareholders were not likely to be significant in lifting the industry's productivity (Nalgo, 1987; WIUC, 1986, 1987 and 1988; Labour Research Department, 1990).

The results of the process of privatisation of the water authorities in Britain as we will now indicate, did not, in practice, bring the anticipated benefits of the political, bureaucratic or industry advocates of privatisation. The reasons for this was related to the nature and structure of the industry, the process of privatisation itself and the character of the environmental problems confronting the industry. The result was a costly exercise as we will now outline, that has not resolved several key problems for the industry or brought the immediate benefits to water consumers and taxpayers anticipated.

4. Regulation and Privatisation

The original proposals for privatisation of the water industry in Britain envisaged breaking up the vertically integrated water authorities in the same way that the electricity industry had been in Britain, to make the industry "competitive". Unfortunately, there was no equivalent of a common transmission system formula like there was in electricity in the UK that could act as quasi market. In any case, problems in managing the electricity "pool" market arrangements for managing the delivery of another monopoly service in Britain suggested problems even in that area for its sustainability (See House of Commons Energy Committee, 1992) and this idea for the water industry was dropped. It was also abandoned because a breakup of the ten water authorities would create new entities not vertically integrated and their profitability would be unknown and therefore make it difficult to sell them off. As the provision of water services are monopolistic and public opinion was concerned its interests should be protected, a regulatory regime was created for the industry that rested on establishing a major body concerned with the "light handed" economic regulation. Another body was created to deal with the water environment supported by specialist centralised and localised agencies to deal with industrial pollution, drinking water standards and waste management. The regulatory agencies established are those set out in the Table 1 below.

The primary role for the economic regulation of the water industry was assigned to an independent Director General of Water Services supported by a regulatory office (Ofwat) with powers over charges (prices), investment levels, operating costs, efficiency targets and service standards. To facilitate and ensure the investment necessary to rebuild existing water service infrastructure and improve it, it was decided to establish a modified cost "pass through" system of pricing to manage the industry, adapted from the work of Littlechild (Littlechild, 1986).

The cost "pass through" mechanism was selected to restrict price increases through the capture of economic efficiency gains for consumers and to facilitate the planning of the necessary longer term investment required in the industry and to enable its "pass through" into consumer prices. It is effectively a price capping mechanism with an extended cap made up of additions to prices from the cost of authorised capital expenditures *less* any improvements made in the operations of utilities water services that should be passed on to consumers in lower prices as well as capture the price effects of inflation. Capital expenditure levels for ten years were agreed before privatisation with each water authority, and are set out in column 1 and 2 in Table 2 below and fixed with an agreement that Ofwat would not review these for 5 years and not change them for a further 10 years. The reasons for these decisions were to secure the resources for investment the authorities required and to reassure potential investors in them of the returns they would receive for the foreseeable future. In addition, the legislation enacted in 1989, limited the regulatory control of Ofwat to company's water service core functions that were monopolistic, ie., the delivery of water and sewerage services to consumers.

The object of the economic regulatory mechanism was to provide freedom and stability for the authorities in their operations, guarantee reasonable returns to investors and provide benefits to the consumers (and the environment) at the minimum of regulatory cost. However, too many benefits were assumed from too little capacity availaible to the regulator, whose powers were set out in the Water Act of 1989, and some of the consequences were:

(a) In order for the pricing mechanism to be regulated properly by Ofwat, it was necessary in practice for it to have access to all the necessary data to estimate accurately the efficiency dividend and review the investment programme costs of the companies. This required an ever increasing amount of information from the companies (requested by Ofwat in what it coyly calls "Dear Managing Director" letters). This was due to the uncertainty of the effects of changing macroeconomic variables (like interest rates) on the operations of the companies and the fact that the companies' investment programmes are potentially

Table 1. The Economic and Environmental Regulatory Agencies in England and Wales Established Under the Water Act (1989) and Environmental Protection Act (1990)

Central Govt

A. Dept of Environment (DOE)
(General responsibility for EP-Exp £350m pa)
Functions:
legislation, research and appraisal, economic instruments, EC & international representation, monitoring, standards of enforcement

B. Ministry of Agriculture Fisheries & Food (MAFF)
Functions:
flood defence and fisheries in Wales and agriculture and food standards in England and Wales
Welsh Water Industry regulation

C. Secretary of State Monopoly & Merger Commission
Function:
regulation of takeovers in the water industry

Local Govt

Local Govt, District Councils & London Boroughs
Functions:
waste regulation, dangerous substance transport and noise control, air pollution control

Supra Nat-ional

European Economic Community
Functions:
drinking water standards
bathing water standards
sewage sludge standards
wastewater standards

1. Director General of Water Services (Offwat)
Functions:
Regulating all Water Companies especially
- charges (prices)
- investment levels

2. Her Majesty's Inspectorate of Pollution (HMIP)
Functions:
regulating 5,000 major industrial plants and their process, pollution of land and water
- regulating radioactive waste disposal & storage in non-licensed sites (Radioactive Subs. Act 1960)
- regulating local govts waste regulation function

3. Drinking Water Inspectorate (DWI)
Functions:
with DOE Water Directorate regulates water companies compliance with Water Supply (Water Quality) Regs, 1989

4. National Rivers Authority (NRA) (budget £450m pa)
Functions:
effluent & discharge regulation (outside HMIP control), advises HMIP, flood control, water resource management, fisheries conservation, recreation & navigation, water environment management

Source: Adapted from DOE, 1991, various pages.

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

Table 2. Total UK Water Industry Investment Programme 1989/90 1990/91 (at 1990/91 Prices).

Category	1989 Planned Expenditure £m	1989 Actual Variance £m	1989/90 Plans Expenditure £m	1994/5 Change Expected Variance £m
Water Resources	95	-0.9	770	+89.0
Water Treatment	178	+32.1	2290	+9.0
Water Distribution	449	-2.3	3630	-1.1
Sewerage	335	-8.1	2740	-103.4
Sewage Treatment	450	-18.1	4350	+220.8
Management & General	259	+12.9	1840	+34.5
Total	1766	-48.6	15620	+248.8

Source: Reprinted from Ofwat, 1991, p. 38 Table Water Industry Investment Programme

unstable for a range of reasons (that include the capacity for completing activities on time, within estimated operational limits and within budget). This was indicated by planned investment variances already beginning to be experienced even in 1989, and shown in Table 2. The result is an ever increasing amount of information demanded from the companies, including the smaller private water companies who were regulated in 1990 for the first time by Ofwat and the beginning of virtual "shadow management" of them by the regulator (see Ofwat, 1991). For the water companies, due to inherent instability in their ten year investment plan growing over time, it means progressively a return to the regulator undertaking short term price setting, a problem privatisation was meant to end.

(b) The split of the companies into regulated (monopoly) and unregulated (commercial) portions with "ring fencing" between them, was difficult for the regulator to monitor and contributes to increasing regulatory interference. The possibility of increasing regulation to minimise cross-subsidisation is perhaps one reason why the non-core activities reported in some companies annual reports, post privatisation, shows a massive growth in non-core business revenues as they assign more assets, revenues and profits to non-core business activities undertaken by the companies or their subsidiaries (see Thames Water Annual Report, 1990/91).

(c) The growth of regulation has been reinforced by the regulator acting as the body that mediates consumer complaints and pursues government's interests in this area, for example, in the determination of

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

> community service obligations. The reasons for this are many, but I will briefly outline three of them. Firstly, the independent consumer complaints committees that were established in each company's area are appointed by government via the regulator and while these are likely to be compliant at first, the demands by consumers for their independence, and new appointments to them by new governments with different perspectives of priorities, are not likely to sustain this. Secondly, the tendency for more intervention is likely as "user pays" for water is introduced and the system moves from a property rate based charging system to a metered system and the large cross-subsidies of domestic water users by business areas that are said to exist are removed (see Ofwat, 1991, p. 27). This will mean future increases on top of the large price rises already approved to increase capital investment. Thirdly, community service obligation determination including service conditions covering connection and disconnection rules, charges for rental properties and charge rebates for some classes of customers (eg. pensioners) only began in Britain in 1990/91 and this development is likely to contribute to the accelerated growth of regulation (see Ofwat, 1991, pp. 31, 53). The pressure for more regulation is now indicated when in 1991/92 Ofwat reported 900,000 summonses by companies for non-payment of water bills and water was cut off from 21,000 residences as a result of the recession and the commercial priorities of the companies (See Mitchell, 1992).

In conclusion to the analysis of the economic regulatory framework established at privatisation, it cannot be claimed that the arrangements made contributed to "market competition" at the water service supply end of the activity or delivered price or quality benefits in the short run either, although the investment programme, at a substantial cost, should deliver these in the future. What privatisation did do, was to replace the set of complex objectives determined directly by government prior to privatisation by a similar set established indirectly by the government after it, enforced through the regulator. Further, the temporary reduction in information collection by the authorities for government at privatisation in 1989/1990 has been followed by a growth in the amount of information required by the regulator. Another consequence was that while it was claimed customers would be better looked after under the new arrangements, this was not a result of "market forces", but at the behest of Ofwat and its regulatory companions like the Office of Water Quality, that determines drinking water quality standards on which companies must report (see water quality reports by Yorkshire, 1991 and Severn Trent, 1991).

It must be pointed out that the introduction of an independent economic regulatory body that accompanied privatisation did bring benefits, even if it did not produce the benefits identified by the advocates of privatisation. The establishment of Ofwat opened up the activities of the authorities to a degree of public scrutiny that they had not received since 1983. Further, the establishment of the price setting mechanism and its manager Ofwat did place some constraint on the possibility of the companies earning monopoly profits after privatisation at the expense of consumers (in a fashion similar to the old rate of return mechanism imposed directly by government). It also removed price-setting and performance monitoring activity at arms length from the Conservative politicians and Treasury bureaucrats who caused the near collapse of the industry in the 1980's and allowed the industry to undertake the investments it needed to rebuild and improve the system. Investments that were facilitated by the average increases in prices of 12.8 per cent in 1990/91 and 14.8 per cent in 1991/92 of all ten privatised companies set out in Table 3. Finally, it provided a capacity for the centralised control of all the components of the industry including the 27 water supply only companies that previously were not regulated.

Table 3. Actual Price Rises for Water Services in UK, Current Prices, 1990/1-1991/2

Authority	% Increase	1990-91	1991-92
Anglian		13.2	15.2
Northumbrian		14.7	16.7
North West		12.5 (-0.2)	14.7
Severn Trent		13.2	15.2
Southern		13.2	14.7 (-0.5)
South West		14.2	16.2
Thames		12.2	14.2
Welsh		14.2	16.2
Wessex		12.2	14.2
Yorkshire		10.7	12.7
Average		12.8	14.8
Composed on	Average of Retail Price Index	7.7	9.7
	K Factor	5.1	5.1

Source: *Labour Research* (1991), Vol 80, No. 4, April. The figures in parentheses are the lag in the level of price rises below allowable limit of K in the pricing formula adopted by water authorities.

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

The need for dedicated environmental regulation was not seen as necessary under the original 1985 privatisation proposals for the water industry, as it was probably thought that the "market place" for water would solve this problem. This was not acceptable to important environmental interests, for example, those with an interest in rural England and Wales, as well as business interests like the Confederation of British Industry (CBI), who saw conflicts of interests between companies that were profit seeking services suppliers and environmental regulators (Ogden, 1991, p. 28). The result was not only a delay in privatisation to develop economic regulatory proposals but also to create a new set of regulatory agencies brought into being to deal with the environment. To take over the environmental regulatory functions of the authorities controlled through the Department of the Environment (DOE) a number of new bodies were created under the same department. The integrated river basin resource management function and overall pollution control function of the authorities were lodged in a new National Rivers Authority (NRA), with a specialised agency, Her Majesty's Inspectorate of Pollution (HMIP) created to regulate the pollution of 5,000 major industrial plants as well as monitor and control local governments planning and regulatory role over waste, noise and air pollution. (see Table 1). The priority of the NRA was identified as general pollution standards, rather than water resource management, and this was of concern to the nascent private water companies, because it meant a loss of control of the companies over their water resources. Environmentalists also had a concern that appropriate environmental standards in some regions would be eroded if general standards were applied. There was also the issue of the overlapping responsibilities of regulators and perceived problems of the coordination of environmental regulatory activity which remains an unresolved problem in Britain.

The concern of the companies prior to privatisation was that high environmental standards would undermine their business viability, but, this was reduced when they were assured, prior to the flotation, that only 95 per cent of British standards set need be achieved and EEC standards that were higher than the British ones would not apply (*Guardian*, 9th August, 1989). The latter assurance did not last long, when in 1990 the deadline for EEC standards to be met was given by the British Government as 1993 (*Financial Times*, 11th September, 1990). This decision had the effect of disturbing the ten year estimates of necessary investment by the companies. In addition, prior to privatisation, the companies were given the so called "green dowry" to assist them in achieving water standard targets of which will be discussed later in this paper. In response to the concerns raised, after their establishment, the environmental regulators, like the NRA began to

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

develop their role in total catchment management and other areas, but a number of obstacles remained to be resolved in the area of environmental management in order for this function to be effectively carried out that have still not been resolved.

5. The Economic and Financial Costs of Privatisation

The sale of the ten water companies in Britain provides a case study of the cost and benefits of a privatisation by a government driven by a conviction that private is better than public at any price. The water authorities were privatised in November 1989 through the sale of shares valued at £2.40 each paid for in three instalments with an issued value of £5.2 billion as indicated in Table 4 below.

The share issue was 5.7 times oversubscribed and the allocation was made to over 2.6 million investors with 47 per cent of the issue going to small investors with the balance to institutions (39 per cent) and foreign investors (14 per cent) (*Guardian*, 12th December, 1989). A "golden share" was retained by the Secretary of State which can be used to proscribe any takeover of any water company before 1992 and after 1989, any attempts to do so could be referred to the Monopolies and Mergers Commission. For two years after privatisation, single shareholdings in the companies were limited to 14 per cent to prevent changes in control, but by 1990, one group of investors, the French companies had begun to secure strategic stakes in the industry.

Despite the sale of shares generating £5.2 billion for the government, the privatisation process did incur a range of costs and benefits for taxpayers, water consumers and the community more generally as we will now outline. We focus in this section on the financial costs/benefits to the first group affected, the taxpayers and deal with the costs of the whole process of privatisation rather than how the specific costs of the sale (See Walker, 1992 for discussion of the issues) we refer also to the costs and benefits to water consumers and to the other group with an interest; the shareholders.

It should be recognised that there were, associated with the float of the water companies, some short term direct costs to taxpayers that we can enumerate and some we cannot, as the data is not available and information shortage is a cause of difficulties also in trying to get some overall estimate of the real net present value of total costs of privatisation. We can therefore, only get a feel for the financial implications for taxpayers and not for the ull range of economic costs/benefits generated by the privatisation. The costs to taxpayers of privatisation were also, to a significant degree, benefits to two different classes of individuals or entities - water consumers and

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

Table 4. Share Issue Prices, Shares Issued, Capitalisation and Yields of English and Welsh Water Authorities (PLCs), 1989-1990.

Authority	Share Price[1] (pence)	Shares Issued (Nos.)	Issued Capital (£ms)	Pro-forma Estimates 1989/90[2] Gross Profits £m	Pro-forma Estimates 1989/90[2] Rate of Div %	Pro-forma Estimates 1989/90[2] Amt.[3] £m.	Prospectus 1990/91 Div. Amt. £m
Anglian	240	294.7	707	136	20	60	68.4
Northumbrian	240	65.5	157	50	21	14	16.2
North West	240	355.8	854	172	21	75	85.2
Severn Trent	240	353.6	849	208	20	70	82.8
Southern	240	163.7	393	81	20	33	38.6
South West	240	122.2	293	82	23	28	32.7
Thames	240	384.2	922	178	19	75	92.2
Welsh	240	144.1	346	93	22	32	37.4
Wessex	240	102.6	216	55	20	21	225.0
Yorkshire	240	196.5	472	98	21	40	46.3
Total		2198.0	5239	1152	20.5	448	524.8

Notes:
1. Shares paid for in three payments 100p with order, 70p and 70p to be completed by July 1991 in two transfers. Discounts on holding period applied.
2. The pro forma Estimates are estimates made by authorities of their performance for the whole year as if debt write offs and other abnormals had applied for the whole year.
3. Amount distributed to shareholders.

Sources: *Financial Times* 5th September, 1987 and 27th October, 1989, and Hill, S.W. *The Privatised Water Services* (1991) and *The Water Company Accounts* (1991), Arthur Collins and Co, London, various tables.

stockholders in the companies. We have listed the benefits in Table 5 in respect to water consumers only. In the actual debate over privatisation, the taxpayer, the water consumer and potential or actual stockholders were often discussed as if they were one and the same, which served to obscure debate of the distributional and therefore equity effects of privatisation. These are effects which we have not dealt with either, through lack of information to do so.

The immediate costs to the taxpayer of privatisation were the sum of the identified direct costs of sale including advertising; consultants advice to the authorities and government administrative expenses; share options for management; cash injections into and reserves retention by authorities and the loss of the annual dividend of authorities These costs roughly totalled a minimum of £5 billion. In addition unknown value of costs that should

Table 5. The Costs of Privatisation to Taxpayers and Benefits to Water Consumers of Privatisation of Ten Water Authorities, 1989

Cost/Benefit	To Taxpayers on Privatisation £mns	To Water Consumers After Privatisation £mns
Promotion of Water as Business 1987/89	- 22	-
Direct Costs of Sales (Admin, Advertising etc)	-286	-
Share Options for Management	-7	+7
Share Options for Other Employees	-?	+?
Discounts on Issue Value of Shares	-?	-
Credit Extended for Share Payment	?	-
Cash Injection	-1511	+1511
Transfer of Cash Reserves	-3174	+3174
Additional Costs of Regulation (1987/89)	-?	+/- ?
Loss of Income Stream from Land Transfers	-?	+/- ?
Loss of Corporate Taxes	-?	+?
Loss of Income Stream from Authorities	-?	+?
Min. Cost of Privatisation	5000 (min)	+4692(min)
Net Revenue from Sales	5239	-
Total Cost/Benefit of Privatisation at Privatisation	+239	-
Write off of Debts	-5030	+5030
Net Effect on Budget, 1989/90	-4791	Minimum Benefits to Water Consumers +9722

Sources: Data derived from Whitefield, D. (1992), p. 172 Table 7, pp. 174 and 187. Financial Times, Annual Water Supplement, various issues.

be added to this list might include the costs and benefits of interest lost on the extension of credit through delayed payment system for buying shares, offset by the proportion of dividends retained by government in the budget year to date of privatisation. For the budget year of privatisation, we should also include the losses of income from land holdings associated with the old authorities; the undervaluation of shares to ensure the float was a success and loss of corporate taxes from the authorities' profits as a result of the tax agreements made by government for the period. The authorities were given a corporate tax deduction on the value of their infrastructure investments for future years in a formula that has not been clearly revealed, but is expected to ensure corporations' income tax is not paid for some (many?) years (Hill, 1991). The net cost to taxpayers of privatisation was therefore a minimum of £5 billion, less the proceeds of sale of shares of £5.2 billion to give a short term net proceeds of sale benefit of £239 million. The government however, wrote off £5.030 million of debt of the authorities, making a net budgetary impact in year one of minus £4,791 million.

If we look at the longer term taxpayers costs in terms of the net present value of total income losses from the land holdings of authorities, lost corporate taxes, possible increased regulation expenses and the lost income stream of authorities we could reasonably expect the cost of privatisation for taxpayers to be much larger. The costs for some individual taxpayers who are also water consumers, were offset by benefits accruing to the water companies of a minimum £9 billion and for stock holders (an unknown group) who may also be taxpayers or water consumers in one form or another a number of additional benefits. In summary we can say that the water authorities were not just given away by the government, but given away with a handsome special offer of "incentives" whose additional costs nearly doubled the cost of the sale. It could be said it would have been much cheaper for the British taxpayers, if every resident of Britain had been sent ten free shares to the total value of £100 in the mail, as a mechanism of privatising the authorities.

For water consumers, water company shareholders and the environment there were benefits of the additional capital to rebuild the water infrastructure, worth £9.7 billion and a future reduction in pollution and other effects on the environment. However, the provision of necessary infrastructure investment and a reduction in environmental impacts did not require or justify privatisation, but could have been dealt with more cheaply by the introduction of mechanisms to do so. The double irony of the whole privatisation process was not only was it expensive, when it was meant to save money, but it did not achieve the objectives for it set out by the government and the elements of the bureaucracy and management of water companies that supported it.

6. The Elusive Capital Market Discipline

One reason for the conclusion that privatisation did not realise the claims of its supporters lies in the lack of creation of "market discipline" for the industry. For example, in terms of "market discipline", on the consumer side, there is no direct discipline as water consumers have no choice in the suppliers of their water services or the prices they pay for them - this is determined by the regulator Ofwat. However, it is suggested that capital markets also fulfil this function either through the buying or selling of the

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stock of companies or through these discipline of companies borrowing on capital markets. As there are many dispersed stockholders in the companies, the discipline they could exert is questionable because of their lack of knowledge and lack of voting power and therefore this sort of "discipline" is unlikely until shareholdings are concentrated at some point in the future. Secondly, it is suggested that capital markets can discipline the companies through regulating the amount of their borrowing programme and the conditions under which they borrow. This does not apply, at least for the foreseeable future in respect to the ten privatised water companies because of their financial structure at privatisation, as we will now outline.

The arrangements made at privatisation envisaged some proportions of the capital they required for rebuilding and improving their infrastructure would be borrowed on the capital market. Prior to privatisation the companies had the capital expenditure programme approved by government indicated on Table 6 and they indicated their intention to borrow capital on the capital markets as indicated on Table 7.

However, the water companies were privatised "debt free" and therefore their capacity to borrow and attractiveness to lenders was considerable. An estimate by Kleinwort Benson, a London merchant bank suggested in 1989 that borrowing by the industry in capital markets in 1990 would be a total of £750m and would reach £7.2b by 1998, a sum equalling 50% of net asset backing of the industry (*Financial Times*, 29th Dec. 1989, p. 15). This compares with the estimated £7.5b level of proposed borrowing by 1995 estimated earlier by the ten water authorities and shown in Table 7 against which the Kleinwort Benson estimate seems somewhat conservative, but may be based on an assessment that the "approved" capital investment programme winds down and reduces the industry's capital needs in the later years of the decade.

A superficial assessment of the costs and benefits of this process would suggest the possibility of higher interest costs for all borrowers in capital markets commensurate with the impact of water authorities' capital raisings on the average costs of borrowings of all borrowers in those markets offset by asny reduction in public borrowing as a result of sales. The low debt levels also meant that the capital/debt ratios were lower for the big company segment of the water industry than for the smaller statutory water supply companies, who requested, but did not get, similar largesse in terms of debt write offs in 1989, and this has distorted the market for water industry capital raising. To the extent that the water companies key borrowing ratios are also lower than those of other comparable commercial borrowers, they are less subject to the "discipline" of the market and will not be while debt/equity ratios are comparatively lower than that of other commercial organisa-

Table 6. Capital Expenditures Approved by Government for the Ten Water Authorities 1990-2000

Authority	Expenditures £ms 1990-1995	1995-2000
Anglian	1,470	1,990
Northumbrian	540	345
North West	2,220	2,060
Severn Trent	2,330	1,750
Southern	830	500
South West	765	525
Thames	1,890	1,920
Welsh	880	875
Wessex	650	625
Yorkshire	1,210	1,210
Total	12,785	11,800
Total Programme	24,585	

Source: *Financial Times Water Supplement*, 11th November, 1990, p. III.

Table 7. Debt Write offs and Proposed Capital Market Borrowing of Water Authorities 1989-1995

Authority	Debt Write Off 1989 £m	Borrowing Level Proposed 1989-1995 £m
Anglian	859	800
North Western	1050	1200
Northumbrian	450	400
South West	129	NIL
Severn Trent	831	1500
Southern	276	350
Thames	121	1500
Wessex	315	450
Yorkshire	559	600
Welsh	440	450
Total	5030	7500

Source: *Financial Times*, 5/9/1989 and 27/10/1989.

tions which will be for many years. Further, if the revaluation of the land and other capital assets of water authorities upwards is fairly elastic, which

https://doi.org/10.1177/103530469200300204 Published online by Cambridge University Press

it is likely to be (because these were most likely undervalued at privatisation) and these can be used as collateral to raise fresh market equity, then this period of time may be stretched indefinitely. The potential consequence of this lack of "discipline" is the possible misallocation of investment resources raised on capital markets, especially in the commercial activities of the water authorities that are not overseen by Ofwat. It also must be said that if any of the water companies fail, it is unlikely they will be allowed to stop operations given the nature of the service provided.

Associated with any assessment of the levels of investment and debt is the question of the total capacity of the water authorities to sustain their capital investment programme, which they may not be able to sustain, or want to as the industry and regulation changes. There is also the matter of what their investment is going to be used for i.e. will it be used to sustain or improve the existing service and reduce their deleterious effects on the environment, which was their stated purpose at the time of privatisation, or be used for other activities. The first question may partly be answered by the 1991 Report of Ofwat that suggests investment targets are being met by the ten water authorities (PLCs) with a 1% expenditure variance in 1989/90 on their share (93%) of base projections of total water industry investment at privatisation, of £1.8b of gross capital expenditure (GCE). The smaller water companies however, fell 35% short of their targets, which accounted for 7% of the total GCE (Ofwat, 1991, p. 37). The reason given for this was that the K setting process for the latter companies was only finalised in March 1990 or later in the year. The question remains however, whether the expenditures will be used for the purposes agreed before privatisation and how this will be monitored.

7. The Disappearing Shareholders

The flotation to no one's surprise was a success. The allocation of shares, following previous privatisation practice favoured applicants for small numbers of shares leading initially to a broadly based group of shareholders (*Guardian*, 12/12/89). In other privatisations in Britain small shareholders began to sell off their shares as soon as the share price stabilised at a level reflecting the true value of the companies. The numbers of shareholders in the water companies also began to shrink as it did after previous floats of privatised government enterprises as shown in Table 8. The result in all cases was the gradual evaporation of the broad class of shareholder petty capitalists, who retired from the scheme with their capital gain, while there was evidence of the emergence of larger shareholders on the share register.

By the 27th June 1990, the numbers of shareholders with water companies had fallen to 51% or 1.3m of the initial number at privatisation and this fall did not include the "stags" who sold straight after privatisation (The Daily Telegraph, 11th July, 1990 reported in Labour Research, March 1991, p. 23). The growing portfolio of big shareholders include not only British institutional investors but also the French water conglomerates, leading to a concern that there will not only be a possible concentration of ownership over basic resources, but this control would be held by foreign companies. These fears have been allayed by the British government who point to the regulations on share ownership and the arrangements for Board membership that apply until 1992, but, of course, beyond this there is no guarantee.

The regulations created to restrict takeovers indicate that until three years from privatisation elapse in November 1992, the water authorities will be controlled by the Secretary of State and a dwindling group of shareholders. Takeovers can then be expected soon after these arrangements have lapsed. The first targets will be those smaller companies with smaller capitals and significant land and other assets that can be stripped and reorganised to pay for the costs of takeovers and boost profits. The likely buyers, the French, and perhaps Biwater, the only significant British investment company in the water industry and possibly other privatised utility companies, for example in the electricity sector.

Takeovers are likely as the water industry in England is vulnerable to a concentration of ownership and control because of the nature of the float and the undervaluations of the assets of the water companies. This will be so into the future up to the point that profits and share prices reflect both the water companies underlying assets, and profitability, which is expected to be some time ahead. The reason for the vulnerability was the nature of the float that sought broad based shareholding, but in fact encouraged short term profit taking and not long term profit making. The losers were the British citizens who lost not only in not realising the full value of their assets and their future returns on them, but are also losing control over a resource that is basic to their future material and social wellbeing.

8. Curbing the Trade Unions

The industrial relations climate in the British water industry deteriorated significantly in the 1970s and 1980s ending in a coordinated campaign by the trade unions to stop privatisation. The decline of morale and increasing militancy amongst employees in the industry stemmed from the failure of successive British governments to increase investment in the industry,

Table 8. Shareholder Concentration of Selected Privatised Government Business Enterprises in England and Wales, 1982-1990.

Company	Date of privatisation	Number of successful share applications	Latest number of shareholders (date)	% drop from original shareholders
Amersham International	1982	65,000	5,854 (1989)	91
BAA	1987	2,000,000	889,067 (1989)	56
British Airways	1987	1,200,000	338,350 (1989)	72
British Gas	1986	4,500,000	2,480,564 (1990)	45
British Steel	1988	650,000	336,823 (1990)	48
British Telecom	1984	2,300,000	1,200,655 (1990)	48
Rolls-Royce	1987	2,000,000	738,659 (1989)	63

Source: Labour Research Department (1991) *Privatisation and Cuts: The Government Record*, LRD, London, August.

improve working conditions or training and were aggravated by their use of cuts in employment as a key indicator of improvement in efficiency (see White Paper, 1986, p. 34). Employment cuts were an extremely suspect method of improving efficiency over the long term anyway, given the combined service provision and regulatory role assigned the authorities and their declining infrastructure that required more maintenance. The evidence suggests for example that a decline in the quality of the assets occurred in the period; that job shedding may have exceeded any reasonable target that might have been identified to deal with overmanning or any other wasteful use of labour, and that this had a significant impact on the long term welfare of the industry (See, for example O'Connell-Davidson, 1990; Ogden, 1991 and Ferner, 1991).

The Conservative Government, despite the fall in employment in the industry, saw the public sector unions as the major obstacle to change. Tom Moore, Minister of the Treasury quoted in Ogden (1991, p. 21) noted in 1986:

> Public sector trade unions have been extraordinarily successful in gaining advantage for themselves in the pay hierarchy by exploiting their monopoly collective bargaining position.

One object of privatisation then was to break up the claimed labour monopoly, presumably reduce wages and let "managers manage" in the new privatised industries to create efficiency. The question here is how far the arrangements of the 1980s were changed by the process of privatisation of the water industry. Prior to the announcement of privatisation, many of the changes affecting the industrial relations of the industry were already taking place as they were in many other privatised industries (Ferner, 1991). Some of these included cuts in the direct labour force and a growth in the use of contracted out services; a drive to negotiate flexible pay and conditions at the authority and workplace levels; discourage unionism among management where possible (and institute employment contracts) and finally, establish consultation mechanisms with the workforce that excluded, where possible, trade unions. Ferner noted that these strategies avoided open conflict where possible as this would disrupt the capacity to make rapid changes and in the immediate period before privatisation upset investor confidence in the industries to be privatised (Ferner, 1991, p. 7).

In the water industry Ferner and O'Connell-Davidson (Ferner, 1991, p. 8 and O'Connell-Davidson, 1990, p. 534) note that these changes were trialed long before privatisation in centres undertaking "non-core" activities that operated in competitive environments (like plumbing services) that could be either maintained or contracted out. However, the employees in the core activities of the water authorities continued after privatisation as before and mostly continued to be directly represented by trade unions in the workplace who negotiated wages and conditions on a company by company basis. These union-employer negotiations up to 1991 brought benefits in higher wage and condition improvements to the employees of water companies compared to those employed in the water regulators and wage rises were greater than the CPI in Britain (Nalgo, December 1991).

The consequence of privatisation as far as its industrial relations were concerned was the continuation in some growth of diversity in employee-employer relationships that had begun between "core" and "non-core" businesses in the early 1980s. The conflicting 1980s demands of cost cutting that often focussed on cutting labour costs and maintaining service quality that depended on industrial relations stability that applied in the industry before privatisation in Britain, still applies in the 1990s. The change however, that observers like Ferner identify after privatisation, is that the pressure for labour cost cutting and anti-union strategies comes from financial markets whereas before it emanated from government. The management however still is concerned for industrial relations stability to gain commitment to authorities' objectives and this provides the countervailing force to job cuts (Ferner, 1991, p. 13). The costs and benefits of privatisation for employees and their trade unions as well as employers from an industrial relations standpoint are difficult to identify in the "core" water businesses as these are only slowly evolving. The question of a better way, of course, in the English case remains unanswered.

The major changes between 1985 and 1991 however, can be said in summary to include: An attempt to create a corporate culture to focus employees on the companies' objectives and on improving services to consumers. This involved management reforms and incorporated employees at all levels of the organisation through delegating authority and provision of training. The evidence of the effectiveness of these reforms however, has not been demonstrated. There was also the increasing use of contracting-out of water authorities activities. This was used to discipline employees and introduce reformed work practices in some workplaces. This was initiated despite the fact that this activity serves to undermine employees' work commitment and the cost savings and productivity gains are often less than expected (see Paddon, 1991 and Johnson, 1991; 1992). The introduction after 1989 of consultative mechanisms in some water authorities about company objectives also took place, but there was no movement towards the provision of either full information sharing or participative management (Jackson, 1991); and therefore a failure to harness the full productivity benefits from involving employees in all the activities of the organisation. Finally there was the institution of share ownership schemes after privatisation in some water companies, profit sharing and performance pay in others to promote commitment to companies and their objectives, mechanisms that so far has not markedly influenced the industrial relations of water authorities (Jackson, 1991). Share ownership schemes in any case, never allowed employees to hold a substantial share of their companies' capital in the British water industry. This was despite the rhetoric of allowing employees, through privatisation, to become shareholders, because in no case in Britain has this been significant, except where management buy-outs took place.

9. Conclusions

Privatisation arose from the failure of governments of both persuasions in Britain to realise that measures to achieve short term economic efficiency and increase rates of return to governments had the effect of reducing necessary infrastructure investment to the detriment of water service consumers and the environment. For the Conservative Government, the industry's disintegrating infrastructure in the 1980's and high financial returns provided an ideal opportunity to justify and carry through privatisation at a massive financial cost with gains that did not justify it. The cost of making the necessary arrangements to achieve the privatisation objective cost British taxpayers far more than the resources generated from the sale of the water companies and did not introduce the "market disciplines" that were supposed to ensure its future efficiency and effectiveness. If there was any benefit from privatisation it was to force a Conservative Government to create, against its will, the independent regulatory agencies to oversee an improvement in the industry's economic efficiency, lift its level of investment and ensure an improvment in the industry's environmental impact. These objectives could have been achieved more quickly and at a lower cost without privatisation. These developments call into question not only the drive to corporatise and privatise some of Australia's large water authorities but the failure to introduce, except in New South Wales, appropriate independent regulatory frameworks to ensure that authorities meet their economic, social and environmental objectives.

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