

A New Source

**Finding a Better Way to Fund Investment in
Scotland's Water Industry**

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Synopsis

Scottish Water's performance is improving within an industry that is increasingly dynamic. But as a publicly owned company it is saddled with a major disadvantage: its investment finance is provided from the annual budget of the Scottish Government. This is inconvenient and expensive, and fraught with political risk at a time of budgetary contraction. The usual solutions to this problem are unsatisfactory. Privatisation would work, but is a political taboo in Scotland. Mutualisation is a flawed compromise. And using public private partnerships to raise finance ultimately faces the same restrictions as government borrowing.

This paper proposes an alternative: A new structure for Scottish Water similar to that of Network Rail. The result would be a company accountable to the Scottish people, but able to arrange its own funding through access to the capital markets. It would also mean a substantial annual saving to the Scottish Government of up to £350m. Now is a good time to consider such a change because reform of Scotland's devolved institutions is likely, and restructuring Scottish Water could be accomplished as part of this

Introduction

The Scottish water industry has gone through a remarkable transformation in recent years. In a pioneering series of reforms, a market in providing water to non-household customers¹ has been opened up to competition. This means that, since April 2008, such customers have been able to choose their water provider from a number of licensed suppliers. This provides scope for all sorts of innovations in terms of price and levels of service that should improve the performance of the industry as a whole to the benefit of Scotland and its economy.

This reform is an international first – no other UK jurisdiction, nor any other country globally has implemented such a radical and advanced regime, and the reform must count as one of the triumphs of devolution.

At the same time the performance of Scottish Water itself – still state owned – has improved considerably.

All sorts of challenges and opportunities face the industry. Not least is the prospect of extending competition to household consumers², but also to the sourcing (known in the industry as abstraction) and treatment of water and the treatment and discharge of sewage.

¹ Businesses, public sector bodies, charities and other organisations of all sizes.

² Currently household consumers are charged according to property bands collected on Scottish Water's behalf alongside the Council Tax under the Water Services Charges (Billing and Collection) (Scotland) Order 2006. Competition would ideally require a change to a metered billing arrangement so that retailers could provide proper pricing and service incentives.

However, this paper confines itself to one pressing problem: how to raise finance for Scottish Water's important programme of capital investment?

The timing of this question and the need to find an answer is apt. The recent report by the Calman Commission into Scottish devolution has opened the door to legislative change to the structure and competence of Scotland's government and therefore government owned bodies such as Scottish Water.

At the same time the financial pressures placed on all arms of government by the recession necessitates new thinking on how to fund government investment programmes.

Before addressing this issue in detail, it is worth briefly describing the new structure of the water industry and the context in which Scottish Water operates.

The structure of the water industry in Scotland

The Scottish water industry is overseen by a powerful regulator, the Water Industry Commission for Scotland (WICS), which is lead by Alan Sutherland and chaired by Sir Ian Byatt³. The Commission sets the charging structure, assesses the cost of delivering Scottish Water's capital investment programme, monitors Scottish Water's performance and has driven the creation of the new market in water and wastewater retail services for non-household customers. It now regulates that market by issuing licences for retailers and setting wholesale charges in the competitive market.

At the time of writing, five competing companies⁴ retail water to non-domestic customers. One of them, Business Stream, is still part of Scottish Water, but operates at arms' length under the same conditions as the others. The charging structure by which Scottish Water wholesales water to them is set by the Commission. The Commission also sets default tariffs, which are the maximum level of charges the licensed providers can raise from its customers for a defined minimum level of service⁵.

Outside these constraints, the retailers are able to negotiate the best deal for customers or offer any kind of additional services they can devise to reduce the customers' costs and improve levels of service. These include individually tailored solutions such as easier billing, quality and consistency of supply and fast reaction response. Licensed Providers also offer environmental advice for leakage reduction and other water saving measures.

In short, the way the market works closely resembles how other liberalised utility markets have been set up in the UK, notably in gas and electricity, although Scotland is the only place where this kind of structure has been instituted for water⁶.

³ See www.watercommission.co.uk.

⁴ Aimera, Business Stream, Ondeo Industrial Solutions, Osprey Water Services and Satec.

⁵ The default tariff increases in line with the non-household charge cap that was in place before competition was introduced, ensuring that no customer is worse off following the introduction of competition.

⁶ Though English policy makers are following development in Scotland closely with a view to copying them Cave, M (2009), *"Independent Review of Competition and Innovation in Water Markets: Final Report"*, Defra.

The role of Scottish Water

Unlike its counterparts in the rest of the UK, Scottish Water remains government owned⁷. It has four primary functions:

1. The abstraction of water through the ownership and maintenance of reservoirs, water purification plants and so on.
2. The distribution of water through a number of separate pipe networks that cover the country.
3. The supply and retail of water to household consumers, who are charged according to their property band that are collected on behalf of Scottish Water by local authorities at the same time as Council Tax.
4. The household retail, collection and safe disposal of waste water and sewage.

As we have seen, a separate part of Scottish Water, Business Stream, is involved with supplying and retailing water to non-household customers, in competition with other companies.

Charges for connection to the water and sewage system, the supply of water to retailers, and household water charges are all regulated by the Water Industry Commission for Scotland.

Scottish Water's investment programme

Scottish Water undertakes a very extensive programme of capital investment in the assets it owns. There are a number of elements to this.

- The pipe network needs constant maintenance and upgrading to deal with changing patterns of demand, wear and tear, and environmental considerations. There is a particular emphasis on reducing leakage, a programme overseen and agreed by the Water Industry Commission for Scotland, who sets ambitious targets in this respect⁸.
- Scottish Water is responsible for connecting new buildings and developments to the water and sewage network. This is an area of real concern to industry (in particular construction) who in the past have seen Scottish Water as an impediment to new development on top of delays inherent in the planning process. The disconnection of local authorities from the water supply and waste treatment process has meant that on occasions the planning permission for developments has been out of sync with the capacity of the network. Again, the Water Industry Commission for Scotland has an oversight role here⁹.

⁷ Water Industry (Scotland) Act 2002.

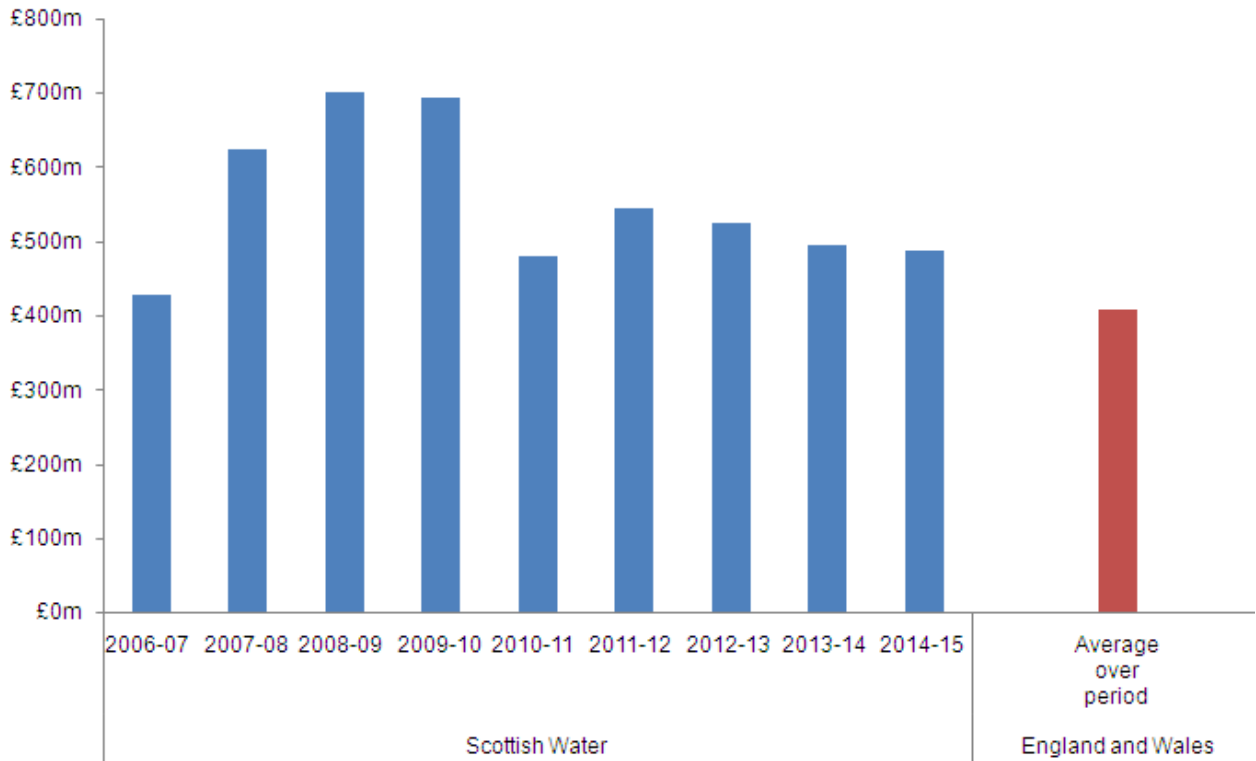
⁸ According to WICS Scottish Water underperformed its 2007-08 leakage target by 8%, however, it outperformed its 2008-09 target by 5%. Between 2005/6 and 2007/8 leakage fell by 16%.

⁹ The final determination of charges for 2006-10 provided for Scottish Water to relieve development constraints for 60,000 household properties. As at March 2009, Scottish Water has relieved development constraints for 54,201 water and 26,306 wastewater properties (according to *Scottish Water's 2008-09 Q4 delivery plan update*).

- Scottish Water has to keep up with new environmental goals, often set by the European Union, which require higher standards of waste water treatment and disposal and also of water abstraction and treatment.

In 2008/9 Scottish Water invested £687m in its infrastructure as part of a £2.4bn programme of improvement and maintenance¹⁰. Investment is forecast to continue at a level higher than the English and Welsh average for the next few years:

Annual Capital Expenditure (2007/8 prices)



Source: WICS

Overall, the performance of Scottish Water, in terms of customer service and operating costs as measured against its counterparts in the rest of the UK has improved considerably over the past few years. According to Sir Ian Byatt¹¹,

“Scottish Water has continued this year to respond well to regulatory challenges. It is a real public sector success story.”

The Water Commission’s ambition is that Scottish Water should be in the top quartile of UK water companies in levels of service and cost efficiency by March 2014, based on 2007-08 company performance.

¹⁰ See Scottish Water Annual Report 2008/9.

¹¹ The Water Industry Commission for Scotland, The Strategic Review of Charges 2010-14 the Draft Determination, 30 June 2009.

Raising capital

Currently, the money for Scottish Water's investment programme comes from two sources. First, income from charges made to its various customers (including licensed providers) can be reinvested in its asset base.

Second, as a government owned entity, Scottish Water has access to an element of the government's own capital raising capability. In the case of Scottish Water, this comes from the capital element of the Scottish Government's annual budget. As the Scottish Government does not have the ability to borrow on its own account, Scottish Water's funds are part of an annual, current financial settlement, (approved at Ministerial level):

Scottish Water's Borrowing, funded from the Scottish Government Budget

(£m)	2007-08	2008-09	2009-10	2010-11 (draft)
Net new borrowing	196.3	161.3	181.8	150.0

Source: Scottish Budget Draft Budget 2010-11, Scottish Government

The Scottish Government sets the investment requirements, called Ministerial Objectives, for the industry, (these are often imposed by regulation stemming from sources beyond their control, such as the EU). The Water Industry Commission for Scotland, in setting charges for the following regulatory control period, must finance these objectives; and at the same time consider the interests of Scottish Water's customers, the funds available from the Scottish Government, and the sustainability of Scottish Water itself.

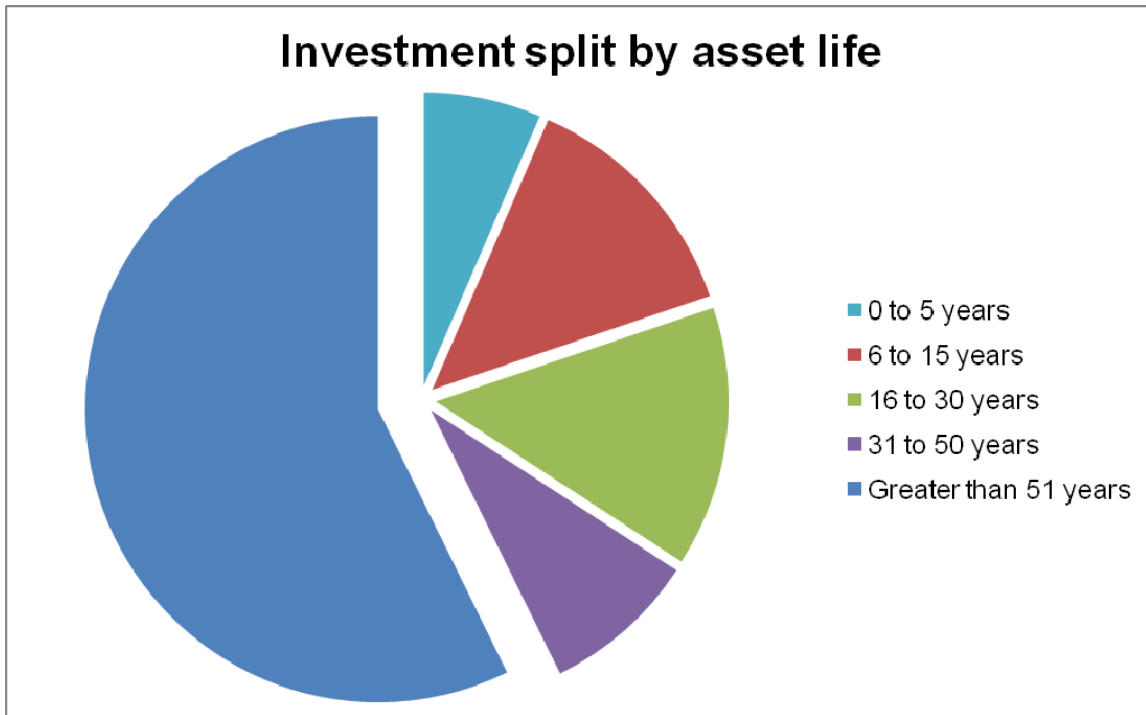
The Commission does not want to burden customers with paying for investment capital up front, so the main variables are the efficiency of Scottish Water (on which it is making good progress as we have seen) and the availability of government funding.

It is this latter source that gives cause for concern.

There are two main problems in relying on annual government budgets for investment capital for a company like Scottish Water – the annual nature of such funds, and the uncertainties over the future availability of government money.

The problem of annuality

Most investment undertaken by Scottish Water is in long term projects that require funding over a period of several years. The following chart shows the longevity of Scottish Water's capital projects by value:



In a normal commercial environment, companies (or indeed sovereign governments) would secure long term funding to match their investment programme. Any coherent strategy requires long term vision and commitment.

The advantages of this are that both the procuring company and its contractors have confidence that the project in hand is securely funded for its duration, and this in turn gives the company the ability to plan its programme of investment going forward with certainty.

Scottish Water does not have that luxury. As a result, contractors charge a risk premium because they cannot be certain that Scottish Water will be able to continue to fund projects from one year to the next. Scottish Water is also restricted in its ability to design new plant to meet standards which will come into play in the future.

At the same time Scottish Water is exposed to short term fluctuations in the availability of labour, materials and other capacity and has difficulty in securing long term contracts at competitive rates.

The uncertainty over future public finances

At a time of great economic uncertainty, when government finances are coming under increasing pressure, there can be no guarantee that the Scottish Government's munificence towards Scottish Water will continue to such an extent.

These pressures on the Government's finances are becoming apparent, as Scottish ministers have already cut the availability of capital to Scottish Water, from £182m per

year over 2006-10, to less than £150m per year, over 2010-15¹². But ministers themselves do not know what future circumstance will bring. Who can predict what further hard choices may confront the government two years hence? It may be that curbing Scottish Water's investment programme seem more palatable than, say, the closure of a hospital.

In effect then, Scottish Water is exposed to both political risk and overall economic risk, when its finances would better be decided by the risks inherent in its own business model.

Overall, while the cost of government finance may be slightly lower than that available to major utilities in the capital markets, if we include the hidden premiums that must be attached to Scottish Water's political, economic and timing disadvantages, the picture does not look attractive.

Solutions – the usual suspects

The answer to Scottish Water's current and potential problems in raising finance must lie in allowing it to access long term funding at competitive rates. With that in mind a number of solutions have been put forward, but each has flaws which have prevented their acceptance until now.

Privatisation

Privatisation would bring Scottish Water into line with the norm in England and Wales. It would certainly allow the company to access the capital markets for funding, relieving pressure on the Scottish Government's budget and securing long term financial stability for investment programmes. The sale would also raise a considerable capital sum for use by the Scottish Government.

In addition, Scottish Water would have to compete for investment with the rest of the private sector, and such competitive pressures would provide a strong incentive towards operational efficiency, while the regulator could continue to protect the interests of Scottish Water's customers.

However the privatisation option is not really on the table for political reasons. Scottish Water remained in state hands at the time of the privatisation of the rest of the UK industry because the concept aroused such public hostility, and there is no reason to believe that things have changed. Certainly the main political parties have all set their faces against privatisation.

Besides, the Water Industry Commission for Scotland appears confident that comparable efficiencies can be achieved through a regulatory regime by benchmarking against the private companies in England and Wales, and as we have seen, they do seem to have grounds for this optimism.

¹² The Scottish Government's Principles of Charging for water services 2010-2015 statement, www.scotland.gov.uk

Mutualisation

An oft-proposed alternative would be to establish Scottish Water as a mutual organisation, owned by its customers. This is an option espoused by the Scottish Conservatives and is regarded sympathetically by some other politicians. Indeed, one water company south of the Border has mutualised¹³, having once been a public limited company. There is strong support for this approach amongst the business community.

The advantages are that the company would gain access to most forms of private debt capital, but the solution would be more politically appetising because Scottish Water would be owned by its customers (who comprise the full gamut of the Scottish public, businesses and the public sector) rather than by seemingly rapacious and anonymous capitalist investors who might not have the interests of Scotland at heart (a considerable proportion of the capital behind England's privatised water companies is based offshore).

However, there are some question marks over the accountability of mutual organisations, whose owners have neither the power of exit (as do private investors) nor the power of direct intervention (as does the government)¹⁴.

Politically, this option is sometimes seen as privatisation by the back door (especially since the Conservatives espoused it). Also, it does not carry the cherry of a major capital sale for the government.

These three reasons, neither of them particularly strong in themselves, seem together to have scotched the mutualisation solution up until now.

Public / Private Partnerships and SFT

One source of long term infrastructure finance, that has grown in importance in the last two decades, is Public Private Partnerships, which used to be known as the Private Finance Initiative, and is often abbreviated to PFI/PPP.

Under these arrangements, a private company (often a special purpose vehicle formed for the purpose and co-owned by several parents with the right set of skills) undertakes to build, maintain and operate a new asset in return for a long term government contract.

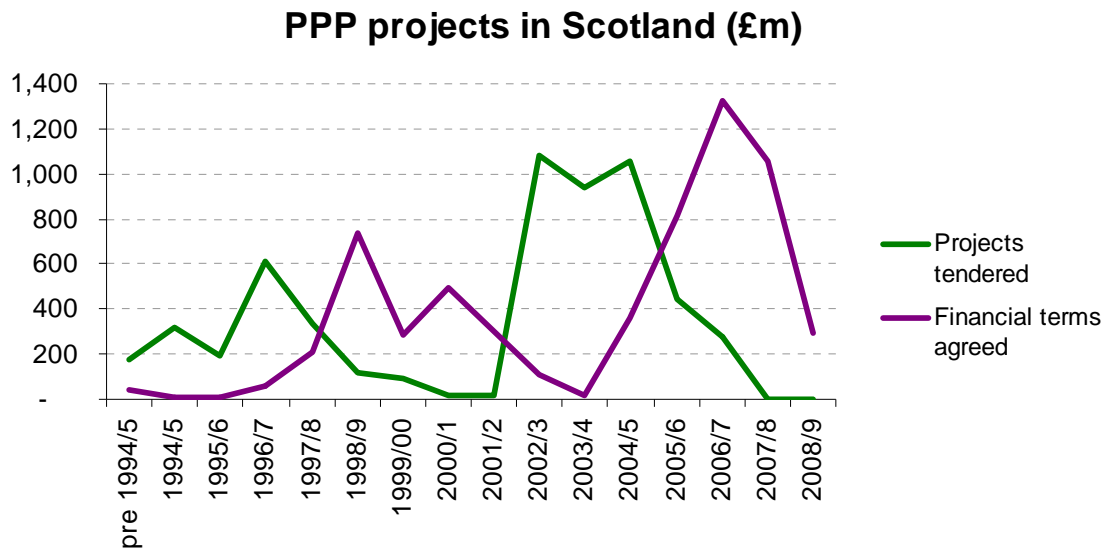
In essence government uses the private companies to raise capital privately on its behalf. The additional costs of so doing is (it is hoped) outweighed by management efficiencies that the private operators can bring to bear.

The devolved Scottish administration, devoid of its own borrowing powers, made increasing use of this model in the years up to the 2007 election, not least in the provision of water and sewage infrastructure.

¹³ Dŵr Cymru (Welsh Water)

¹⁴ An impression strengthened by the recent collapse of Dunfermline Building Society.

However, the SNP has set its face against a continuance of this, partly on ideological grounds (the objection that the asset is owned and managed by private companies) but also on grounds of cost. The following graph shows the rise in the value of PPP deals and subsequent tail-off.



Source: Partnerships UK

In practice the evidence shows that PPP/PFI is cost efficient compared to traditional public sector procurement¹⁵. However, so extensive was PPP/PFI in the middle of this decade that the Scottish Government has been burdened with considerable contract obligations that would make much more debt acquisition difficult to cater for in their budgets going forward.

In a recent speech¹⁶, John Swinney, Cabinet Secretary for Finance and Sustainable Growth, stated that

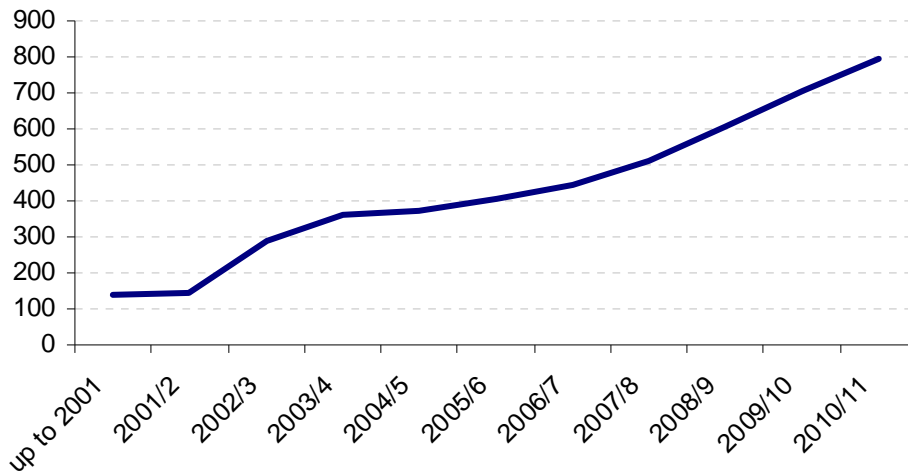
“By 2011-12 – the end of this parliamentary term – the annual cost of PFI will be £867 million. In the course of four years I have to find in total £2.7 billion in cash terms of new money to fund PFI. And that has to be found from a budget which is now largely static in real terms and may even fall in real terms in the years ahead.”

The rising cost of PPP payments is illustrated below:

¹⁵ ref (see our research)

¹⁶ Scotland’s financial future, 16 April 2009, David Hume Institute

PPP payments Scotland (£m)



Source: Scottish Parliament Finance Committee

So while the SNP Government is taking steps to construct an ideologically acceptable alternative called the Scottish Futures Trust, there may well be budgetary constraints similar in effect, though different in nature, to those that may cause Scottish Water problems in the first place. In essence PPP/PFI/SFT may in principle allow more long term funding but it does not offer an escape from dependence on a tightening Scottish budget.

Add to this the contractual complexities of securing funding under such arrangements¹⁷, and SFT does not seem to be a satisfactory answer, though Scottish Water should still attempt to persuade SFT and the Scottish Government to continue to consider sewage and water projects as part of SFT's remit.

The analogy of Network Rail – an alternative funding arrangement

The flaws in the usual solutions as detailed above themselves describe the parameters that are required within which Scottish Water must find a solution for its funding problem: It must remain in the public sector while being able to raise funds on its own behalf in the private capital markets.

Fortunately there is already a UK organisation which fits within these parameters pretty exactly. Network Rail provides good model for a structure that would suit Scottish Water very well.

Network Rail is the organisation created by the UK government on the collapse of Railtrack, the previously privatised rail infrastructure owner and manager. Network Rail has important similarities to Scottish Water. Both are government monopoly operators of

¹⁷ ref on length of process and add to problems of setting up SFT.

a nationwide infrastructure network that has competing companies as its customers. Each has a strong regulator. And both have major long term investment commitments.

The big difference is in their funding structures. The UK government was understandably reluctant to take on Railtrack's portfolio of investment responsibilities – it would have added enormously to the public debt. So it has created an arm's length relationship with Network Rail whereby the company is accountable to a group of 100 or so 'members'. The majority of these are members of the public, recruited in a process of open selection. There are also some industry members, and the Department for Transport is a member with special rights¹⁸.

Network Rail is able to borrow on its own balance sheet (a situation endorsed by the EU), and acts in most other ways as a PLC. But it remains ultimately accountable to the government and its electors.

Opportunity knocks

Such an arrangement would suit Scottish Water and the Scottish Government admirably. As we have seen, Scottish Water would be able to access long term capital without political risk. The Scottish Government, meanwhile, would find an innovative solution that kept Scottish Water accountable to the Scottish electorate.

A budgetary bonus

At the same time the Scottish Government would benefit from a major financial bonus – the funding which at present it makes available for Scottish Water could be used for other purposes. We have already seen how the funding directed to Scottish Water was £182m in 2009/10 and will be £150m next year according to the draft budget. But the dividend from refinancing Scottish Water could be much greater than this.

The Scottish Government pays an annual 'cost of capital' charge to the Treasury for the financing of Scottish Water. This charge was £181m in 2009/10 and is budgeted for £195m in 2010/11, and is matched by a corresponding element of the block grant received by the Scottish Government. If Scottish Water were refinanced from private capital markets, the charge would no longer be payable, but the block grant element should stay in place¹⁹. The Scottish Government would then benefit in net terms by this additional amount, making a total annual saving of some £360m from reforming the way Scottish Water is financed.

This data shows just how much that would be worth. £150m is equivalent to the entire budget for training nurses, or would finance a 10% cut in business rates. £360m is greater than the whole rail infrastructure budget for Scotland.

¹⁸ See www.networkrail.co.uk.

¹⁹ Because it reflects the 'ownership' element of Scottish Water as an asset, which is currently enjoyed by the Treasury on behalf of the government in Scotland. The final settlement would have to be agreed by the UK government.

A Window of Opportunity

There now exists a great political opportunity for such a reform. Reforming the structure and status of Scottish Water would require Westminster legislation because of the changes needed to the financial relationship with the Treasury and the new special status of Scottish Water.

Under normal circumstances it would be highly unlikely that the UK government could be persuaded to open up the devolution settlement for change on account of such a relatively minor matter as Scottish Water's funding arrangements.

However, the politics of the Calman Commission and the renewed debate over devolution and the constitution makes change to the Scotland Act highly likely. An important part of this debate is the financial arrangements of government in Scotland in terms both of borrowing and financing the budget.

Would it not be more natural for sensible reform of Scottish Water to be included in this process? Now is the time, therefore, for politicians, regulators and the water industry to make the case for change so that when the train of constitutional reform leaves the station, Scottish Water is firmly aboard.

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