

**SOME THOUGHTS OF THE WORSHIPFUL COMPANY OF WATER  
CONSERVATORS (WCWC) ON THE FUTURE GOVERNANCE AND ECONOMIC  
REGULATION OF WATER SERVICES IN ENGLAND**

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**Overall Executive Summary**

- The headline insight by the WCWC is that the fundamental 1989 model of a privatised, vertically integrated, dual-service water utility operating to balance affordability and maximum efficiency to satisfy service and environmental aspirations and regulated economically, served the national well in the conditions of the 1990s and is still valid. The WCWC supports the view that it needs to be adjusted to reflect thirty years of experience and the changing circumstances of water service delivery in 2022
- The WCWC supports the primary duty of OFWAT as being to ensure that the functions of water and sewage undertakers are properly carried out and that Appointees can finance them. Subject to that, the economic regulator must protect customers, and promote economy and efficiency by comparative competition using provisions in the Appointment to adjust prices to ensure that both customers and investors benefit from efficiency gains and to meet the cost of additional obligations. Customers should be protected from unnecessarily high charges or a poor service or both and companies must invest wisely to maintain an adequate infrastructure of assets and expect to be monitored on outcomes. In return for effective delivery, companies and their investors should be able to expect the economic regulator to help achieve an objective, balanced and affordable/financeable scale of obligations arising from changing expectations and circumstances.
- No matter what system of governance is in place more investment will lead to higher, not lower prices.
- Diverting attention and creating physical or corporate boundaries by restructuring across the whole industry would introduce very significant risks.
- The evidence shows that while the behaviour of some private equity firms has been simply impossible to defend, it is by no means the only problem. Nevertheless, taking steps to mitigate a financial markets-based approach will contribute to the way forward and restoring public trust.
- Suggestions are made to amend the price review processes.
- Other contributing factors such as Planning Strategies need addressing at the same time.
- If the proposals from Ofwat and the WCWC are followed through, it would seem to be going back to the broad concept of the pre-1989 private equity based statutory water companies and that this needs examination. The WCWC is not advocating a return to a rate of return model.
- The Price Review process has thirty years of accretion and the time has come to determine if it can be simplified. One way of doing this would be to reset the relationship of the Letter of Appointment and the Price Review process. Changes to the Appointment would allow some principles to be set more permanently whilst other could be varied as factors impacting the price review process vary.
- Steps to change company behaviour are suggested.

- There must be a continuing commitment by, and support of, staff for professional development as part of the effort to restore trust in the sector.
- In view of the intense interest in the future of water services, there is an urgent need for a national forum or summit, or preferably a Commission drawing on historic experience, including all interested parties to develop and agree a national strategy.
- Communication on water is distorted by poor information and its presentation and must be remedied.

## **Full summary**

S1 This think piece is produced by the Worshipful Company of Water Conservators (WCWC), the City of London Livery Company focussed on the long-term health of our water resources and the broader environment. Our members include senior professionals from water, environmental and related industries and regulators, along with others who share our passion for water and the environment. Our experience and knowledge ranges from the complexities of environmental sciences, through the application of engineering to deliver the goals identified by those sciences, and the subsequent management of the assets created. The Company's purpose is *Promoting a diverse and sustainable environment*.

S2 It is accepted that this is a long paper covering comprehensively a wide range of relevant topics. So, a short form version based on this Summary has also been prepared and both are archived on the Company's website. It forms part of a suite of papers concerning different aspects of water conservation. To avoid confusion between the use of the term Company and water companies, the acronym WCWC is used.

## **Why has the Worshipful Company produced this paper?**

S3 This year has experienced a very substantial increase in angst in England about environmental water quality, such as the impact of storm sewage overflow, water resources during the drought and the performance of water companies and their regulators. Some criticism is well-founded, some ill-founded. More reasoned debate is needed in order to ensure that whatever changes are made, they are well founded and focussed on productive improvement.

S4 The issue of communication is very difficult. On one hand, it must be recognised that the populist reporting of all matters associated with water conservation is often highly biased against the water companies and even Defra and the regulators and distorting proper debate. Any criticism and counter assertion of this is portrayed as complacent and defensive. The WCWC recognises the diversity of views across the nation which must be reconciled in moving forward and even within its own membership there is a range of views for which even it has found a challenge in preparing this paper. The Utility Week Forum in November 2022 shows how much work needs to be done to restore public trust in the water service systems. So, in many ways the challenge is twofold: improving the service provided and being seen to be doing the right things so that myths can be dispelled. Equally, there is a need for other contributors to be equally clear about their responsibilities for other factors, such as the sensitivity of the planning processes.

S5 But right at the start of this think piece, it is worth observing that that whatever the causes of the present situation, a lot more investment is needed at a time when there is a drive to contain and reduce public debt. This has echoes of the 1970s and 80s so it is important to

understand how we arrived at the way that water services are managed now. As the cost of borrowing rises, the more likely trend is that extra money will be found through equity and ill-informed bad publicity will deter investors (see Utility Week Forum November 2022). The WCWC wish to provide a place of well-informed debate on the way forward.

S6 This contribution is part of an extended process of engagement by the WCWC. It is also planning to organise a conversation, 'Running Water' in London on March 21st 2023, the eve of World Water Day, as part of WET 10, a partnership of City Livery Companies sharing an interest in water. It is planned that the leaders of the water sector, including the regulators, will make contributions.

### **The dilemmas on which the WCWC are providing views**

S7 These are complex and interrelated, but the WCWC has sought to provide a simple summary.

- Changes in public aspirations, better monitoring, and increased demands on the system through development and climate change are making the task of maintaining an excellent water service more difficult.
- Asset inertia is often overlooked; instant solutions are impossible and growth is not the self-funding answer.
- Greater efficiency will not provide all the funds needed to invest in new assets, but operational performance has to improve; the generally held view of regulators and others is that the water companies can do better.
- Customer charges will have to rise to pay for the improvements, but the current regulatory/political agenda is to reduce charges.
- Political and media demand has been for the returns to investors in water services to be reduced and for the governance of water companies in England to be changed, but these alone will not solve the current challenges.
- There is poor alignment between planning and water strategies.
- Getting the balance of communications right should be achieved, avoiding complacency and defensiveness and ensuring that the debate is based on evidence rather than prejudice.

S8 The principles of governance are explored but the intention is to provide further papers on storm sewage overflows and water resources.

S9 The paper is split into four parts:

### **PART 1: UNDERSTANDING THE ROOTS OF WATER SERVICES NOW**

S10 This seeks to provide some understanding of the journey from a pre regional public authority past to now, and, in doing so, contributing the lessons from that journey to help determine the best way in future. There is as much to celebrate as there is to criticize.

S11 An outline of the history of the current industry is given not just as historical background but to understand the underlying dynamics of service delivery today. The integrated regional service delivery was created in 1974 following reviews of water services and local government. But upon entry into the European Community, although the UK led on concepts like river-basin catchment management, it found that in the 1980s:

- It was described as the ‘Dirty Man of Europe’ because of issues like marine discharge quality and the dispersal of sewage sludge at sea, and was in breach of multiple EC standards on drinking water, bathing water and river quality with no prospect of meeting them in a foreseeable time-frame at the then rates of investment, but with every prospect of litigation and costly fines from the EC
- The regulatory system was not fit for purpose. Apart from the small independent HMIP the RWAs were responsible for both operations and environmental regulation. If monopolies were to be privatised a system of economic regulation was needed as well
- River quality suffered as a result of a lack of government investment

Action was needed particularly to invest a lot more, and the answer was privatisation. This has echoes of the dilemmas today: more investment at a time of fiscal constraint.

## **PART 2: THE STARK CHOICES FOR THE FUTURE**

S12 This looks at the options for organisational change and concludes that the fundamental model of a vertically integrated dual service water company utility operating to comply with environmental and customer services’ legal requirements and regulated economically is right for England. But it needs some significant and far-reaching adjustments.

S13. There are undoubtedly major weaknesses and poor performance with the existing model, but WCWC suggest that addressing them does not justify the disruption and extra cost that would accompany major organisational changes:

There are also strong practical and political arguments against the main possible organisational alternatives:

- Re-nationalisation cannot possibly provide the investment required either for the short or long term.
- Franchising—the main form of partial public ownership discussed as an option in public has been found so wanting in other public service sectors

Diverting attention and creating physical or corporate boundaries by restructuring across the whole industry would introduce very significant risks.

## **PART 3: DELVES FURTHER INTO THE DEBATE SET OUT IN THIS SUMMARY**

S14 This points out that the causes and hence the solutions do not lie in simple assertions like excessive company dividends, although these do undoubtedly need to be addressed.

S15 The evidence about the causes of the current dilemmas is equivocal but, after 30 years, it is timely to review the roles of regulators and the companies. This is needed to identify and address some of the unintended flaws that have appeared over the last 30 years including the impact of private equity ownership. Change is needed not only to address better the environmental imperatives but to restore public and investor confidence

## Getting the mindset right

S16 In trying to understand the current situation better, it was an advantage to think in terms of two worlds in which people played roles. In practice, life is never as simple as that. This is set out here in the Summary to provide a framework for understanding the essence and origins of the points being made in the main body of the paper

### *The Two Worlds of Finance and Operations*

S17 One world has been Financial Markets, populated by issues like:

- Dividend and equity
- The best or most effective way of raising money to invest – in bonds, in group loans, in external loans etc.
- It is often impatient

The other world has been water services engineering populated by matters like:

- Capital or operating solutions to real environmental problems
- Operational efficiency
- Customer service
- Compliance with regulations
- The impact of decisions on customer charges

S18 This latter world underlined the Defra consultations on environmental targets earlier this year. It is a world that demands patience. Even with the best will, changes involving operational capital in particular, cannot be made overnight. But do they communicate effectively with each other? Between them lies economic regulation, involving matters such as: the weighted cost of capital, replacement asset value (RAV), return on capital, and natural capital. In these worlds, even the term ‘capital’ can mean subtly different things to different people.

S19 The problems lie in the communication between these two worlds and that creates myths. Articles in recent editions of Utility Week highlights the complexity, and Ofwat seeks to make that connection. There is no doubt that the consequence has been an accretion of economic regulation over the last thirty years. There but there does not seem to be a direct line of sight between projects like the reduction of storm sewage and overflows and the impact on decisions like how these should be funded directly by revenue or debt or equity. The Generally Accepted Accounting Practice rules will eliminate some of the debate.

S20 Whilst the concepts of the Water Industry Environment Programme and the Water Industry Strategic Environmental Requirements (WISER, May 2022) are embedded, they help, but what about all the other current initiatives?

S21 A study of the problems of Southern Water demonstrates the lack of communication of these two worlds, but it was private equity and equity injection which avoided its final demise (Utility Week Forum November 2022). They must work more closely in future, or even merge.

S22 In 1974, loose financial systems in municipalities were translated into normal profit and loss accounts and balance sheets. There was some added sophistication with moves to current cost accounting and the introduction of the RAV to determine returns earned in the absence

of market forces as part of the construction of economic regulation in 1989. The markets-based approach arrived with the more demanding private equity owners, which resulted in very weak balance sheets. The model worked well initially, but flaws became apparent and were exploited.

S23 In the original concept of privatisation in the economic model of 1989, managing money was a means to an end, for delivering better water services. But now the perception is that the roles are reversed and there needs to be some rebalancing. There is now an apparent complexity of desired outcomes.

S24 Ofwat aspires to make a real drop in customer charges after 2025, the Defra consultation documents recognised the cost impacts of the investments and operational costs of environmental targets, including the reduction of storm sewage overflows. It is claimed this dilemma will be resolved by lowering dividend, by reducing the allowable cost of capital and by increased efficiency, whilst at the same time reducing the sale of product - drinking water, the basis of all variable income? There must be a greater understanding and practical response to this paradox. In the future are charges to go up or down? The pointer appears to be going up.

S25 The paper seeks to make suggestions to bring these two worlds closer together, which is a challenge. That challenge involves regulators as well as the companies. The debate has been made more intense by the demands for higher criminal and civil penalties imposed by the Environment Agency and Ofwat which are not perceived to ensure that what is expected, is delivered.

#### **PART 4: LOOKS INTO WHAT CAN BE DONE TO EVOLVE THE 1989 MODEL TO REFLECT THE REALITY OF 2022**

This sets out a number of suggestions for ways forward, which are listed in the key point listing below

##### **Insights for the future**

**S26 The headline insight by the WCWC is that that the fundamental 1989 model of a privatised, vertically integrated, dual service water utility operating to balance affordability, and maximum efficiency, to satisfy service and environmental aspirations and regulated economically served the national well in the conditions of the 1990s and is still valid. It supports the view that it needs to be adjusted to reflect 30 years of experience and the changing circumstances of water service delivery in 2022.** The model has, in general, delivered large improvements in the quality of drinking water, sewage treatment, the remedy of customer service deficiencies and systematic monitoring and improvement of underground and overground assets. But a revision of the model is needed to address new technical and financial demands and the changes in water and sewage companies (WASC) ownership.

##### **Conclusions and Suggestions**

S27 Throughout the paper various specific conclusions and suggestions arise to ease the way forward and for ease of reference in the paper and in this Summary, they are highlighted in red in the text and paragraph numbers are given here:

41-42 Ofwat has already introduced Design Procurement for Customers for large projects, which may ease the development of new reservoirs. Particular scrutiny of the cost assumptions, RAV and returns will be needed to ensure confidence in such projects. The 2013 Water Industry Specified Infrastructure Projects (English Undertakers) Regulations for large projects, might offer opportunities.

44 The WCWC, from practical experience, concludes that, in general, vertical integration should be maintained, wherever possible.

47 The WCWC, from practical experience, concludes that water and sewerage services must not be separated, but this in no way offers any comment on the efficiency of the water only companies.

58-59 The WCWC already opined that the water regulatory framework needs sorting out. It is a jigsaw of initiatives at present. framework for environmental quality and use needs sorting out, it is a jig saw of initiatives at present. The WCWC very much support any initiative to ensure that the rivers of England are not only fit for use but are havens for wildlife. The WCWC has been advocating a national strategy in which there are agreed sets of quality criteria for recognisable uses.

- The quality specification for a defined stretch of river should be created after public consultation to agree sets of quality criteria for recognised uses using agreed national criteria for each use, including protection of habitats.
- These should then be used to determine catchment management strategies, including discharge consents, abstractions and river flow regimes, using models such as SIMCAT or SimBasinQ based on Monte Carlo simulations. And must incorporate costs associated with outcomes

This would be much better approach rather than the random one currently evolving for inland bathing waters, but would still embed the principles sought by campaign groups. This would be a good step in evolving the creation of Catchment Plans under the future Regulations of the Environment Act and would be focused on activity rather than just end of pipe solutions. This will be the subject of a further think piece.

65 The WCWC, from practical experience, concludes that the management of infrastructure and its operation must be kept together, and there needs to be a clearer understanding of the fluid relationships between capex and opex.

67 As stated in the headline insights **The WCWC concludes that the fundamental model of a vertically integrated dual service water company utility operating to comply with their environmental and customer services legal requirements and regulated economically is right for England, although it needs some adjustment.**

68-72 It cannot be determined from the EA data that private equity produces the worst performance now. But all companies are perceived through the same 'lens'. There is no doubt that other factors must be taken into account in moving forward, such as the contribution of Planning Strategies, and matters concerning use of the water systems, for example water efficiency labelling. But there is a focus in this paper on the

impacts of private equity, because there is such intense public interest in them; mitigating those impacts will at least contribute to solving the current problems.

77 The WCWC are of the view that a very useful step would be to determine if and how the extent of the NAO recommendations on Ofwat have been implemented.

80 The WCWC concludes that more accessible and universally accepted headline data are required. This needs to be appropriately detailed and presented in an easily appreciated format so that the debate is founded on fact, rather than assumption. The debate must be about what to do rather than incorporating debate on the validity of the evidential data. It is suggested that this might be a useful ONS project.

85 In making a judgement on the extent of extra cost incurred by the current system, it is notable that a study done a few years after privatisation showed that if the same investments had been made by public finance with an addition to the PSBR it would have been more expensive. It is crucial that up-to-date comparisons such as these are carried out.

99 The WCWC concludes that the extension of Ofwat powers on dividends probably even to dividend capping is right. And that as interest rates rise future investment in assets could come more from equity. But there is also no doubt in the view of the WCWC, that the future system must not allow a market-based approach to be for the unsustainable benefit of investors. This probably means a review and modification of Appointments rather than further elaboration of the Price Determination process. But as later paragraphs argue the whole business of what should be included in the Appointments and what should be included in the Price Review process needs a major single review.

107 In discussion the WCWC have also identified the full definition of RAV and fair rate of return to need attention. It has been suggested that the RAV should be reduced to take out the value of non-performing assets (including those which have been off-line for unaccountably long maintenance works, cost overruns) and even clawback where past returns have incorporated non-performing assets. However, there may be some challenge in agreeing a process of defining non-performance and there is a danger that this will reduce innovation and its associated risk taking and even impact resilience investments. This has led to an interesting debate worthy of being explored elsewhere which the concept of risk and innovation paired together as part of investment criteria, Should we invest in 'flying bicycles' was one comment. The WCWC suggest that UKWIR should be actively involved in the question as to which way forward on innovation. The WCWC supports the focus on innovation in the companies, such Blue Wave in Southern Water, as contributing to a better future.

109 A simple model of company governance used by the WCWC to explain what needs addressing is the relationship between the PLC Board, the Board of the water service company (WSC), the de facto subsidiary (the WSC), the employees led by the Chief Executive, and the assets they own, extend, maintain and operate. This is a unique variation of the usual concept of a Holding Company and subsidiary. The Board of the WSC must hold the executive to account in terms of performance, the executive must hold the Board of the WSC to account for making the right finances available at minimum cost to customers and it must hold the PLC to account to ensure



that the right finances are available. It does recognise that this approach is open to debate.

110 The Board and Executive must continue to make sure that the staff have the necessary skills. This should include the concept of registered status with associated Codes of Ethics. Whilst companies are free to employ who they wish, it ought to be part of the contract<sup>[EB1]</sup> which exists between the monopoly company and the rest of the community that the best people are employed. And hence the WCWC considers that not only dividends, but employee remuneration should be linked not only to financial performance, but substantially environmental, performance.

111 In the current environment of blame there has to be a distinction between wilful breaches of the legislation, unavoidable breaches of the legislation due to external issues like development and climate change which the assets cannot cope with, and changes in attitudes towards what is acceptable and what is desirable. This does not excuse negligent or wilfully damaging behaviour. The Companies Act 2006 introduced a new duty on directors to “have regard to [among other things] the impact of the company's operations on the community and the environment”.

119 The WCWC suggests that the current voluntary enhancement of the Articles of Association of the WSCs to cover explicitly the commitment to sustainability, maintaining and improving environmental standards and acting in the long-term interests of the community and customers should be made a formal part of the regulatory system. This would improve tangible accountability of Boards and Directors and would enable the government to be in a position to state that it had taken action on a change in the status of companies without massive structural changes. This would have the advantage that there would be a manifest commitment to the environment alongside responsibility to shareholders

120-121 A interesting idea has arisen in the discussions. If some of the ideas put forward find favour it might well be that the 2022 model might be migrating towards the model of private equity ownership of Statutory Water Companies (see paragraphs 18-20). Moving to this model might change the nature of the private equity investors which would be more interested in this ‘patient investment’. So, the WCWC are of a view that looking at this suggestion might be worth investigating, as part of any review of the Licence. But this suggestion is not advocating a return to the Rate of Return model.

122-3 The Price Review process has 30 years of accretion and the time has come to determine if it can be simplified. One way of doing this would be to reset the relationship of the Letter of Appointment and the Price Review process. Changes to the Appointment/Licence would allow some principles to be set more permanently whilst other could be varied as factors impacting the price review process vary. So, rather than current piecemeal changes the WCWC recommend that there must be a major single review as soon as possible.

124 The WCWC suggest that in view of the intense interest in the future of water services, there is an urgent need for a national forum or summit, or preferably a Commission, drawing on historic experience, including all interested parties to develop and agree a national water strategy.

125 And finally the WCWC suggests that there needs to be a national consensus on communications, perhaps with the central entity, suggested above, taking a lead.

S28 Members of the WCWC stand ready to develop the ideas put forward.