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“Social policies and private sector participation in water supply – the case of Great Britain”

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1. Introduction

One of the most contentious political issues in the United Kingdom (UK) in the second half of the twentieth century was the relationship between individual citizens and the state. In the years immediately following the second world war a consensus emerged between the main political parties on the role of the state as a provider to citizens of a range of goods and services— particularly those associated with the utility industries - in order to achieve specific distributional ends¹. By the mid 1970s, however, doubts were being raised by leading politicians² about the efficacy of public corporations in meeting redistributive or other social obligations, and the consensus began to break down. The election, in 1979, of a Conservative administration committed to changing the relationship between the citizen and the state marked the beginning of a period in which alternatives to the public sector provision of goods and services were explored. A technically challenging and politically ambitious privatisation programme followed, in which many nationalised industries, including some but not all the utilities (previously considered the exclusive preserve of the state), were restructured, divested of particular social obligations, given clearer economic objectives, made subject to new forms of economic regulation, and sold to private sector investors³.

The water and sewerage industry in Scotland, England and Wales was not immune to these wider policy developments. Indeed, according to Bakker (2001, p1), the English and Welsh industry's evolution over the last thirty years may be understood in terms of shifting policy priorities, resulting in a changed perception of the relationship between the service supplier and recipient. Thus, instead of suppliers prioritising social equity in seeking to supply all citizens at subsidised rates, changes in policy ensured that they gradually came to prioritise economic equity in selling to those customers able to pay on a full-cost recovery basis. In other words the 'public service' model⁴ of the relationship between producer and consumer began to give way to a 'business organisation' model.

Against this background the Great Britain case study analyses the issue of affordability of water services and how social policies are designed, in Scotland, England and Wales⁵, with particular reference to low income households.

2. Institutional setting

During the early and mid twentieth century a wide variety of organisations, both public and private, undertook the tasks of supplying water and sewerage services to domestic households across Great Britain. Whilst local municipalities generally came to assume responsibility for the provision of sewerage and sewage disposal services

¹ Thus a National Health Service was established and industries such as coal, rail, gas and steel were taken into public ownership. In the water industry the number of private sector operators dwindled as local authorities took over responsibility for service delivery across most, but not all, of the country.

² Most notably from within the Conservative Party led by Mrs Margaret Thatcher.

³ An early discussion of the rationale for the UK privatisation programme is presented by Kay and Thompson (1986). More comprehensive analyses are offered in Vickers and Yarrow (1988), Armstrong et al (1994) and most recently for the English and Welsh water industry in Bakker (2003).

⁴ Penning-Rowsell and Parker (1983), p 170.

⁵ The analysis does not extend to the fourth constituent of the United Kingdom, Northern Ireland, as at present the costs of domestic service delivery are met primarily through an allocation from a general consolidated property-based tax fund. It is therefore not possible to identify accurately charges for water and sewerage attributable to individual household units. This undermines empirical analysis.

within their own jurisdictions, private sector organisations worked alongside public sector bodies in the abstraction, treatment and distribution of water. A process of consolidation and amalgamation gradually reduced the numbers of separate undertakings in both branches of the industry from over 2000 at the beginning of the century to around a tenth of this number by 1970.⁶

2.1. England and Wales 1974 to date

In England and Wales, the most significant organisational change to the industry in the second half of the twentieth century came about through the passing of the 1973 Water Act, which created ten Regional Water Authorities (RWAs)⁷. These bodies, organised under the general principle of 'Integrated River Basin Management', assumed responsibilities relating to the planning and control of all uses of water in each river catchment area: responsibilities which had previously been exercised by a large number of separate water and sewerage organisations⁸. As public bodies, they were ultimately responsible to central Government, in particular the Department of the Environment (the Welsh Office for Welsh Water) except on matters of land drainage and fisheries where they reported to the Ministry of Agriculture, Fisheries and Food.

A significant feature of this reorganisation was the fact that the 29 private (statutory) water companies existing in 1973 were allowed to continue operating under section 12 of the 1973 Water Act, even though the RWAs assumed responsibility for the supply of water in all areas. Where a private company operated within the area of the RWA, the RWA was required to discharge its water supply and distribution functions through the company. Close cooperation was required as responsibility for water resource development lay with the RWA. However, in many areas the company acted as agent of the Authority. All twenty-nine private water supply companies in existence in 1973 continued to operate under tight regulatory control until 1989. Supplying approximately one quarter of the population in England and Wales their combined contribution was significant throughout the period. Thus private and public water suppliers co-existed in England and Wales from 1974 to 1989.

In 1989 the RWAs were privatised⁹ and ten public limited companies were created. These were group holding companies sharing similar corporate structures, in which a subsidiary water and sewerage company (WaSC), assumed the main operational responsibilities. The WaSCs delivered services under an 'Instrument of Appointment' granted by the Secretaries of State for the Environment and Wales.

The assets and liabilities of the RWAs were transferred to the subsidiary Appointees on 1st September 1989 with shares in the holding (Group) companies being offered for sale in November 1989. The share offer was oversubscribed, due in part to the success of previous public share offerings in the large utilities, and the perception on the part of potential investors that the companies had been underpriced to maximise the chance of a successful floatation.

⁶ A description of the twentieth century development of the English and Welsh water industry may be found in chapter 5 of Hassan et al (eds) 1996 and chapter 11 of Vickers and Yarrow (1988).

⁷ The Regional Water Authorities came into existence on 1st April 1974.

⁸ The creation of the RWAs was intended to allow the exploitation of economics and scale and scope in service provision and the promotion of greater pollution control.

⁹ Under the Water Act 1989.

Each Appointee's Licence to operate, granted either by the Secretary of State for the Environment or the Secretary of State for Wales, was awarded initially for a period of 25 years. Licence terms and conditions, binding the companies in various ways, were enforced by the industry's new economic regulator, Office of Water Services (Ofwat), and covered matters such as charging, codes of practice on consumer matters, debt and leakage, levels of service, asset management plans and the provision of information.

A special or 'golden' share in the WaSCs was retained by the Secretary of State until 31 December 1994. This share gave ultimate ownership rights to the Secretary of State, effectively ruling out the threat of merger or takeover for the initial post-privatisation period. For all water companies the Director General of Water Services was required to refer any proposed merger of companies which breached a particular financial threshold to the Competition Commission. For larger mergers EC Mergers Regulations came into play.

As far as the 29 private water companies were concerned, the Act preserved their status and areas of supply. They were appointed to supply water services (only) within their own areas under Licence in the same way as the ten WaSCs. Restrictions on their ability to borrow and pay dividends were loosened, some became PLCs, and many attracted the interest of domestic and foreign companies as potential takeover targets. To date, the majority of the original 39 companies have either merged or been taken over and now operate as subsidiaries of larger companies. Only a minority retain a separate London Stock Exchange listing.

As far as economic regulation was concerned, the main innovation of the 1989 Water Act was the appointment of an independent economic regulator, the Director General of Water Services (Ian Byatt), who headed the Ofwat¹⁰. The economic regulator's duties set out in section 2 of the consolidating 1991 Water Industry Act as updated by section 39 of the 2003 Water Act included; the promotion of consumer interests (through the promotion of competition where appropriate), securing that the functions of the companies were properly carried out and that they abided by the terms of their licence to operate. Significantly, the economic regulator was to regulate through the use of a price cap mechanism, with periodic reviews every five years. In setting price caps Ofwat's primary duty was to ensure that the companies were able to finance their functions, in particular, by securing a reasonable rate of return on their capital. From 1 April 2006 the functions of the Director General of Water Services transferred to the new Water Services Regulation Authority¹¹.

2.2. Scotland 1975 to date

Scotland's answer to the English and Welsh industry's reorganisation in 1974 came about as part of wider local government reform. Thus under the terms of the Local Government (Scotland) Act 1973 the nine regional and three islands councils established on 16th May 1975 became responsible for water and sewerage services within their own areas, and responsibility for the prevention of pollution of inland and

¹⁰ Ofwat is a non-ministerial government department, and therefore not subject to direction from Ministers. It is accountable to Parliament, provides evidence for Parliamentary Select Committees and provides an annual report to the Secretary of State and the First Minister of Wales.

¹¹ The Ofwat title was retained.

defined coastal waters on mainland Scotland was transferred to seven River Purification Boards (RPBs)¹².

Overall responsibility for the economic regulation of the industry post 1975 remained with the Scottish Office, a department of central government. It continued to set the macroeconomic framework within which the bodies were to work, but delegated some regulatory powers to regional and islands councils that set charges at a level high enough to cover annual expenditure. The councils were responsible for their actions to the local electorate. Funds for capital investment were allocated by the Scottish Office on an annual basis under section 94 of the Local Government (Scotland) Act 1973.

Following privatisation of the ten English and Welsh RWAs in 1989, the Conservative Government signalled its intention to restructure the Scottish industry as well. After lengthy public consultation and heated debate, during which a proposal to privatise the industry was decisively rejected, the statute reforming the industry passed into law as the Local Government etc. (Scotland) Act 1994. Under its terms, responsibilities for water and sewerage services were transferred from the nine regional and three islands councils to three new Public Water Authorities (PWAs) on 1st April 1996. The Secretary of State for Scotland became responsible for the appointment of all PWA board members, effectively removing responsibility for these services from local government control for the first time. He also remained ultimately responsible for the setting of prices, and for the release of money for large scale capital investment through fixed Eternal Financing Limits. The amount of money available through this route, however, was restricted and PWAs were encouraged to bridge any funding gap with money from the Private Finance Initiative (PFI) and increased charges. Thus, although privatisation of the industry had not been implemented, the principle of private sector involvement had been established for the first time since 1975.

An important regulatory change came about through the Water Industry Act 1999 which established the post of Water Industry Commissioner for Scotland¹³. The Water Industry Commissioner's primary functions were to promote the interests of the water authorities' customers and to advise the Scottish Executive on the level of water charges over periods of several years. Responsibility for approving charges, however, remained with the Minister. For the first time Scottish water authorities were issued with individual price caps or limits on annual price increases.

Concerns over the impact on customer charges of the large investment programme and a desire to capture further unexploited economies of scale led to the creation of a single public water authority for Scotland. Under the terms of the Water Industry (Scotland) Act 2002 the North, East and West of Scotland PWAs merged on 1 April 2002 to become Scottish Water. Most recently the Water Services etc (Scotland) Act 2005 replaced the Water Industry Commissioner for Scotland with a Water Industry Commission (WIC) which began operating on 1 July 2005. This new body acts independently of Scottish Ministers to set periodic price caps for Scottish Water. Should Scottish Water contest price determinations of the Commission the appeal is now to the UK's Competition Commission and not to Scottish Ministers.

Although a public authority, Scottish Water has inherited a set of commercial relationships with private sector firms, and has sought to develop others. Inherited

¹² The role of the existing Central Scotland Water Development Board, in developing bulk supplies to regions of southern Scotland, was preserved by this institutional restructuring.

¹³ The first Water Industry Commissioner for Scotland (Alan Sutherland) took up post on 1st November 1999.

commercial relationships included, significantly, the nine large scale waste water projects that were eventually commissioned under PFI agreements and which currently process around half of the waste water in Scotland. More recent public-private partnerships include a joint venture enterprise – Scottish Water Solutions Ltd (SWS) – the purpose of which is to manage and deliver a large part of the industry’s capital investment programme.

To summarise, during the last thirty years the pattern of water and sewerage service provision across Great Britain has evolved in ways which have increased private sector participation. Having sketched in this background we turn now to consider the broad changes in government and regulatory policy relating to service provision that precipitated many of the institutional reforms.

3. Changing policy priorities

3.1. From social to economic equity and back

A survey of water service pricing practices in OECD countries, published in 1987 (OECD 1987), listed criteria used by governments and regulatory bodies in designing charging systems. Ten years later (OECD 1999) the list of criteria remained largely intact¹⁴. However, the author drew attention to the way in which particular criteria had been given greater priority over others by different governments and regulatory agencies during that time. Some, for example, had introduced policies which had given greater emphasis to criteria emphasising narrow economic efficiency objectives; others had prioritised broader social equity goals¹⁵.

3.2. England and Wales

In a penetrating study of the English and Welsh water industry, Bakker (2001) developed this theme of changing government and regulatory priorities within a British context, arguing that institutional developments in general, could be helpfully understood in terms of changing government and regulatory policies. Changes to tariff structures resulting from new regulatory arrangements, for example, could be seen to reflect a shift towards the prioritisation of economic equity over social equity: a movement from the ability to pay principle to the benefit principle¹⁶. Thus it is notable that in the early 1980s an English and Welsh inter-regional charge equalization levy was phased out and Keynesian regional employment policies which contributed to high staffing levels within the industry fell out of favour. RWA boards were restructured, reduced in size and populated with central rather than local

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