

**POLICY INSTITUTE**

# **Reviving The Scottish Water Industry**

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# *Reviving The Scottish Water Industry*

## *Synopsis*

Any industry must be open to competition to serve its customers well. Companies should also be in private hands. Nationalised monopoly companies have performed poorly because neither their customers nor their owners can move to an alternative. They therefore suffer from weak efficiency incentives. The current structure of the Scottish water industry exhibits these failings, which have resulted in extensive public criticism. Proposed reforms do not go far enough to correct this. Instead, the regulator must be given a strong pro-competition remit to encourage new entrants to produce and supply water for both industry and households. Scottish Water should be restricted to transporting it for these companies, at fees set by the regulator. It should also be privatised to encourage shareholder pressure on its management.

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### **POLICY INSTITUTE**

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# *Reviving The Scottish Water Industry*

## *Introduction*

Any industry must have two key elements if it is to operate efficiently and serve its customers well.

First, the market for its products should be competitive. No supplier should have captive customers: anyone who is dissatisfied with his or her current supplier should have somewhere else to go. In those circumstances, all suppliers are kept on their toes, having powerful incentives not just to keep down current costs but to innovate in terms of prices and quality so as to maintain or improve their market positions. Because of market rivalry, cost reductions and the benefits of innovation tend to be passed on to consumers.

Second, companies should be in private hands. If they are, competition in capital markets will mean their shareholders will press managements to perform efficiently, reinforcing the pressures from competitive product markets. Managers who do not respond risk loss of office, because a falling share price will make the company a takeover target and a new management team may take their place.

Experience shows that both are necessary - and possible - in the 'network utilities' like gas, electricity and water, as well as in other parts of the economy.

In practice, markets - like all human institutions - work imperfectly. Nevertheless, experiments with other forms of economic organisation, in particular establishing monopoly state corporations in the belief that they will pursue the 'public interest', have proved inferior to competitive markets with private ownership. Incentives to operate efficiently, to innovate and to respond to the wishes of consumers are weak. Managements cannot perform well in such circumstances, not so much because of the failings of individuals but because the system is at fault. Both economic principles and the lessons of history indicate that monopoly state corporations are doomed to failure.

This message about state corporations, however, was ignored by those who established the Scottish water supply regime. As a result, standards of service are not as high as they should be, and costs not as low.

This paper examines the difficulties inherent in nationalised ownership of industries that produce goods and services for sale,

and discusses the problems specific to the Scottish water industry. It proposes a reformed structure that could revitalise the industry by encouraging competition and private ownership<sup>1</sup>.

The paper omits two issues that are closely related to its subject but that merit separate examination. It discusses the supply of water only and does not deal with sewerage. Second, it does not consider in any detail environmental and quality regulation of the water industry<sup>2</sup>.

### *Scottish Water – The Background*

Three years ago, when the Scottish water industry was reorganised, state ownership was maintained and its monopoly characteristics were reinforced. Three regional water companies, in east, west and north Scotland, were amalgamated to form Scottish Water (SW). It is a nationalised monopoly with a regulator, the Water Industry Commissioner for Scotland (WICS)<sup>3</sup>.

SW is one of the bigger companies in the water industry in Britain, with a turnover of about £1 billion a year and about 4,000 employees. Because it is nationalised, it cannot be compared in terms of market value with the privatised water companies in England and Wales. However, Table 1 below, which uses various physical size indicators to compare SW with the ten regional water and wastewater companies in England and Wales, shows that SW is bigger than any of the English and Welsh companies in terms of length of mains and number of water treatment works and is ranked third by length of sewers.

Given the cautious nature of the 2002 reorganisation, it is hardly surprising that it failed to stem the flow of complaints about the industry. Criticism is rife in the Scottish media about SW's alleged inefficiency, its charges, its standards of service and, more generally, its apparent lack of concern for the interests of its consumers. New legislation passed by the Scottish Parliament in February 2005 - the Water Services etc (Scotland) Act<sup>4</sup> - makes some significant changes to the industry and, in particular, the

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<sup>1</sup> I have received many helpful comments on a draft of this paper from Dr Eileen Marshall and a number of anonymous referees, none of whom has any responsibility for its conclusions.

<sup>2</sup> This form of regulation is driven primarily by directives from the European Union. It aims to improve water quality even though its authors have no idea how much consumers would be willing to pay for water of different qualities. It is increasingly intrusive and needs reconsideration. Colin Robinson, "Water privatization: too much regulation?", *Economic Affairs*, Vol.24, no.3, September 2004 suggests alternatives to 'command and control' environmental regulation.

<sup>3</sup> Most regulatory bodies for British utilities were established after privatisation. Another corporation which is still nationalised but has a regulator is the Post Office.

<sup>4</sup> For explanatory notes on the legislation, see [www.scottish.parliament.uk/business/bills](http://www.scottish.parliament.uk/business/bills).

way it is regulated. But it does not address fundamental issues about the industry's ownership and structure.

**Table 1. Scottish Water Relative To Water Companies In Britain**

	<b>Scottish Water</b>	<b>Ranking relative to British water companies</b>
<b>Length of water mains (km)</b>	46,508	1
<b>Length of main per property (m)</b>	18.74	5
<b>Length of sewers (km)</b>	44,854	3
<b>Length of sewer per property (m)</b>	13.34	7
<b>Number of water treatment works</b>	371	1
<b>Number of wastewater treatment works</b>	616	4

*Source: Water Industry Commissioner for Scotland, Our Work in Regulating the Scottish Water Industry: the scope for capital investment efficiency, Vol.5, Executive Summary.*

### *Scottish Water: Efficiency And Standards Of Service*

Some of the most critical comments on the state of the Scottish water industry have come from its 'economic' regulator, Alan Sutherland, the Water Industry Commissioner. For instance, in a November 2004 report, WICS made an 'overall performance assessment' across a range of services. It found that in 2002-3 SW's standards of service were far worse than those in England and Wales<sup>5</sup>. He scored SW's performance at only 38 per cent of the worst performing water company in England and Wales. The comparison may seem unfair since SW was only formed in 2002 from its three predecessor bodies and so has had little time to reorganise. Moreover, SW has argued, the England and Wales industry has surged ahead because of its big investment programme since privatisation<sup>6</sup>.

However, as WICS points out, the 'asset bases either side of the border appear to have many similarities' and, in the last twenty years, investment per connected property in Scotland has matched that in England and Wales. WICS therefore concluded that **it is**

<sup>5</sup> WICS, Customer Service Report, 2002-03: Scottish Water, November 2004, chapter 6.

<sup>6</sup> 'Scots water service "is the worst in the UK"', *The Scotsman*, 19 November 2004.

**inefficiency in investment, not lack of investment funds**, that distinguishes the Scottish water industry from its counterpart in England and Wales<sup>7</sup>. In his words,

*“Customers in Scotland have paid for, and so deserve, an equivalent standard of service to that which customers in England and Wales receive.”*<sup>8</sup>

As explained below, efficiency comparisons between water companies are fraught with difficulties, so there is room for argument about the size of the difference between SW and the companies in England and Wales. Nevertheless, there seems to be a significant lag in performance in Scotland.

Nationalisation may not be the only reason for this poor performance. But anyone familiar with the history of the nationalised industries in Britain will find a familiar ring in the criticisms made of SW. They echo those that used to be made of the ‘public’ corporations that were established just after the war in Clement Attlee’s nationalisation programme. Most of these corporations, including ‘utilities’ such as gas, water, electricity and telecommunications, were privatised in the 1980s and early 1990s. But a few remain nationalised, including the Post Office as well as Scottish Water.

Describing these nationalised corporations as ‘public’ bodies is misleading. ‘National ownership’ did not mean that the corporations were genuinely accountable to the public. Indeed, one of the main reasons for frustration with their performance was - and still is where they remain - that **the general public has no control over what they do and feels powerless to influence their behaviour**.

As explained below, such discontent is not so much the fault of particular people in particular organisations. It is an innate characteristic of a regime where nationalised corporations monopolise ‘key’ industries. Seen in this light, one of the underlying reasons for the failings of Scottish Water becomes clearer. It results from political failure to establish appropriate ownership for the water industry in Scotland, an appropriate structure and an appropriate regulatory regime. Politicians have settled on a nationalised monopoly, protected by statute from competition, in circumstances where that form of organisation is ill-suited to the circumstances of the industry. To consider remedies, we therefore need to look further at the record of

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<sup>7</sup> WICS, *Our work in regulating the Scottish water industry: the scope for capital investment efficiency*, Volume 5, Executive Summary, pages 3-4.

<sup>8</sup> *ibid.*

nationalised monopolies, why they have so often been failures and why, in most British industries, state corporations no longer exist.

### *Nationalisation And Its Problems*

#### **The Record Of Nationalisation**

By the 1970s there was serious concern about the poor performance of Britain's nationalised industries, including utilities such as water, electricity, gas and telecommunications<sup>9</sup>. Nationalisation had begun with high hopes in the 1940s when Herbert Morrison, one of the founding fathers of state ownership in the Attlee government, had said that '...a public corporation gives us the best of both worlds' because it can '...combine modern business management with a proper degree of public accountability.'<sup>10</sup>

But, after a honeymoon period in the 1950s and early 1960s, disillusionment with nationalisation grew. There were complaints of inefficiency, technological backwardness, lack of concern for consumers and poor industrial relations. Tensions between the boards of the corporations and governments increased. By the 1970s, there were few people who held to the idealised Morrisonian view of state corporations. Opinions about remedies varied, but the deficiencies of nationalisation were all too obvious.

A series of White Papers in 1961, 1967 and 1978<sup>11</sup> failed to bring about any improvement. Attempts to impose some of the concepts of welfare economics on the industries – such as long run marginal cost pricing and test discount rates comparable to those used for low risk private sector projects – foundered on the sheer practical difficulties of implementing such ideas and on resistance from both politicians and the industries.

There are some functions that most people would agree must be performed or at least administered by government – defence and law and order, for instance. But, in the case of the British nationalised industries, governments strayed far outside these so-called 'public goods'<sup>12</sup> into activities that are plainly commercial -

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<sup>9</sup> See, for example, D.Heald, 'The Economic and Financial Control of UK Nationalised Industries', *Economic Journal*, June 1980.

<sup>10</sup> *House of Commons Hansard*, 6 May 1946, Cols 604-5.

<sup>11</sup> Cmnd.1337, Cmnd.3437 and Cmnd.7131 respectively.

<sup>12</sup> Pure public goods are those where it is not possible to exclude people from their supply and where consumption is non-rivalrous (supply to one does not reduce supply to another so the marginal cost is zero). Because all the benefits of these goods are 'externalities' private suppliers cannot appropriate any benefits and so will not be willing to supply. In practice, there are very few pure public goods though a number of goods and services have some public good characteristics. Even classic public goods such as law and order and

where a product is for sale for which charges can be made and there is no reason why private suppliers should not operate successfully.

### **Problems Inherent In Nationalisation**

What are the problems that arose in the British nationalised corporations? And why do they seem inherent in such a form of organisation?

- Ownership by no one and its consequences. One of the most serious ingrained problems in markets where there are state corporations is that citizens have virtually no means of influencing what the corporations do. 'Public' ownership in this sense is valueless because the 'owners' have no transferable property rights in the organisation: in the well-known phrase, what is owned by everyone is perceived to be owned by no-one<sup>13</sup>. The 'agency' problem, that always exists when there is a divorce between the ownership and the management of an organisation, is maximised in the case of nationalised corporations. They have no shareholders other than government. They are immune to the pressures usually exerted by shareholders on managements. And they cannot be taken over.

The owners of any company need means of monitoring and controlling the actions of the managers who are their agents. They do not want those managers to pursue their own interests but those of the owners. It is notoriously hard, even under private ownership, to devise incentive structures (such as performance-related rewards) that align the interest of owners and managers. Nevertheless, shareholders in companies have the power of 'exit' as well as 'voice'. Complaints to managers or protests at annual general meetings may not be very effective. But the prospect of a plunging share price, as disgruntled shareholders 'exit' by selling their holdings in protest at underperforming managers, is a remarkably effective way of concentrating managers' minds. The wealth of managers who are shareholders will be reduced and, more important, the decline in the company's stock market value may make it a target for a potential bidder.

'Owners' of nationalised corporations lack the power of exit that private shareholders enjoy. They have no property rights to sell

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defence do not have to be financed and supplied entirely by the state: sometimes voluntary collective action is possible and so is contracting out of service provision.

<sup>13</sup> The problems of 'public' ownership are explained in Colin Robinson, 'Privatisation: analysing the benefits', in David Parker and David Saal (eds.), *International Handbook on Privatization*, Edward Elgar, 2003.



if they do not like the way the state corporation is performing. Instead, they must rely on making their voices heard, principally through the politicians and civil servants who are the immediate principals of the state corporation managements. Such indirect influence is highly unsatisfactory - unless one assumes that politicians and civil servants are altruistic, wise, well-informed individuals devoted to the interests of the community as a whole, and the further assumption that those interests are discoverable and can be pursued other than through market processes<sup>14</sup>. In practice, not only do politicians and civil servants lack relevant information, they may also have all kinds of objectives in mind for the corporations other than their being efficient and responsive to the wishes of citizens/customers.

- Weak efficiency pressures. Given these agency problems, efficiency pressures on state-owned corporations are extremely weak. They are subject to monitoring by government departments but, in the absence of capital market comparisons, these departments have no way of determining how efficient the corporations are.

The problem is compounded if, as is often the case, the state corporation has a monopoly of the national product market. Private monopoly can be a problem but private companies that exploit their market power usually find that, in the course of time, rivals enter their market and compete away their profits. State monopolies are, however, protected by statute from competition. Consumers are captives, unable to exit from their existing supplier. There are no rivals to drive innovation, cost reduction, higher standards and lower prices. A government or a government-appointed regulator is unable to foresee what the outcome of a competitive market would have been. It has no relevant standard of comparison against which to judge the corporation and is forced back on unsatisfactory efficiency comparisons and efficiency audits.

- Politicisation. Another serious issue in markets where there are state corporations is politicisation, which has implications for efficiency. Because politicians are likely to be held responsible for major (and sometimes minor) decisions by state corporations, they tend constantly to interfere with decision-making. A common complaint from senior managers of the British nationalised corporations was that governments would not allow them to manage.

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<sup>14</sup> Robinson, 'Privatisation: analysing the benefits', op cit.

Governments used to lean heavily on the nationalised corporations to pursue changing political objectives. They were controlled by the state as well as owned by the state. Nationalisation is a form of regulation but one without clear rules and predictable outcomes. The regulated company is usually subjected to backdoor pressure from politicians and civil servants. Before privatisation, the British nationalised industries were, at times, induced to hold down their prices in order to make the general rate of inflation appear lower. At other times, they had to increase or to decrease investment, not according to the prospective rate of return on capital, but depending on the financial position of the government and whether it was seeking to boost or restrict the rate of economic growth.

Morrison had believed that there could be an 'arm's length' relationship between politicians and nationalised industry managements. But, given the ill-defined responsibility governments had for the industries, the political interference that was so resented by managements came not just at the 'macro' level as explained above, but in 'micro' detail. Managerial objectives were confused by doubts as to whether the industries should follow 'commercial' or 'public service' aims or simply do the bidding of the government of the day. By their actions, governments created severe regulatory uncertainty in the industries they owned.

One consequence of nationalised ownership is that lobbying is rife. Managements realise that their activities are affected at least as much by the actions of politicians and civil servants as by their own efforts to innovate and cut costs. Lobbying therefore appears to be a relatively high-return activity into which corporate resources inevitably flow, diverting scarce management resources away from innovation and efficiency improvement. Lobbying is, of course, present also in markets where there are no state corporations, but the relatively high returns to lobbying by state corporations means that it is innate in such organisations.

To summarise, in the case of monopoly state corporations, the absence of competitive market forces means that pressures on the corporations to increase efficiency and to pass gains on to consumers are very weak. Politicisation is rife and resources flow into lobbying. Attempts by governments and regulators to simulate the results of competitive pressures are a pale shadow of the real thing: in the absence of information from either capital markets or product markets virtually all the facts required for meaningful efficiency comparisons are absent.

## *English, Welsh And Scottish Water: Problems Of Nationalised Monopoly*

In England and Wales, the water industry was privatised in 1989 and an independent regulator (the Office of Water Services, Ofwat) was established. Though regulation is generally recognised to be open and transparent<sup>15</sup>, there are many flaws in the privatised structure - a number of regional monopolies supervised by an 'economic' regulator and environmental and quality regulators. Up to now, there has been very little competition (and that only for a few very large customers), and it is not clear that a new regime under the 2003 Water Act will be effective in liberalising the non-household market<sup>16</sup>. The regulator operates primarily by using 'yardstick' or 'comparative' competition to compare different companies. As explained below, that is not a very satisfactory basis. Other problems arise because existing companies have some protection from takeover because of the *de facto* ban on water-to-water mergers<sup>17</sup>. In general, the industry seems to suffer from too much regulation.

Nevertheless, whatever the problems in England and Wales, the industry has made some advances since privatisation<sup>18</sup> whereas Scottish Water still exists in a setting similar to that in which the British nationalised sector as a whole used to operate. The deficiencies of that sector are all too easily recognisable in the water regime in Scotland as it has operated so far. There is 'public' ownership: so there are no shareholders with property rights and no share price. There is monopoly: Scottish Water has so far been the sole provider of water and waste water services in Scotland so consumers have no choice. There is politicisation: the Executive Board of Scottish Water is answerable to the Scottish Parliament.

As well as this direct political control Scottish Water is, like the privatised English and Welsh companies, subject to an 'economic' regulator, WICS, who regulates charges and service standards but who, in a significant difference from England and Wales, has so far worked as an adviser to ministers. SW is also, like the industry in England and Wales, subject to quality, environmental and health and safety regulators - in SW's case the Drinking Water Quality Regulator, the Scottish Environmental Protection Agency and the Health and Safety Executive.

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<sup>15</sup> Colin Mayer, 'Commitment and Control in Regulation: The Future of Regulation in Water', in Colin Robinson (ed.), *Governments, Competition and Utility Regulation*, Edward Elgar, forthcoming 2005.

<sup>16</sup> Colin Robinson, 'Water privatization: too much regulation?', *op cit.*

<sup>17</sup> *ibid.*

<sup>18</sup> Mayer, *op cit.*

Politicians have not been shy of involving themselves in the company's business, as one would expect given the statutory position of Scottish Water and previous experience of nationalised corporations. The Water Industry (Scotland) Act 2002 permits Scottish ministers to give guidance to WICS about how he should perform his functions and ministers set out guidelines for Scottish Water. In February 2005, for example, the Minister provided objectives for the water industry in Scotland from 2006 to 2014<sup>19</sup>. According to these, Scottish Water was told it should not increase charges by more than the inflation rate between 2006 and 2010 and was set various objectives relating *inter alia* to drinking water quality, environmental improvement, sewer flooding prevention, connection of new homes and the rebalancing of charges in favour of businesses. Scottish Water has to draft a business plan to show how it will comply with ministers' demands. Plainly, once ministers have stated their objectives they are bound to monitor Scottish Water's progress in achieving them and to exercise control when the company appears to be falling short. Thus the intervention in company decision-making that used to be such a feature of British nationalised industries seems inevitable in the Scottish water industry.

The 'economic' regulator, WICS, has up to now lacked some of the powers of the Office of Water Services (Ofwat) in England and Wales. WICS has not itself set charges as does Ofwat<sup>20</sup>. Its role is indirect, with principal duties including:

- to advise ministers on the revenue required by Scottish Water to provide customers with a 'sustainable service' and to fund its investment programme;

- to consider and approve Scottish Water's annual scheme of charges (though with any disputes being referred to ministers);

- to advise ministers on Scottish Water's service standards and customer relations; and

- to advise ministers, when requested, on a range of matters relating to Scottish Water's impact on customers.

Thus its role has been as ministerial adviser rather than independent regulator. Furthermore, though there has been a move in Britain to remove competition policy from political control, up to now disputes between WICS and SW have been resolved by ministers rather than being referred to the Competition

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<sup>19</sup> The objectives are listed on Scottish Water's website [www.scottishwater.co.uk](http://www.scottishwater.co.uk).

<sup>20</sup> Both Ofwat and WICS are, of course, constrained in their actions by the views of the environmental and quality regulators.

Commission (as they would be in similar cases in England and Wales).

Although WICS has said that there are safeguards for his independence of view and that he is not controlled by ministers<sup>21</sup>, his position as adviser to ministers has been well out of line with the rest of the utility regime in Britain. That regime has three 'pillars' – regulatory offices independent of political control, competition promotion duties for the regulators and incentive-based price control of monopolies<sup>22</sup>. Up to now, WICS has lacked the first two of these, which are arguably the most important, and has not itself controlled the price cap.

Contemplating the Scottish water regime as a whole, it has up to now embodied most of the worst features of an old-style nationalised system that involves politicians and civil servants in trying to run a major industry. Government has controlled not just the general direction of the industry but also its charges and standards of service. Decades of practical experience in Britain, as well as theoretical considerations, should have shown the authors of the present Scottish water regime that the past record of these corporations is not just an aberration from some much superior norm that can be achieved in the Scottish water industry. Far from following the public interest, nationalised corporations have *inherent* undesirable characteristics – inefficiency, politicisation and disregard for the interests of their (captive) customers. Indeed, it is significant that the Scottish regulator should take as his standard of efficiency the performance of the privatised industry in England and Wales. One of WICS' objectives – to '...ensure that the level of customer service is on a par with the service delivered in England and Wales'<sup>23</sup> – is an implicit admission that ownership, structure and regulatory regime combine to produce a superior performance in England and Wales as compared with Scotland.

### *Starting A Revival? The 2005 Water Services Act*

Some of the problems of the Scottish water industry, including the tensions in the relationship between WICS and ministers, may be eased by the passage in February 2005 of the Water Services etc (Scotland) Act. This, *inter alia*, establishes a new Water Industry Commission which bears a closer resemblance to Ofwat. The Commission will have powers to set charges (within policy guidelines from ministers) and Scottish Water will have a right of appeal to the Competition Commission against price

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<sup>21</sup> *Role of the Water Industry Commissioner for Scotland*, [www.watercommissioner.co.uk](http://www.watercommissioner.co.uk).

<sup>22</sup> Colin Robinson and Eileen Marshall, 'Regulation of Energy: Issues and Pitfalls', in David Parker and Michael Crew (eds.), *International Handbook of Regulation*, Edward Elgar, 2005 (forthcoming).

<sup>23</sup> WICS, *Our Work in Regulating the Scottish Water Industry*, op cit, 2.1.1

determinations, thus bringing the Scottish regulatory system for water closer to that in England and Wales<sup>24</sup>.

The new Act is both a recognition that, up to now, there have been major problems in the water supply regime in Scotland under the 2002 Act and a first step along the road to correcting some of the errors of the past. It gives greater independence to the regulator and provides for limited competition for non-household consumers. But it is no more than an initial step. Fundamental difficulties remain - above all, that Scottish Water is still a nationalised corporation, subject to political pressures, with substantial monopoly power and poor incentives for management. Some specific problems - both of commission and of omission - under the new regime are discussed below.

The regulator gains considerably in independence from political control and the ability of Scottish Water to appeal against regulatory decisions to the Competition Commission is a step forward in reducing political influence. But, since Scottish Water remains in 'public' ownership, it is not clear to what extent the Scottish water industry has been freed from politicisation.

Although the new Water Industry Commission has the power to determine Scottish Water's charges, its freedom is bounded by constraints of 'principles' set out by ministers about 'charge limits for different consumer groups'<sup>25</sup>. In February 2005, the Deputy Environment Minister announced that the poorest households would get a 25 per cent discount on their water charges, paid for by abolishing the 25 per cent discount now enjoyed by second home owners. Such actions suggest ministers are pursuing income redistributive objectives through water pricing<sup>26</sup>. Another problem is that in Scotland SW does not charge consumers direct, thus reducing contact between supplier and customer. Charges are collected by local authorities and may thus impinge on their ability to collect council tax, increasing the risk that there will be political manipulation of water charges<sup>27</sup>. Ministers also have a duty to provide Scottish Water with 'standards and objectives...in the provision of core services'<sup>28</sup>. Past experience of relations between ministers and nationalised industries suggests that such provisions will permit ministers who wish to interfere still to do so.

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<sup>24</sup> Scottish Executive, letter from Ross Finnie to WICS, 26 May 2004 and Water Services etc (Scotland) Bill, Explanatory Memorandum.

<sup>25</sup> Scottish Executive, op cit, paras 3.5 and 3.6.

<sup>26</sup> 'Ministers limit water charge rises to rate of inflation', *The Scotsman*, 10 February 2005. This introduces the principle of variable charging of customers on perceived ability to pay (or not) regardless of the amount or cost of the product or service consumed.

<sup>27</sup> 'City leaders want to pull plug on collection of water rates', *Edinburgh Evening News*, 19 January 2005.

<sup>28</sup> Scottish Executive, op cit., para 3.4.

Continued government ownership also means that there will be no efficiency pressures stemming from shareholders and that Scottish Water will remain outside the market for corporate control. The lack of capital market efficiency pressures is a serious matter, given the apparent inefficiency revealed by the regulator's studies.

Of course, if product market competition were to emerge, that would itself increase efficiency pressures and provide better incentives for managers as competing companies would have an incentive to reduce their costs and to innovate. **But the new Act goes so far as to prohibit competition for domestic consumers: bans on competition by politicians are, almost always and almost everywhere, an extremely bad idea.** It also rules out a common carriage system that might be a way of promoting competition. **And it gives ministers a role in licensing entrants to the industry, permitting them to specify 'other factors' (other than those a regulator would normally take into account) in deciding whether an applicant is suitable - a provision which clearly could be abused.**

### **Limited Competition**

An innovation in the legislation is the possibility of competition for larger consumers between entrants and a new 'arms-length' subsidiary of Scottish Water. SW would not be allowed to discriminate in favour of this subsidiary and against entrants. Licensed entrants would seek water supplies from Scottish Water which, if agreement was reached, would supply water to the customer through the 'public' supply system.

Unfortunately, however, this 'competitive' regime - like its counterpart in England and Wales, under the 2003 Water Act - seems likely to run into the problems that usually plague regulated access systems<sup>29</sup>. Experience with British Gas, for instance, suggests that a considerable advantage is enjoyed by an incumbent which controls the pipeline network (as will SW) and from whom entrants have to request a water supply. It is hard to avoid discrimination against potential entrants, particularly since SW can plead that entry might jeopardise the performance of its statutory functions. Moreover, experience in England and Wales suggests that bureaucratic delays in regulated access arrangements and delays in the resolution of complex disputes by the regulator are likely to put off prospective entrants. As the Monopolies and Mergers Commission (now the Competition Commission) remarked of the old British Gas regime, **it was incapable of providing the 'necessary conditions for self-**

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<sup>29</sup> Robinson, 'Water privatisation: too much regulation?', op cit.

**sustaining competition'**<sup>30</sup>. Unlike British Gas, SW would have a separate subsidiary but, even so, the prospect of entering a market dominated by a nationalised competitor is unlikely to seem attractive unless the regulator adopts an open and determined pro-competitive stance.

If it is true that competition will not flourish under the provisions of the new Act, except perhaps at the margins of the industry, efficiency pressures on SW from product markets will continue to be weak. Since, as explained above, SW faces no shareholder efficiency pressures either, **the prospects for improved efficiency under the new regime do not look good.**

If Scottish ministers leave the regulator alone, the Commission will have a better chance than in the past of stimulating efficiency improvements in SW. But, in the absence of any significant information from markets, the regulator will have very little information on which to base comparative efficiency studies. Presumably he will fall back on comparisons with the English and Welsh water companies, as he does now: the amalgamations in Scotland have suppressed possible Scottish 'comparators'. Yet these comparisons are unlikely to be fruitful. As explained above, there has been very little attempt to liberalise the industry in England and Wales which therefore suffers from an intrusive and tightening regulatory system<sup>31</sup>. **Because there is little real competition among the regional monopolies, regulators have made do with so-called 'competition by comparison' ('yardstick competition') which is extremely unsatisfactory. There are serious difficulties in making useful efficiency comparisons within England and Wales because of differences in the conditions in which the companies operate.** The econometric models used seem far too weak to standardise for varying conditions and to form the basis for comparisons which are used for price-setting<sup>32</sup>. Given this inherent weakness, it is stretching the system even farther beyond its proper bounds to try to include in the English and Welsh regime the Scottish water industry, where conditions are different again.

### *Privatisation And Liberalisation*

**It is difficult to see how the Scottish water industry can be revived unless it is privatised. But privatisation should only be regarded as a necessary first step, an enabling measure. In**

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<sup>30</sup> Monopolies and Mergers Commission, *Gas and British Gas plc*, Cmnd.2314-2317, 1993, Vol.1, para 1.6.

<sup>31</sup> Robinson, 'Water Privatisation: too much regulation?', op cit.

<sup>32</sup> Colin Robinson, 'Moving to a Competitive Market in Water', in Robinson (ed.) *Utility Regulation and Competition Policy*, Edward Elgar, 2002.



**itself, it is not sufficient. Market liberalisation is particularly important and should accompany privatisation.**

Privatisation subjects privatised companies to the discipline of the capital market. However, it may not itself result in product market liberalisation and so there is no guarantee that efficiency gains from privatisation will be passed on to consumers. A number of British privatisations have simply transformed state monopolies into private monopolies, in the short term at least. In the case of the railways, for example, there is very little competition except for franchises (and then most winning companies receive state subsidies). The water industry in England and Wales, though privatised, is divided into a number of regional monopolies and hardly any competition exists. British Gas was privatised whole in 1986 and, for a number of years after privatisation, had a virtual monopoly because it owned the pipeline system others had to use and had most of available gas from the North Sea tied up on long term contract.

**The advantage of product market liberalisation is that it sets in train competitive processes which add to the efficiency pressures stemming from the capital market and, crucially, passes on the benefits to consumers. Competitive markets give to consumers, as well as to shareholders, the power of exit.** Thus there is constant pressure on producers to provide combinations of lower prices and higher standards which appeal to consumers and which their competitors then have to try to emulate: in other words, there is a race to the top. This kind of market process is what Adam Smith and later classical economists meant by competition<sup>33</sup> - **a process of dynamic change in which the *status quo* is constantly disturbed by entrepreneurs who are looking for better ways of doing things.** Free entry is the key. That means not just removal of statutory monopolies but establishment of economic conditions in which competition can flourish: if competitors can enter the market, incumbents (unlike monopoly nationalised corporations) cannot ignore them but must respond to the prices and service standards they offer.

Twenty five years ago, a question that might have been asked about liberalisation of the markets of nationalised corporations was - is competition feasible and, if feasible, is it desirable? Many people regarded these industries as 'natural monopolies' where efficiency dictated that there should be only one supplier. **However, theoretical advances, now backed by substantial practical experience, show the natural monopoly argument to have been largely false.** Some of the nationalised industries, such as coalmining and the airlines, were unnatural monopolies: that is,

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<sup>33</sup> For an explanation see Mark Blaug, 'Classical Economics', in J.Eatwell, M.Milgate and P.Newman (eds), *The New Palgrave - A Dictionary of Economics*, vol.1, Macmillan, 1987.

they were state artefacts where there were no efficiency advantages from sole ownership<sup>34</sup>. In other cases, in the utilities, there are natural monopoly elements, but large parts of the industries are potentially competitive and there is no economic reason why they should not be liberalised.

A recent insight about the nature of 'network' utilities <sup>35</sup> is that the traditional gas, water, electric or telephone utility consists of a network of pipes or wires which is (given existing technology) a natural monopoly, and other activities such as production, storage and supply to consumers which are potentially competitive. There are considerable advantages to consumers in having actual competition introduced into these latter areas. For example, the good can be produced at the wholesale level by a number of rival companies, thus keeping down production costs and promoting innovation; there can be competition in storage, in meter provision and in meter reading; and, at the final stage, of supplying customers, rival companies can compete in terms of price and service. Consumers have choice of supplier, now they are no longer the captives of a nationalised monopoly, and so gain the power to switch to a better offer, if one is available.

An essential part of this scheme of liberalisation is that the rest of the industry, the natural monopoly network, should be separated (preferably in a separate company) because, unlike the competitive areas of the utilities where supplier rivalry protects consumers, some specific consumer protection against exploitation by the monopoly, including discrimination against potential entrants, has to be established. In the British utilities, the usual form of protection has been by an independent regulatory office (Ofgem, Ofcom, Ofwat, etc.) which uses an RPI-X price control, among other devices, to keep network charges within bounds. Competitive parts of the industry are not subject to price controls (except for an interim period in which competition is being established), though the regulator uses his or her competition-promotion duty and duties under the Competition Act 1998 to keep a general watch on them and the Competition Commission stands ready in the background to take action if necessary. In the sectors where this scheme has been applied – introducing competition where possible and regulating where there is no immediate prospect of competition – it appears to have worked well. In the energy utilities, in particular, where the regulators have been most assiduous in promoting competition, competition flourishes in both wholesale and retail markets.

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<sup>34</sup> Colin Robinson and Eileen Marshall, *Can Coal be Saved?*, Institute of Economic Affairs, Hobart Paper 105, 1985.

<sup>35</sup> Due primarily to the late Professor Michael Beesley. See M.E.Beasley, *Privatisation, Regulation and Deregulation*, Routledge, second edition, 1997.

## *What To Do*

The present scheme of ownership, organisation and regulation of the water industry in Scotland shows virtually no sign of any application of economic principles nor does it recognise the insights that have already been gained from utility privatisation and regulation schemes. Only political expediency and bureaucratic convenience (and perhaps an emotional attachment to 'public' ownership, despite all the failings described here) can explain the original scheme and its modifications so far.

Under the new arrangements the industry remains essentially a nationalised monopoly (though there may be some competition at the margin for some large consumers). Thus, despite the welcome granting of greater independence to the regulator, **it is not clear that the regulator and Scottish Water have escaped political control. If politicians did not wish to interfere, there would have been no reason to keep the industry nationalised.**

Efficiency pressures are muted. The regulator may well continue to 'shadow' the England and Wales industry in an attempt to bring the Scottish industry up to the apparently much higher England and Wales standards. **But, given the existing deficiencies of comparative competition in England and Wales, shadowing that system is most unsatisfactory. Indeed, it is paradoxical that an industry that has deliberately been kept nationalised should implicitly accept that it is inherently inferior to the privatised system in England and Wales by trying to model itself on privatised companies to obtain the benefits of their better standards of service.**

The key objectives of reform should be to find ways to promote efficiency in the Scottish water industry and to pass those gains on to consumers. Experience elsewhere indicates that under nationalised monopoly these objectives are most unlikely to be achieved. **Privatisation (to bring capital market disciplines) and liberalisation (to bring product market disciplines) are required.** Reformers should bear in mind that water supply is, in principle, similar to the supply of gas and electricity (where competition now reigns over large parts of the industries). Production (extraction) and storage are dispersed and are potentially competitive; meter provision and meter reading are potentially competitive; the supply of water to consumers is also potentially competitive. Indeed, as in gas and electricity, the only 'natural monopoly' activity that requires regulation is the transport of water by pipeline.

More specifically, the following steps need to be taken:

1. Entry to the industry should be made as easy as possible in the interests of stimulating competition. Licences to supply water should be freely available, subject only to the regulator being satisfied of the applicant's ability to perform the necessary functions. A provision in the legislation that allows a role for ministers to specify 'other factors' that would determine whether or not applicants should be granted licences should go.
2. If the proposals to introduce competition for non-household customers are to have any chance of success, the regulator will have to apply a vigorous pro-competition policy to ensure that entry to the market occurs. Liberalisation of the market is so important that the regulator should be given a specific duty to promote competition.
3. The prohibition on competition in the household market, which provides Scottish Water with millions of captive customers, should be removed. Household competition is not an imminent prospect – competitive supply to larger customers will be easier to introduce and is likely to come first - but it is most unwise to rule households out, given that in some British utilities (notably gas and electricity) households have been major beneficiaries of competition.
4. The disconnection between the industry and its customers that occurs because charges are collected by local authorities should be ended. Customers should be billed by their supplier so it is clear who is responsible for supply and associated services.
5. Scottish Water should be privatised by public flotation so that it has shareholders with an incentive to ensure it operates efficiently and so that it becomes as difficult as possible for ministers to interfere with its actions.
6. When Scottish Water is privatised, water pipelines should be separated from the rest of the company, not in a subsidiary but in a separate private, regulated company. A separate pipeline company is an important competition-promoting device. So long as Scottish Water controls pipeline access, entry is likely to be limited. A separate company, however, would have a powerful business interest in transporting water for all comers and would ensure there would be no discrimination against suppliers other than Scottish Water.

The following box gives a snapshot of how a liberalised, revitalised Scottish water industry might work in the future:

### Hot Water in Glenbogle, 2015

Archie Macdonald, Chairman of the Glenbogle Water Company, is worried. Both he and his rival, Kilwillie Water Supplies, run reservoirs for supplying mains water to both wholesale buyers and individual domestic and business customers. But Kilwillie has stolen a march. He has somehow found a way to extract and store water more efficiently. KWS can now sell at a significant discount to Glenbogle's prices. How can Archie cut costs to compete, without compromising standards?

But Archie's concerns do not end there. He is also having to compete at retail with a multi-utility. The Royal Tank of Scotland doesn't produce water - it buys it wholesale from a range of reservoirs. But RTS has merged with a gas and electricity supplier and found big economies in billing so it is giving discounts to customers who take its gas and electricity as well as water.

But competition is not confined to price. Some of Glenbogle's rivals are offering other attractive services, such as more flexible billing arrangements and discounts on bathroom installation.

However, at least the previous monopolist, Scottish Water, no longer troubles Archie. SW has been privatised and is now a pipeline company restricted to carrying water for companies like Glenbogle, Kilwillie and RTS. SW is keen to expand its business by connecting to new housing and industry. It faces competition in connections, but is not allowed to compete on production and retail. Its carrying charges are capped by a regulator. So competition is driving down charges and improving standards, whilst the regulator makes sure SW does not exploit its pipeline network monopoly.

Meanwhile there are rumours of a breakthrough in Japan in the technology of transporting water. The regulator is questioning SW about what it is doing to adopt this technology. Perhaps even that monopoly won't last for ever!

The people of Scotland, as befits their bounteous position in nature, once again have the world's best - and cheapest - water.

**Colin Robinson was appointed in 1968 to the Chair of Economics at the University of Surrey. There he founded the Department of Economics and is now Emeritus Professor.**

**His research is principally in the energy industries and the regulated utilities. He is the author of 23 books and monographs and over 150 journal papers. He was named British Institute of Energy Economics 'Economist of the Year' in 1992 and in 1998 received from the International Association for Energy Economics its 'Outstanding Contribution to the Profession and its Literature' award.**

**From 1992 to 2002 he was Editorial Director of the Institute of Economic Affairs.**