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An examination of business models within the Water and Sewerage Industry in the UK and Republic of Ireland

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This paper examines the structures, including business model and governance systems within the water and sewrage industry in the United Kingdom and Republic of Ireland.

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Executive Summary

Across the United Kingdom and in Republic of Ireland (ROI) there are various business models for the delivery of Water and Sewerage Services (W&SS):

- In England and Wales W&SS have been delivered by private sector companies since 1989;
- In Scotland W&SS are provided by Scottish Water, a statutory corporation formed in 2002;
- In Northern Ireland a Government Owned Company (GoCo) was established in 2007 to deliver W&SS however, since 2009 this company is also classified as a NDPB due to the fact it continues to be funded from public expenditure as opposed to charging for its services; and
- A state owned company, 'Uisce Éireann' (Irish Water), was established in March 2013 to deliver W&SS in ROI.

England

The decision to privatise the water industry in England was in line with the (then) Conservative Government's policy to sell-off state owned utilities (Telecoms/Gas/Electricity) in the belief that market participation would drive efficiency and attract investment. However, the unique characteristics of the water industry limit the potential for competition, making monopoly control of the market almost inevitable.

The monopolistic position of the new Water companies led to the adoption of a unique system of regulation:

- The economic regulator, Ofwat is responsible for setting limits on pricing and protecting customer interests, encouraging competition and adequate investment within the industry, and administering and enforcing the licensing regime for water and sewerage companies (set out in the Water Services Act 1991);
- The Drinking Water Inspectorate (DWI) and the Environment Agency (EA) are responsible for drinking water and environmental quality respectively.

There is little evidence to suggest that the progress made in the English water industry is based on the fact it was privatised. The fact is that the old water authorities were extremely inefficient and any form of restructuring, including keeping the water companies within the public sector would in all likelihood have produced similar or perhaps even better results.

Wales

The Water Industry in Wales was subject to the same legislation as the English industry, and was privatised in 1989. By the late 1990s Hyder, the company who provided W&SS in Wales began to have financial troubles, leading to a crash in share value and an 'unprecedented fall in credit ratings'. Glas Cymru (Glas) was formed (as a company limited by guarantee) in 2000 for the sole purpose of acquiring and then owning Welsh Water.

Glas operates under the standard governance framework required under companies law. It is headed by a Board of Directors which is responsible for the strategic direction of the company and for reviewing operational and financial performance. The Board currently comprises 3 Executive Directors and 7 Non–Executive Directors (including the Chairman of the Board).[1] All the directors of Glas are also directors of Welsh Water, and vice versa.

The business model adopted by Glas for Welsh Water makes it markedly different from the investor owned equity financed water companies in England. As a company limited by guarantee Welsh Water does not have any shareholders and is instead focused on providing the best possible service at the lowest possible price for the benefit of its consumers. The role of shareholders is fulfilled by its members, who are experienced unpaid individuals – and not representatives of any interest groups.

The main advantage of the model is the ability of Welsh Water to access cheap finance.[2] For instance, in 2006, Dŵr Cymru issued a 50 year bond at a real interest rate of just 1.4%.[3] This is significant due to the fact that servicing debt is one of the biggest costs for W&SS companies,[4] accounting for one third of the average household bill across the sector.[5]

A key element of the Glas Cymru model for Welsh Water involved the separation of water asset ownership from the day-to-day management of the business – which was initially outsourced. However, in 2010 Welsh Water began a process of taking many day-to-day operations including things like customer services and billing back in-house. This it believed would put it in a stronger position to meet the efficiency challenges set by the regulator in the current regulatory period (2010-15).

Scotland

Scottish Water (SW) is the statutory provider of W&SS to domestic properties in Scotland and wholesale services to licensed providers for the non-domestic sector. SW is a public corporation meaning that while it operates commercially (more than 50% of its income is from fees and charges), the Scottish Government exercises control over its general corporate policy, as prescribed in legislation.

Scottish Water is set up with a similar governance system as the other UK water companies, all of who are subject to companies legislation, the difference is that the

[1] (Welsh Water) Dŵr Cymru [online] Company Information: The Directors. Available from: http://nia1.me/1tb
[2] (Welsh Water) Dŵr Cymru (2013) Your Company Your Say: Our Plans 2015-21 [online] available from: http://nia1.me/1t7
[3] Dŵr Cymru (2012) Environment, Food and Rural Affairs Committee: Written evidence submitted by Dŵr Cymru Welsh Water on 12th October 2012 [online] available from: http://nia1.me/1f0
[4] Glas Cymru (2001) Glas Cymru's plans for Welsh Water [online] available from: http://nia1.me/1ey
[5] (Welsh Water) Dŵr Cymru (2013) Regulatory accounts for the year ended 31 March 2012

role and responsibilities for Scottish Water are set out in its founding legislation, with the Scottish Government ultimately accountable for its performance.

Scottish Water is subject to incentive-based regulation explicitly designed to reward good performance. This is modelled on the regulatory framework developed for W&SS companies to in England and Wales – a similar framework is also used in NI.

Over 90% of SW's revenue is generated through direct charges for its services with the remainder borrowed from the Scottish Government to support capital expenditure. In 2012/13 SW's income from in its customers exceeded £1bn; an additional £100m had to be borrowed from the Scottish Government to fund its operational expenditure (OPEX) expenditure, which included £481m of capital investment.

As a public sector body Scottish Water cannot access finance from capital markets and must borrow from the Scottish Government although with continued pressures on public expenditure, there remains uncertainty over the level of borrowing that may be available from year-to-year over the 2010-15 period – and beyond.

Despite this uncertainty the Scottish Government is expected to spend around £2.5bn (in real terms) during the current Strategic Review of Charges (2010-15), – in 2012/13 alone, it spent £481m.

This incentive based governance framework has seen Scottish Water achieve an accelerated passage from one of the most inefficient water and sewerage providers in the UK, to one of the most efficient.[6] By 2010 Scottish Water's operating costs were 35% lower than they were in 2002-03 whereas over the same period the water industry in England and Wales has seen its operating costs increase by 13%.[7]

In addition to becoming economically efficient, Scottish Water has also been able to significantly improve it overall performance assessment (OPA) score[8] To where Scottish Water is now on par with the English and Welsh average of 290.

[6] WICS (2010) *Governance and Incentives Staff Paper 2* [online] available from: http://nia1.me/17g
[7] WICS (2010) Performance Report 2010 [online] available from: http://nia1.me/17k
[8] Service levels are measured through a points based system: the 'overall performance assessment' (OPA). This attributes points to different aspects of SW's service that are most important to customers

Northern Ireland

Following extensive consultation and analysis the business model chosen for the reform of the water service was a Government Owned Company (GoCo). The main characteristics of a GoCo are:

- Its constitution is set out in Memorandum and Articles of Association;
- It is unambiguously under public sector control;
- It is established under and must conform with companies legislation;
- over 50% of ordinary share capital owned by government;
- shareholders may receive regular dividend payments;
- there is an accountability relationship with a sponsoring Department; and
- it is permitted to recover costs and build up reserves through trading operations.[9]

A regulatory framework, similar to that used in England, Wales and Scotland was adopted. The internal structure of the GoCo also bore many similarities in that a Board was constituted to direct the company. However, the main difference between the GoCo and the other models was that the Minister for Regional Development assumed the position of sole shareholder.

Northern Ireland Water Limited (NIW) is a company limited by shares, created under the Companies Order (Northern Ireland) 1986. All the shares are owned by the Department for Regional Development (DRD). NIW was made the sole water and sewerage undertaker for NI under *The Water and Sewerage Services (Northern Ireland) Order 2006.*

It was clear that for many these new structures, put in place under direct rule, were not welcomed. Therefore, once devolution had been restored in 2007, the Minister for Regional Development set up the Independent Water Review Panel (IWRP) to review the reform process. As NIW was a new entity its performance could not be fully assessed by the review team. However, it did offer some positive feedback with regards to the new structure: [10]

- the new structures open up the potential for better services and greater efficiency; and
- the reform process was not (despite public opinion) predicated upon eventual privatisation.

The IWRP did, however, identify four significant flaws in the outcomes of the reform process overseen by the NIO Minister:

- the lack public confidence;
- clarity about roles and responsibilities of government and other stakeholders;

[9] IWRP (2007) Strand Two Report Management, Governance and Delivery [online] available from: http://nia1.me/1se
[10] PAGE 26 IWRP (2007) Strand Two Report Management, Governance and Delivery [online] available from: http://nia1.me/1se

- openness and inclusion; and
- a lack specialised expertise.

A major outcome of the review of the reform process carried out by the IWRP was the delay in introducing domestic water charges. The IWRP Strand One Report identified that consumers were already making a contribution to the funding of W&SS through their regional rate payments and recommended that the full extent of this should be acknowledged prior to the introduction of any additional charges. The Executive accepted this recommendation and deferred any additional consumer contribution before 2010.[11] Legislation has since been introduced ruling out the introduction of charges until 2016.

While NIW continues to operate as a GoCo, the fact that it depends on government for around 76% of its revenue[12] meant that in March 2009 it was designated as a Non-Departmental Public Body (NDPB) for Public Expenditure purposes. As a NDPB, NIW is now subject to the full suite of public sector governance and compliance measures which affect the day-to-day operation of the company.[13]

Operating under this new ‘hybrid model' means financial management is made more complex by the need to comply with, and be audited against, government accounting standards, as well as regulatory and statutory accounting standards. This dual status adds a layer of complexity and administrative burden to the company's governance framework.

The utility regulator considered a number of problems with the current governance framework for NIW when considering its Price Control Determination[14] including:

- No ‘end of year flexibility'
- Uncertainty of the public expenditure budget; and
- An inconsistent Profile of public expenditure

In 2012 new governance arrangements were put in place to ease burden caused by the hybrid status of NIW. These were presented in the form of a Management Statement and Financial Memorandum which was drawn up and agreed by DRD and NIW. This came into effect on the 1st April 2012 and will remain valid for as long as NIW continues to rely on public subsidy.[15]

[11] NI Executive (2007) Executive's response to IWRPs Strand One Report [online] available from: http://nia1.me/1sj
[12] UREGNI (2012) PC13 Final Determination Main Report [online] available from: http://nia1.me/1sm
[13] NIAO (2010) Measuring the performance of NI Water [online] available from: http://nia1.me/1sh
[14] Ibid.
[15] Management Statement and Financial Memorandum between the DRD and NIW [online] available from: http://nia1.me/1sc

Republic of Ireland

Irish Water is a new state owned company established in March 2013 (under the Water Services Act 2013) to bring the water and wastewater services currently provided by the 34 Local Authorities together under one national service provider. Irish Water will gradually take over the responsibilities from these Local Authorities on a phased basis from January 2014, taking approximately five years for Irish Water to be fully established.

Reform of the water industry in Ireland was necessary as the current model was inefficient and economically unsustainable. To address this, the reform process will proceed on the basis that Irish Water will become self-financing through being able to access third party finance and the introduction of charges to domestic customers.[16]

The Government decided in April 2012 that Irish Water should be established as an independent state owned company within the Bord Gáis Group. The Government believe that Bord Gáis Group has key capabilities that can assist in the successful establishment and operation of Irish Water.

One of the key requirements in the success of Irish Water will be the development of a new funding model which includes the introduction of domestic water charges. Currently W&SS are largely State funded, through a combination of Exchequer grants and local authority resources, including the Local Government Fund.

Water charges are due to commence in Quarter four 2014, with customers due to receive their first bills in Quarter one 2015. The rates and pricing structures will be decided by the regulator, the Commission for Energy Regulation (CER) through a process involving public consultation. The pricing structure is not yet available. [17]

Irish Water is accountable to the Minister for the Environment, Community and Local Government.

- The minister appoints a Board of Directors to run the state enterprise;
- The Board then decides upon the policy of the enterprise and place executives in charge of day to day business.

Conclusion

One of the biggest problems with the reform process in Northern Ireland carried out under direct rule Ministers was that it failed to secure public confidence due largely to a lack of openness and transparency in their decision-making and accountability processes.

Aside from that, The Strand Two report was not overly critical of the chosen GoCo model, suggesting that if there was some greater clarity with the governance

[16] Environment, Community and Local Government (2012) Water Sector Reform: Implementation Report [online] available from: http://nia1.me/1te
[17] Irish Water [online] About Irish Water. Available from: http://nia1.me/1tg

arrangements then it could work, indeed having compared four options this report stated: “What matters is not so much which legal form is adopted as the content that is put in place in practice. Each model has the potential in principle to meet all of its objectives:

- public confidence
- effective delivery of high quality services
- maximum cost-effectiveness for customers
- affordability; and
- sustainability”

It is clear from the evidence presented in this paper that the ability to operate without the operational and financial restrictions imposed by NIWs status as a NDPB is essential to the future well-being of NIW. However the only way this can be made possible is through the introduction of water charges for domestic customers that will lead to NIW becoming ‘self-financing’ or at the very least bring it to a stage where at least 51% of its revenue comes from charges.

This conclusion gives rise to two key questions:

- Is the Executive/Assembly prepared to oversee the introduction of water charges for domestic consumers? and
- Should water and sewerage service be delivered within government (an executive agency) at arms-length from government (GoCo or Statutory Corporation) or completely divorced from government (PLC, CLG or CIC)?

Contents

1 Background and context

Water and sewerage services (W&SS) in Northern Ireland (NI) have been delivered by central government since 1973. Prior to 2007 the body responsible for these services was Water Service, a former executive agency within the Department of Regional Development (DRD). However, following a process of reform W&SS are now delivered by the Government Owned Company (GoCo) Northern Ireland Water (NIW). Across the rest of the United Kingdom (UK) and in Republic of Ireland (ROI) there are various models for the delivery of W&SS:

- In England and Wales W&SS have been delivered by **private sector** companies since 1989;
- In Scotland W&SS are provided by Scottish Water, **a statutory corporation** formed in 2002;
- A **state owned company,** 'Uisce Éireann' (Irish Water), was established in March 2013 to deliver W&SS in ROI,

The privatisation of the water industry in England and Wales and subsequent structural reforms in Scotland, Northern Ireland and ROI have all been predicated on the need to generate revenue, through charging, in order to meet massive capital requirements of the industry; in England and Wales for example, £85 billion has been spent since 1989,[18] while £2.5 billion is being invested by Scottish Water during the period 2010-15.[19]

The result of this investment is evident with each region achieving considerable improvements in terms of drinking water quality, meeting environmental standards, and general service standards. However, it is reflected in a cost to consumers:[20]

- The average household bill for water and sewerage services (England and Wales) went from £248 in 1989 to £356 in 2011 (in 2011-12 prices);
- The average water and waste water bill for households across Scotland in 2009/10 was £324 which is significantly lower than the UK average; and
- The average notional charge for domestic users in Northern Ireland is £424 (2012-13)[21].

The Northern Ireland figure is £68 (17%) higher than the English and Welsh average and £100 (24%) higher than Scotland. However, as the NI Assembly has recently passed legislation to defer water charges to at least 2016 the Executive currently pays customer bills, at a cost of £282 million per year.[22]

[18] Ofwat (2009) *Future water and sewerage charges 2010-15: final determinations* [online] available from: http://nia1.me/16y
[19] The Scottish Government (2012) Scotland the Hydro Nation [online] available from: http://nia1.me/1t6
[20] Ofwat (2011) *Average household bills 2011-12* [online] available from: http://nia1.me/16v
[21] UREGNI (2012) Water Directorate Report on NI Water's Scheme of Charges for 2012-13 [online] available from: http://nia1.me/1tr
[22] Briefing by DRD officials on Water and Sewerage Services (Amendment) Bill, 21 November 2012 [online] available from: http://nia1.me/1t5

2 Privatisation of water and sewerage services in England and Wales

Until 1974, water services in England and Wales were run by local authorities, at which time the regional water authorities (RWAs) were created, each covering a river basin area, under the effective control of central government. In 1989 the Thatcher government privatised these regional companies by selling their shares on the stock exchange.[23]

The UK Government's decision to privatise the water industry in England and Wales was controversial with commentators arguing the assertion that privatisation would stimulate competition and result in better outcomes for consumers was flawed given the unique characteristics of the water industry:[24]

- Water is not only a physical good, but also a cultural and social resource with great economic and political significance;
- Because of the existence of economies of scale, the drinking water market is not competitive;
- The (sunk) initial costs are usually so high that they constitute an effective barrier to entry and, ultimately, only a single firm can survive in such a market;
- This form of monopoly ownership requires either government control or regulation.[25]

Despite this opposition the decision to privatise was taken in line with the policy of the time to sell-off state owned utilities (Telecoms/Gas/Electricity) in the belief that market participation would drive efficiency and attract investment.[26]

The monopolistic position of the new Water PLCs led to the establishment of the current system of regulation:

- As the economic regulator, Ofwat is responsible for setting limits on pricing and protecting customer interests, encouraging competition and adequate investment within the industry, and administering and enforcing the licensing regime for water and sewerage companies (set out in the Water Services Act 1991);
- The Drinking Water Inspectorate (DWI) and the Environment Agency (EA) are responsible for drinking water and environmental quality respectively.

2.1 Has privatisation paid off?

There is little doubt that this privatised and strongly regulated regime in England and Wales has produced some positive outcomes, as noted in the Cave Report:

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[23] Hall, D. and Lobina, E. (2008) From a private past to a public future? the problems of water in England and Wales
[24] Akintoye, A. Renukappa, S. The UK Water Industry: infrastructure, governance and procurement [in] Gunawansa, A. and Bhullar, B. (2013) Water Governance: An evaluation of alternative architectures. Edward Elgar: Cheltenham
[25] Hall, D. and Lobina, E. (2008) From a private past to a public future? the problems of water in England and Wales
[26] Lynck, E.L (1993) Privatisation, joint production and the comparative efficiencies of private and public ownership: The UK water industry case. Fiscal Studies vol 14(2)

> *"…the industry has attracted nearly £80 billion in investment, generally at favourable terms, to enhance the network and improve water and environmental quality. As a result, drinking water is safer than ever before and more rivers and beaches are meeting the required European Union standards."*[27]

However, this has come at a cost to consumers. Since 1989, household charges have risen in real terms by 42 per cent while the UK taxpayer faced a significant bill for the sell-off of the regional water authorities:

- Government cancelled all of the long term debt owed by the water and sewerage companies at a total cost of £4.9bn (in 1989 prices);
- It provided a cash injection of £1.5bn to the balance sheets of the water and sewerage companies, known as the 'green dowry'. This was to enable them to meet the environmental standards required by the EU; and
- Government made for the provision of capital tax allowances of £7.7bn to ensure that the companies were not put at a disadvantage compared with other companies

Indeed the amount written off was roughly equivalent to the total received for the sale of the companies and these public subsidies alone financed roughly one-third of all the investments in the first 10 years of privatisation.[28]

The level of investment attracted to the privatised water industry in England and Wales is often put forward as an indication of the success of privatisation. However, it is clear when we look at Scotland (further into this paper) that private finance is not a prerequisite for the delivery of a multi-billion pound investment programme.

Efficiency has also been presented as reason to increase private sector involvement in W&SS. However, evidence from France, previously a strong proponent of privatisation, has shown that this is not necessarily the case: In 2008 the city of Paris decided not to renew the contract with the companies Veolia and Suez who had owned the water network since 1985, reassigning it to the municipality. In 2010 the municipal company Eau de Paris was founded and the city managed to save 35 million euros per year while reducing the tariffs by 8%.[29]

The fact is that there is little empirical evidence to support the privatisation of the water and sewerage industry and a growing body of evidence in support of public sector ownership.

[27] Cave. M (2009) Independent Review of Competition and Innovation in Water Markets: Final report [online] available from: http://nia1.me/1ti
[28] Hall, D. and Lobina, E. (2008) From a private past to a public future? The problems of water in England and Wales [online] available from: http://nia1.me/1tn
[29] Fragkiska, M. (2013) When Water Is for Sale: What Water Privatisation Really Means. Huffington Post 04/06/2013 [online] available from: http://nia1.me/1tl

2.2 Renationalisation

A series of papers by the Public Services International Research Unit (PSIRU) have identified the many shortcomings of privatisation in the water industry in both the UK and beyond. Hall and Lobina (2009) comment:

> *"The experiment with water privatisation has failed. Since about 1990 privatisation has been actively promoted by the international institutions, donors, and private companies themselves as a way of delivering investment, efficiency and building effective water operators in developing countries. These expectations have not been delivered."*[30]

This view, while strong, is supported by a large scale renationalisation of the industry:

- 5 major corporations, Veolia, Suez, Agbar, RWE and Saur, held 71% of the global water market in 2001;
- Today, large corporations own only 34% of the market while 90% of the 400 largest cities in the world still have a public water network.[31]

3 Welsh Water

Following privatisation of the Water and Sewerage industry in Wales in 1989, Dŵr Cymru (Welsh Water) assumed the assets of the former Welsh Water Authority, later becoming Hyder when it acquired a South Wales regional electricity supply and distribution business (Swalec). By the late 1990s this newly formed multi-utility company began to have financial troubles, leading to a crash in share value and an *'unprecedented fall in credit ratings'*.[32]

Hyder was acquired by US Company Western Power Distribution Ltd. (WPDL) in September 2000. However, their main motivation for this deal was to acquire the electricity distribution arm of the company, therefore WPDL agreed to sell Welsh Water, a company valued at £1.8bn, to Glas Cymru in November 2000 for the nominal price of £1.[33]

In order to finance the operation of Welsh Water, the founders of Glas, Nigel Annett and Chris Jones acquired a £1.9 billion bond issue; this is thought to be the largest ever, non-government backed Sterling corporate bond issue. Glas is unique in the UK utility industry in that it is:

- a private company with no shareholders;
- financed in the capital markets, with no government support;

[30] Hall, D. and Lobina, E. (2009) The private sector in water in 2009 [online] available from: http://nia1.me/1tm
[31] Fragkiska, M. (2013) When Water Is for Sale: What Water Privatisation Really Means. Huffington Post 04/06/2013 [online] available from: http://nia1.me/1tl
[32] Thomas, D. (2000) Hyder: the rise and fall of a multi-utility. Utilities Policy vol. 9, pp. 181-192
[33] Ibid.

- not allowed to diversify into other activities or geographies; and
- all financial surpluses are used for the benefit of its customers.

3.1 Welsh Water Group Structure

Glas Cymru (Glas) was formed (as a company limited by guarantee) in 2000 for the sole purpose of acquiring and then owning Welsh Water. Glas's status as a company limited by guarantee (CLG) means that it operates on a non-profit basis and has no shareholders; therefore, any profit it does make is reinvested into the business for the benefit of Welsh Water's customers. The activities of Glas are limited to the provision of water and sewerage services in the region served by Welsh Water therefore Glas cannot diversify into unrelated activities, as has been the case in Scotland.[34]

Dŵr Cymru Cyfyngedig (Welsh Water) is the principal trading company of the group, appointed by the Secretary of State for Wales as a water and sewerage undertaker under the Water Industry Act 1991; Welsh Water is required to comply with the conditions set out in the Instrument of Appointment (the 'Licence') issued thereunder.

Dŵr Cymru Financing Limited is an investment company whose primary role is to provide long-term funding for the activities of Welsh Water.

Dŵr Cymru Customer Services Limited was established in 2012 as part of the groups restructuring. It provides (in-house) income collection and billing services to Welsh Water.

3.2 Governance and Accountability

Glas is headed by a Board of Directors who are responsible for the strategic direction of the company and for reviewing operational and financial performance. The Board currently comprises 3 Executive Directors and 7 Non–Executive Directors (including the Chairman of the Board).[35]

All the directors of Glas are also directors of Welsh Water, and vice versa. This identity is designed to ensure that the risk of conflicts of interest between the responsibilities of the two boards is minimised, and the same directors also form the Board of Directors of Dŵr Cymru (Financing) Limited, the debt-raising vehicle of Welsh Water).

There are three committees which are (joint) committees of both Glas Cymru and Welsh Water boards: The Audit, Remuneration and Nominations Committees. The Quality and Environment Committee is a committee of the Board of Welsh Water only.[36]

[34] Glas Cymru (2009) Policy and Procedure for the Selection and Appointment of the Members of Glas Cymru Cyfyngedig [online] available from: http://nia1.me/1ta

[35] (Welsh Water) Dŵr Cymru [online] Company Information: The Directors. Available from: http://nia1.me/1tb

[36] Dŵr Cymru (2012) Dŵr Cymru Cyfyngedig Regulatory accounts for the year ended 31 March 2012

3.2.1 Members

The Board is accountable to the Members of Glas Cymru for its management of the Company. Members play an important role in scrutinising Welsh Water's performance against commercial and other targets, as well as against water industry benchmarks for quality of service and cost efficiency. The role of a Member is similar to that of a shareholder in a public limited company, although a Member has no financial interest in the Company. Members perform this corporate governance role by receiving regular reports on the Company's performance and by participating in Members' conferences and in general meetings of the Company.[37]

Members have an important role in ensuring that Glas is managed in line with the highest standards of corporate governance and that it acts in accordance with the Principles of Good Governance and Code of Best Practice as annexed to the listing rules of the London Stock Exchange (the "UK Corporate Governance Code"). In addition Members have a role in:

- Approving certain major transactions or changes to the Company's constitution;
- Approving the appointment and re-appointment of Directors; and
- Approving the appointment and re-appointment of the Company's auditors.

Members are appointed because they have an appropriate combination of expertise, based on experience and capacity to contribute to the governance of Welsh Water. By way of example the types of people on the board include:

- **Brynley Bellis** - a retired chartered engineer and former Managing Director of Dee Valley Water with over 40 years experience of working in the water industry;
- **Nick Bennett** is a former Cabinet Special Adviser to the Deputy First Minister in the Welsh Assembly Government where he supported a number of portfolios including economic development, rural affairs and culture and the Welsh Language. He is currently the Chief Executive of Community Housing Cymru, the national membership body for not for profit housing providers;
- **Philip Bishop** recently retired as Head of the Water and Environment Branch of the Welsh Assembly Government (WAG); and
- **Geoffrey Daw:** a chartered civil engineer working in the public sector on coastal defence and flooding with over 35 years experience working in the water industry.[38]

The Board believes that around 50 independent Members (the maximum is 200) is enough to embrace the key stakeholder perspectives served by Welsh Water – there are currently 57 independent Members, plus the nine Directors are also Members.[39]

Members are initially appointed for periods of between two to five years but this can be renewed, with a maximum tenure of ten years. Members assume a very limited liability

[37] Glas Cymru (2009) Policy and Procedure for the Selection and Appointment of the Members of Glas Cymru Cyfyngedig
[38] Dŵr Cymru [online] Company Information: Glas Cymru. Available from: http://nia1.me/1tc
[39] Ibid.

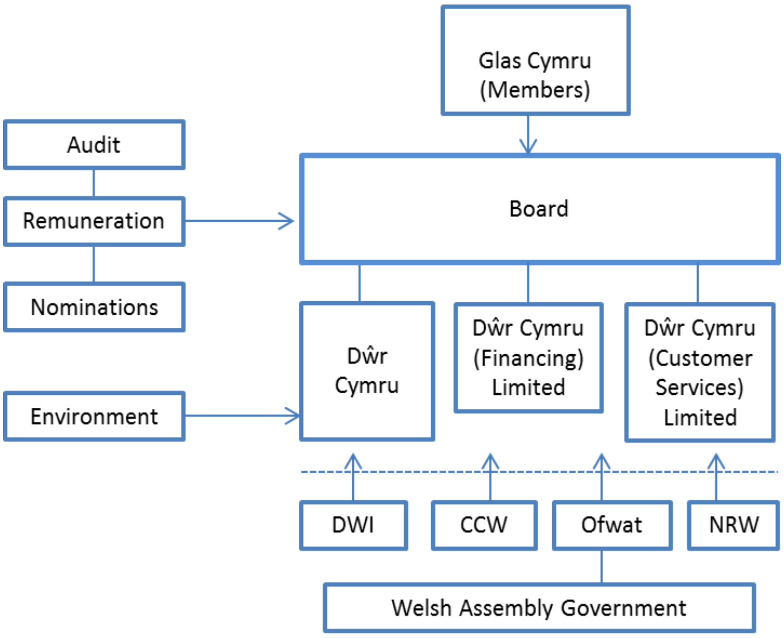
for the well-being of the company; in the event it was ever "wound up" then each Member would be required to contribute £1 to the assets of the Company. This is the maximum liability of any Member, and this liability would only arise at all if the Company was to be "wound up" in circumstances where it was unable to meet all of its debts in full.

Members receive no payment whether by dividend, bonus or any other form. However, they are reimbursed all reasonable expenses incurred in respect of their attendance at the Annual General Meeting, Members' conference(s) or similar events.

3.3 Regulation

Welsh water works under the same regulatory framework as the water companies in England. The exception is that Welsh Assembly ensures that Welsh Water complies with EU and UK legislation by making regulations and issuing statutory guidance. The Assembly also issues guidance to the Director General on the drinking water and environmental quality programmes to be taken into account when setting price limits.

Figure 1: The Governance Framework of Welsh Water



3.4 Business Model

The primary objective of Welsh Water is the same as for any other W&SS undertaker: to provide safe drinking water and sanitation which are essential for the protection of public health and the environment. However, the business model adopted for Welsh Water makes it markedly different from the investor owned equity financed water companies in England.

Whereas W&SS companies in England are motivated by profit and must answer to shareholders, as a company limited by guarantee Welsh Water does not have any shareholders and is instead focused on providing the best possible service at the lowest possible price for the benefit of its consumers. The role of shareholders is fulfilled by its members, who are experienced unpaid individuals appointed, following a process undertaken by an independent membership selection panel, to look after the best interests of customers – they are not from stakeholder groups.[40]

3.4.1 Welsh Water is not a mutual

The Welsh Water model is often described as being a 'mutal' which describes a private company whose ownership base is made of its clients or policyholders. The defining feature of a mutual company is that its customers, who are also its owners, are entitled to receive profits or income generated by the mutual company in the form of dividends.

Under Glas's 'not for profit' model, Glas customers are not owners and therefore they do not receive a dividend. Instead all profits are reinvested or held in reserves as an equity buffer, protecting Welsh Water and its customers against the risk of adverse trading conditions and financial shocks.

The consequent absence of the need to pay equity dividends has enabled the company to reduce its gearing (level of borrowing) from 93% at creation to 63% by 31st March 2013, thereby improving credit quality such that it now has the best credit ratings in the UK utility sector. Customer reserves now stand at £1.6 billion.[41]

3.4.2 Cheap Financing

No utility with a significant capital programme is self-financing making borrowing essential. Borrowing to help fund long-term investment programmes is an efficient way of financing the construction of long life assets and does not put an undue burden on the customers of today to pay for assets that will provide service for many years. Welsh Water's finances its capital programme through debt is in the form of low cost bonds raised on the capital markets.

Welsh Water's strong credit rating enables it to *borrow money* at very competitive rates.[42] For instance, in 2006, Dŵr Cymru issued a 50 year bond at a real interest rate of just 1.4%.[43] This is a significant advantage of this particular business model as servicing debt is one of the most significant costs of W&SS companies[44] accounting for

[40] Dŵr Cymru [online] Company Information: Background. Available from: http://nia1.me/1ez
[41] Dŵr Cymru (2013) Regulatory accounts for the year ended 31 March 2012
[42] (Welsh Water) Dŵr Cymru (2013) Your Company Your Say: Our Plans 2015-21 [online] available from: http://nia1.me/1t7
[43] Dŵr Cymru (2012) Environment, Food and Rural Affairs Committee: Written evidence submitted by Dŵr Cymru Welsh Water on 12th October 2012 [online] available from: http://nia1.me/1f0
[44] Glas Cymru (2001) Glas Cymru's plans for Welsh Water [online] available from: http://nia1.me/1ey

one third of the average household bill across the sector – meaning that a one per cent increase in the cost of capital can add 5% to bills.[45]

3.5 Corporate restructuring

The Glas Cymru bid for Welsh Water involved the separation of water asset ownership from the day-to-day management of the business which was to be contracted out in two parts:

- one comprising of operations and maintenance; and
- the other covering customer services including customer contact, billing operations and revenue collecting activities.

As Glas's acquisition of Welsh Water was debt financed, it was felt outsourcing key parts of its service under fixed-price contracts would provide it with more certainty about its cash flows, enabling it to bring the debt back down to a more acceptable level. This is the way the water industry has been managed in many other countries, including France and the US, and is often referred to as the "French model". This strategy worked; as discussed earlier the level of borrowing has fallen from 93% when Glas took over Welsh Water to 63% as of the 31st March 2013.

On 9 February 2010 it was announced that Welsh Water was to undertake the biggest restructuring of the company since it was bought by Glas Cymru. The price limits for the five years to 2015, set in November 2009 by Ofwat, called for Welsh Water to invest £1.3 billion in water quality and other improvements. But Welsh Water was also challenged to reduce its day-to-day operating costs by some 20% to enable the forecast average household bill to fall by more than £20 in real terms, over the 5 years to 2015.

In previous years, around two thirds of operational costs related to outsourced service contracts - the major contracts were with United Utilities Operating Services Limited (UUOS) (for the operation of the water network and the wastewater network in North Wales) and with Kelda Water Services (KWS) (for the operation of the wastewater network in South Wales and Herefordshire).

The contracts with both companies were terminated by agreement with effect from 1 April 2010 and 1 May 2010 respectively. As a result of this 1,600 staff transferred to the direct employment of Welsh Water. At this stage, approximately 60% of Welsh Water's operating and capital expenditures (capex) remained subject to competitive tenders.[46] However, a number of other services, including customer services (billing, account queries etc.),[47] IT, sampling and network and development services; and laboratory

[45] (Welsh Water) Dŵr Cymru (2013) Regulatory accounts for the year ended 31 March 2012
[46] Standard and Poors (2010) Dwr Cymru (Financing) Ltd. Rating
[47] Glas Cymru (2013) Report and Accounts 2013 [online] available from: http://nia1.me/1t8

services have now been taken in-house and across Wales, Glas now employs in excess of 2500 staff.[48] [49] Maintenance and capital contracts continue to be outsourced.

4 Scottish Water

Scottish Water (SW) is the statutory provider of W&SS to domestic properties in Scotland and wholesale services to licensed providers for the non-domestic sector. SW is a public corporation meaning that while it operates commercially (more than 50% of its income is from fees and charges), the Scottish Government exercises control over its general corporate policy.

SW was established by the Water Industry (Scotland) Act 2002. It replaced three regional water authorities (North, East and West of Scotland Water) which were established by the Local Government etc. (Scotland) Act 1994. As a statutory corporation SW is not subject to companies law with its constitution, roles and responsibilities prescribed in its founding legislation - any changes to these require further legislation.

Prior to the formation of SW, W&SS in Scotland were provided by regional councils. The essential attributes of a statutory corporation are:

- created by statute
- constitution set out in legislation
- must act within the scope of its statutory functions and powers, which can be extended or varied only through further legislation
- accountable to sponsoring Department for proper use of public finance
- operating costs normally recovered by means of charges
- separate legal entity from its members
- where the government has a controlling interest, the members are generally the directors
- restricted ability to borrow for capital investments
- subsidies or capital grants score against sponsoring Department’s budget.

4.1 Scottish Water Group

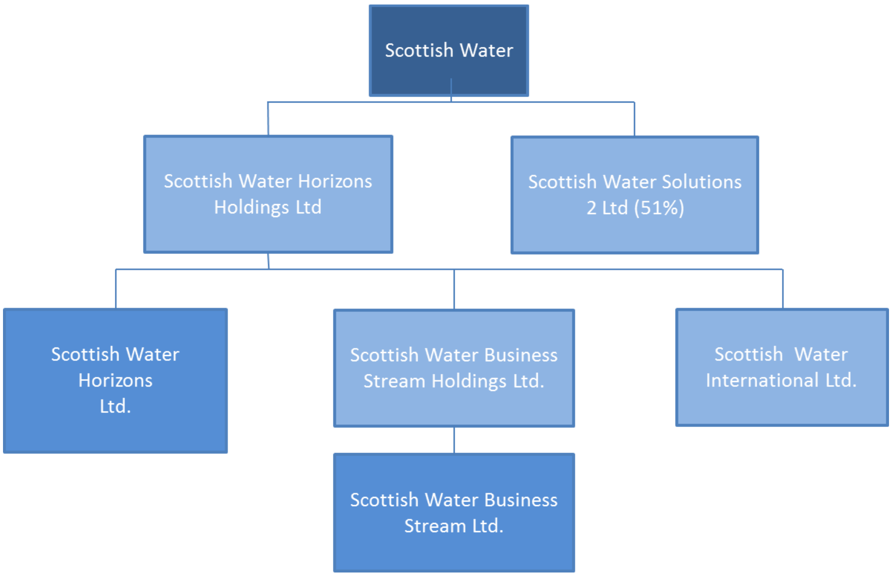
Scottish Water Group includes SW, the statutory provider of W&SS and a number of subsidiary companies:

- Scottish Water Business Stream Ltd (Business Stream), a licensed retail subsidiary which supplies water and waste water services to business customers;

[48] (Welsh Water) Dŵr Cymru (2013) Your Company Your Say. Our Plans 2015-21 [online] available from: http://nia1.me/1t7
[49] (Welsh Water) Dŵr Cymru (2013) Regulatory accounts for the year ended 31 March 2012

- Scottish Water Horizons Ltd (Horizons) provides non-regulated services to customers;
- Scottish Water International offer products and specialist consultancy services to utilities, foreign governments and other international clients.
- SW owns 51% of Scottish Water Solutions 2, the remaining 49% being owned by Thistle Water (a consortium of Jacobs UK Ltd, Laing O'Rourke Infrastructure Ltd and Veolia Water UK Plc). This company was created to deliver part of SW's capital investment programme.

Figure 2: The Structure of the Scottish Water group



Source: Scottish Water (2012)

4.1.1 Business Stream

The Water Services etc. (Scotland) Act 2005 introduced competition in the retailing of W&SS to non-domestic premises in Scotland. Prospective providers must obtain a license from the Water Industry Commission for Scotland (WICS) which enables them to purchase wholesale services from Scottish Water and retail them to non-domestic customers.

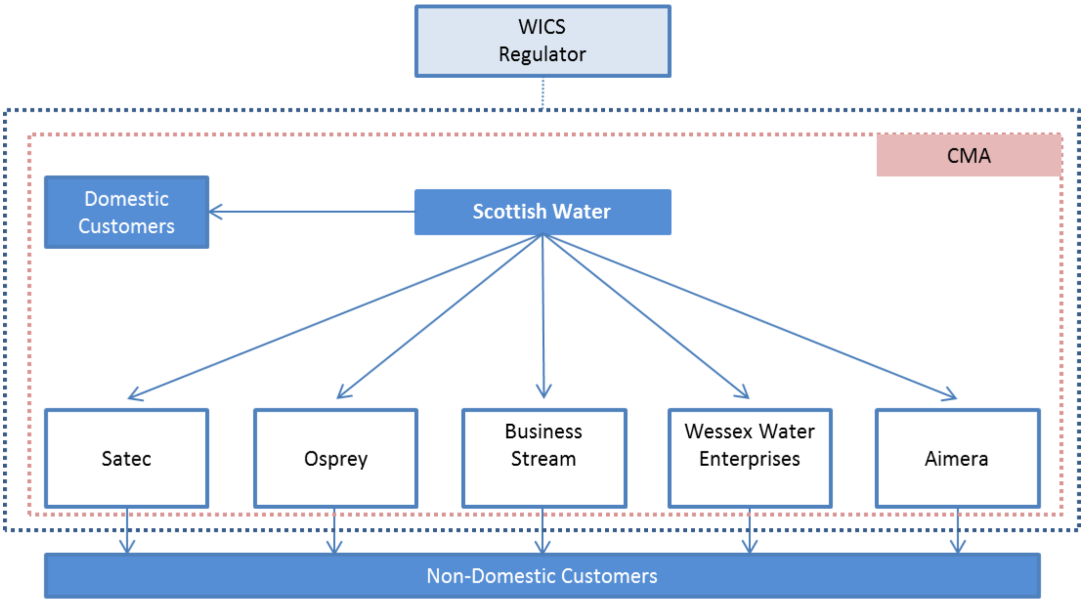
This means that licensed providers are only responsible for billing and other customer facing services, and not the collection, treatment and distribution of water and waste water services. A new body, the Central Market Agency (CMA) was established to administer the competitive water and sewerage service markets in Scotland i.e. it records supplier activity to work out the wholesale charges that suppliers must pay to SW.

It was a requirement of the 2005 Act that the wholesale and retail side of SW are kept separate.[50] This led SW to establish the subsidiary company 'Business Stream'.

[50] SPICE (2012) Water Resources (Scotland) Bill [online] available from: http://nia1.me/1sq

Business Stream now competes with four other licenced providers within the non-domestic retail market. An outline of the non-domestic retail market structure and key stakeholders is shown in figure three below:

Figure 3: The Structure of the non-domestic retail market in Scotland



4.1.2 Scottish Water Horizons

Horizons is another wholly-owned subsidiary of SW that aims to utilise SW's physical and personnel assets to assist Scotland's economy and protect its environment. The services provided by Scottish Water Horizons are discretionary, i.e. SW is not required to provide such services by statute and they are not subject to regulation. Within Scottish Water Horizons there are two distinct elements:

- Horizons Environment: Formerly known as Scottish Water Waste Services, Horizons Environment deals with recycling food waste, composting garden waste, disposing of sludge and liquid waste, emptying septic tanks and handling waste disposal from major events. Horizons Environment also runs an anaerobic digestion facility near Cumbernauld which can produce electricity from food waste.
- Horizons Hydro Engineering: Formerly known as OneSource, Horizons Hydro Engineering specialises in the design and construction of water and waste water infrastructure for housing and commercial developments.[51]

4.1.3 Scottish Water International:

Launched during January 2012, Scottish Water International aims to utilise SW's expertise to offer products and specialist consultancy services to utilities, foreign governments and other international clients.

[51] SPICE (2012) Water Resources (Scotland) Bill [online] available from: http://nia1.me/1sq

4.2 Management Structure

SW is managed by a 13 member board of directors. The board consists of eight non-executive members, appointed by Scottish Ministers, and five executive members. The executive members are the chief executive and the executive leadership team, which consists of an Asset Management Director, Commercial Director, Customer Service Delivery Director and Finance and Regulation Director. Scottish Ministers are also responsible for appointing the chairman of the board.[52]

4.3 Governance Structure

The 2002 Act gives Scottish Ministers a large degree of control over Scottish Water, and indeed under Section 56 they are required to direct the company as to how its affairs are to be managed and conducted. The most recent such direction (Scottish Government 2009), covering the period 1 April 2010 to 31 March 2015, was issued on 27 October 2009.[53]

This direction requires Scottish Water to operate its corporate governance arrangements in line with the principles and best practice contained in the Combined Code on Corporate Governance (CCCG), which outlines the role of key stakeholders in the governance process such as the Board and company Chief Executive. It also deals with issues such as remuneration; accountability and audit and the shareholder relationship.

4.3.1 Regulatory framework

Scottish Water is subject to incentive-based regulation explicitly designed to reward good performance. This is modelled on the regulatory framework developed for W&SS companies to in England and Wales – a similar framework is also used in NI.

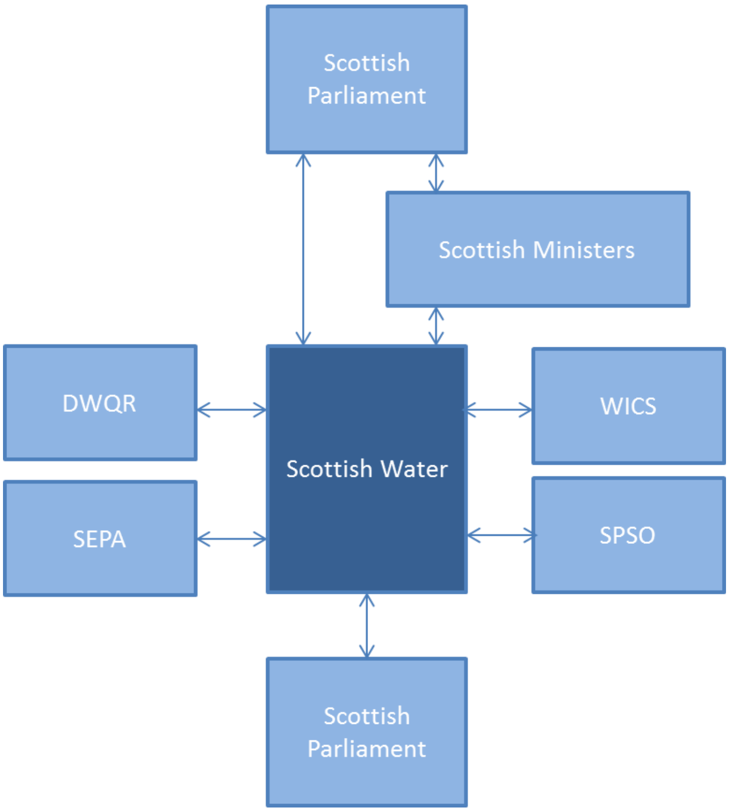
There are five organisations involved in the regulation/monitoring of aspects of Scottish Water's operations. These are:

- Water Industry Commission for Scotland (WICS) is similar to UREGNI, although it was established for the sole reason of regulating the Scottish water industry: WICS has three main roles:
  - setting prices for water and sewerage services for five year regulatory cycles;
  - monitoring Scottish Water's Performance in terms of customer service, investment, costs and leakage; and
  - facilitating competition in the non-domestic retail market. Managing the retail competition framework: All retailers require to obtain a license
- Scottish Public Services Ombudsman (SPSO) investigates customer complaints about water and sewerage providers operating in Scotland.

[52] SPICE (2012) Water Resources (Scotland) Bill [online] available from: http://nia1.me/1sq
[53] Scottish Government (2009) The Scottish Water Governance Directions 2009 [online] available from: http://nia1.me/1sp

- Consumer Focus Scotland is the statutory advocate for the users of water and sewerage services in Scotland. It does not investigate individual customer complaints. Rather, it is required to engage with the key players in the Scottish water industry, which are required to take account of any views it is given.
- Drinking Water Quality Regulator for Scotland: The Drinking Water Quality Regulator (DWQR) ensures that Scottish Water complies with its duties in respect of the quality of public drinking
- Scottish Environment Protection Agency (SEPA) regulates activities which impact on the water environment.

Figure 4: Governance framework of Scottish Water



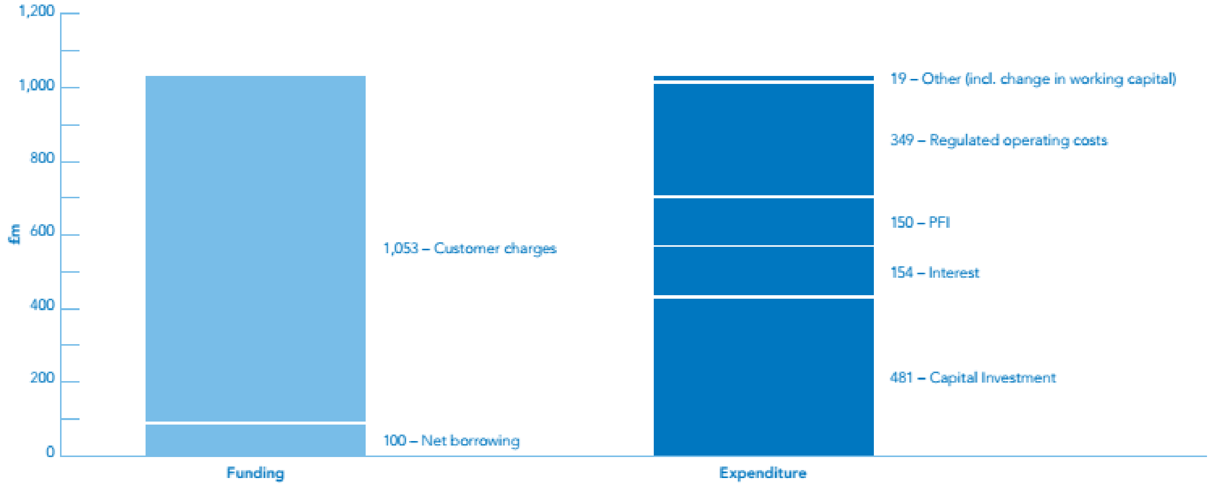
Source: WICS

4.4 Finances

Over 90% of SW's revenue is generated through direct charges for its services with the remainder borrowed from the Scottish Government to support capital expenditure. Scottish Water is also permitted to enter into various forms of contractual agreements, including Private Finance Initiative (PFI) and Public Private Partnership (PPP) agreements.

In 2012/13 SW's income from in its customers exceeded £1bn; to supplement this SW borrowed £100m to fund its expenditure, including £481m of capital investment.

Figure 5: Scottish Water Funding 2012/13



Source: Scottish Water Annual Report (2012/13)

4.4.1 Borrowing

It is the responsibility of WICS to decide on *"a prudent level of borrowing"* for Scottish Water. This is determined in part by the level of capital investment target set for it in the price control period, while consideration is also given to cost of interest payments and the financial ratios that WICS believe that SW should meet.[54]

As a public sector body Scottish Water cannot access finance from the capital markets and must borrow from the Scottish Government although with continued pressures on public expenditure, there remains uncertainty over the level of borrowing that may be available from year-to-year over the 2010-15 period.

During the current Strategic Review of Charges (2010-15), the Scottish Government expected to spend around £2.5bn (in real terms) – in 2012/13 alone, it spent £481m. To sustain this level of spending the regulator has assumed Scottish Water will need to borrow around £140 million per year or £700m over the price control period – with the expectation that the profile may change from year-to-year (see net borrowing [highlighted in red] in table one).

Table 1: The key financial forecasts for Scottish Water 2010-15

Financial projections Forecast outturn prices -£m	2010/11	2011/12	2012/13	2013/14	
Turnover	1,047	1,041	1,060	1,077	1,094
Profit before interest and tax	269	222	227	231	240
Net interest payable	157	163	165	171	179
Profit before tax	112	59	62	60	61
Tax	31	16	16	15	15
Retained profit	81	43	46	45	46
Capital investment (incl. PFI)	444	504	569	552	558
Net new borrowing	106	0	120	210	230
Closing RCV	5,679	5,952	6,290	6,622	6,984
Closing debt	3,119	3,119	3,239	3,449	3,679

Source: Scottish Water Delivery Plan 2011/15

[54] Scottish Government (2009) The Scottish Water Governance Directions 2009 [online] available from: http://nia1.me/1sp

4.4.2 Reserves

The governance directions enable Scottish Water to build up financial reserves, these are generated when it has achieved greater efficiencies and met its performance targets, while spending less than anticipated by the regulator in its price review. Basically the ability to build up reserves acts as an incentive for outperformance. This is in stark contrast the inflexible public financing regime to which NIW is subject.

Holding this reserve, or buffer as it is known, is particularly useful to SW as it removes some of the financial uncertainties if faces when dealing with public expenditure constraints. It can also serve as a contingency to cover costs outside the control of management that may otherwise have led to an interim determination[55] to increase prices.

If Scottish Water sustains its outperformance on costs to the end of the regulatory control period, any resulting reserve can be invested in index-linked, gilt-edged securities. This gilts buffer is intended to maintain the pressure on Scottish Water to improve its performance, by ensuring that good performance in one period could not be used to pay for poor performance in another period. Savings held in the buffer are to be returned to customers in the form of reduced prices if they are not used within four years.[56]

This buffer is an important mechanism to protect customers against risks and uncertainties, and is accessible to Scottish Water only with the agreement of Ministers. In addition to providing financial security, the gilts buffer could potentially be used to return a dividend to customers, thereby reducing charges, as is done within the Welsh mutualised model.[57]

4.5 Scottish Water Performance

This incentive based governance framework has seen Scottish Water achieve an accelerated passage from one of the most inefficient water and sewerage providers in the UK, to one of the most efficient.[58]

In its 2002-06 price control the regulator had anticipated that SW would achieve large efficiencies as a result of what it described as “easy wins” coming from:

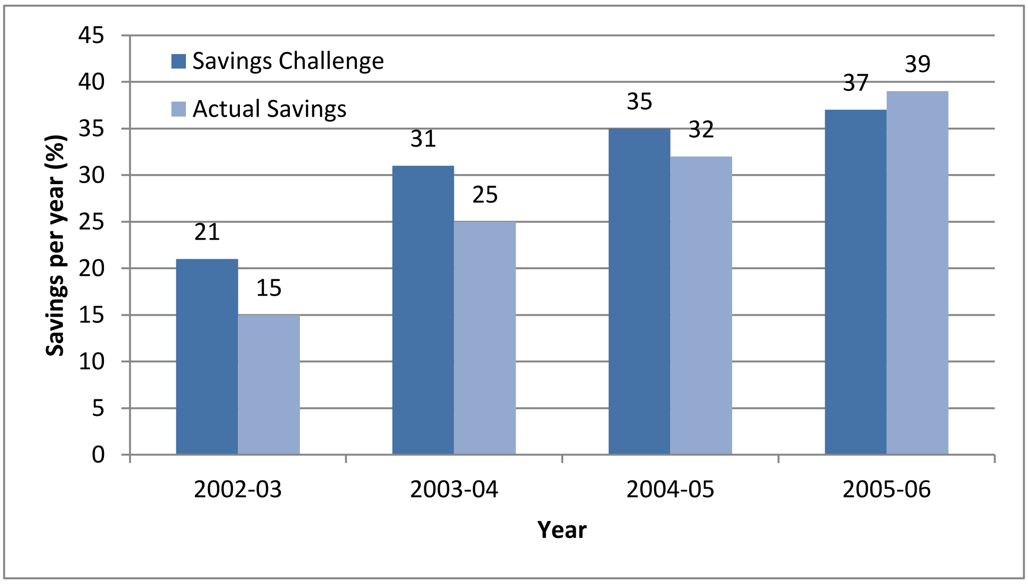
- The merger of three companies;
- The incentives for efficient performance under the regulatory regime; and
- The existing poor level of efficiency at that time.[16]

[55] The process of adjusting charge caps between Strategic Reviews is known as an ‘interim determination’ (or IDoK)
[56] PWC (2010) Irish Water: Phase 1 Report (Appendices) [online] available from: http://nia1.me/1ss
[57] Ibid
[58] WICS (2010) *Governance and Incentives Staff Paper 2* [online] available from: http://nia1.me/17g

In this first period WICS set an efficiency assumption equal to an average of approximately 9.2% per year. Excluding the merger benefits, the annually efficiency target was equivalent to 7.6%.

In its 2006 Performance Report, the WICS presented the OPEX (operating expense) efficiency improvements delivered by Scottish Water over its first price review period (see figure three). This compares the actual costs savings achieved by Scottish Water with the efficiency targets set. This shows that in 2002-03 actual performance was lower than expected performance. However, by 2005-06, Scottish Water had exceeded its cumulative efficiency targets by 2% overall. In money terms this equates to additional savings of £145m (over and above the £1.5bn required by the regulator), comprising cost savings of £100m and additional investment of £45m.

Figure 6: Operating cost efficiency improvements delivered by Scottish Water[59]

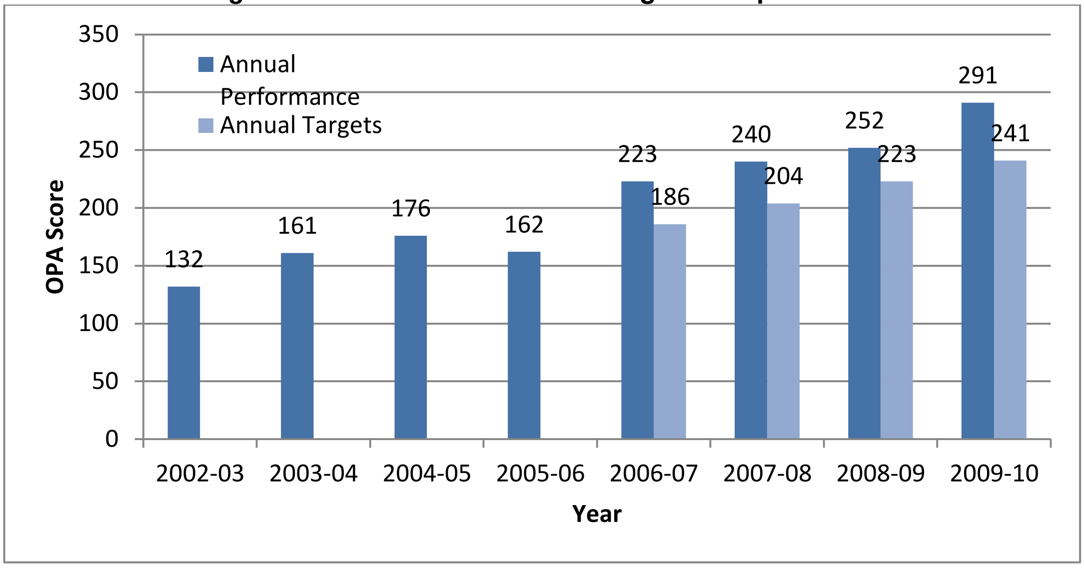


By 2010 Scottish Water's operating costs were 35% lower than they were in 2002-03 whereas over the same period the water industry in England and Wales has seen its operating costs increase by 13%.[60]

In addition to becoming economically efficient, Scottish Water has also been able to significantly improve it overall performance assessment (OPA) score.[61] Scottish Water is now on par with the English and Welsh average of 290.

[59] WICS (2006) Costs and performance report 2003-06 [online] available from: http://nia1.me/17j
[60] WICS (2010) Performance Report 2010 [online] available from: http://nia1.me/17k
[61] Service levels are measured through a points based system: the 'overall performance assessment' (OPA). This attributes points to different aspects of SW's service that are most important to customers

Figure 7: Scottish Water's OPA targets and performance[62]



5 Reform of water and sewerage service in Northern Ireland

The main driver for the reform of the Water Service was the need to address a number of issues caused by historical under investment in water and sewerage assets:

- Standards of service were below the required standard;
- Standards of drinking water quality and waste water treatment were below European Union Standards, bringing the risk of infraction proceedings, while posing risks to public health;
- Investment of some £3bn was required to upgrade water and sewerage infrastructure; and
- A more efficient delivery model was required.[63] [64]

The plan was that reform, in whatever form it may take, would make W&SS 'self-financing'.

5.1 Government Owned Company (GoCo)

Following a period of consultation during which time the privatisation of the water service was ruled an independent review ("the UBS review") was commissioned to identify which structural option for the reformed water service would be best able to:

- achieve self-financing status;

[62] WICS (2006) Costs and performance report 2003-06 [online] available from: http://nia1.me/17j
[63] Water Reform Unit (2003) The Reform of Water and Sewerage Services in Northern Ireland: Public Consultation Document
[64] NIAO (2010) Measuring the Performance of NI Water [online] available from: http://nia1.me/1sh

- deliver the lowest possible costs to customers without compromising standards of service;
- be able to access finance at competitive borrowing rates; and
- be capable of efficient, effective and sustainable capital investment to meet national and international compliance targets.

The report recommended the creation of a GoCo in the immediate term with increasing levels of private sector control, **though not ownership**. This proposition was based on the need to retain a level of public accountability while supporting the drive for greater efficiency, which they argue is best achieved through private sector participation. The main characteristics of a GoCo are:

- Its constitution is set out in Memorandum and Articles of Association;
- It is unambiguously under public sector control;
- It is established under and must conform with companies legislation;
- over 50% of ordinary share capital owned by government;
- shareholders may receive regular dividend payments;
- there is an accountability relationship with a sponsoring Department; and
- it is permitted to recover costs and build up reserves through trading operations.[65]

5.2 Regulatory Framework

The review team went on to recommend the adoption of a regulatory framework similar to that used in England and Wales, through which the GoCo could be incentivised to achieve continued efficiencies, improve service levels and meet domestic and European environmental compliance standards.

The UK W&SS industry operates under price cap regulation that takes the general form of RPI + K. RPI is the 'retail price index' and measures inflation in the economy. The K factor is composed of an efficiency factor, X, which reflects the regulators assessment of each company's scope to reduce its unit costs (usually) over a five-year period, and a Q factor to reflect the higher costs resulting from meeting stricter water quality targets. Quality is policed by the Drinking Water Inspectorate and the Environment Agency.

Raise publication NIAR 790-12 provides a more complete discussion of the approach the regulator takes to set the price limit and compares experiences of price cap regulation across the UK.[66]

[65] IWRP (2007) Strand Two Report Management, Governance and Delivery [online] available from: http://nia1.me/1se
[66] McKibbin, D. (2012) Price Cap Regulation in the UK Water Industry. RaISe [online] available from: http://nia1.me/1ri

5.3 Governance

The Water and Sewerage Services (Northern Ireland) Order 2006 (the Order) provided for the establishment of a GoCo – Northern Ireland Water – to deliver water and sewerage services in Northern Ireland.

Northern Ireland Water Limited (NIW) is a company limited by shares, created under the Companies Order (Northern Ireland) 1986. All the shares are owned by the Department for Regional Development (DRD).

The Shareholder and Governance relationship between the DRD and NIW were originally outlined in the *Governance Letter*[67] issued by the NIO Minister to NIW on 20th March 2007. This established the key responsibilities of each individual/body in the governance of NIW. In line with best practice and the recommendations made in the UBS review, it was envisaged that DRD, as the primary shareholder, would have little to do with the day-to-day operation of NI Water and the duty to oversee these issues would be delegated to the Board and Executive team. The role of Government (as shareholder) under this model would be to:

- appoint the board and agree the terms on which the Directors and senior managers are appointed;
- agree the company's strategic plan with the board;
- hold the board to account for delivering the agreed plan;
- give the board the operational freedom to take any action necessary to deliver the strategic plan; and
- monitor the company's performance to satisfy itself that the strategic plan is on track.

5.4 Independent Water Review Panel (IWRP) response to Governance arrangements

It was clear that for many these new structures, put in place under direct rule, were not welcomed. Therefore, once devolution had been restored in 2007, the Minister for Regional Development set up the Independent Water Review Panel (IWRP) to review the reform process; make recommendations on the level of funding needed for water and sewerage services; and advise the Executive on how the services should be structured and paid for in future.[68]

The IWRP acknowledged that it could not fully assess the performance of NI Water due to the short time it had been incorporated, however it did offer some positive feedback with regards to the new structure: [69]

[67] NI Water Governance Letter, issued by the NIO Minister to NIW on 20th March 2007 [online] available from: http://nia1.me/1rl
[68] IWRP (2007) Strand Two Report Management, Governance and Delivery [online] available from: http://nia1.me/1se
[69] PAGE 26 IWRP (2007) Strand Two Report Management, Governance and Delivery [online] available from: http://nia1.me/1se

- the new structures open up the potential for better services and greater efficiency; and
- the reform process was not (despite public opinion) predicated upon eventual privatisation.

The IWRP did, however, identify four significant flaws in the outcomes of the reform process overseen by the NIO Minister:

- the lack public confidence;
- clarity about roles and responsibilities of government and other stakeholders;
- openness and inclusion; and
- a lack specialised expertise.

The IWRP made a number of recommendations which it believed would improve the established governance arrangements, thereby restoring some level of public confidence. These include:

- The appointment of an independent Water Advisory Panel to advise the Minister on economic, social, environmental and consumer priorities;
- The appointment of a Business Advisory Panel to support the Minister in his role as majority shareholder;
- Stronger powers and duties for the consumer council; and
- Clarification of the powers and responsibilities of the Department and the Utility Regulator.

5.5 Deferral of charges

A major outcome of the review of the reform process carried out by the IWRP was the delay in introducing domestic water charges. The IWRP Strand One Report identified that consumers were already making a contribution to the funding of W&SS through their regional rate payments and recommended that the full extent of this should be acknowledged prior to the introduction of any additional charges. The Executive accepted this recommendation and deferred any additional consumer contribution before 2010.[70]

Subsequent to this deferral, there have been two amendments to the Water and Sewerage Services Order (2010 and 2013) which have enabled the DRD to continue to pay subsidies to NIW. The latest amendment (2013) provides the basis for DRD to continue to make subsidy payments to NIW until 31st March 2016;[71] this is in line with a commitment made in the Programme for Government not to introduce water charges in the current mandate.[72]

[70] NI Executive (2007) Executive's response to IWRPs Strand One Report [online] available from: http://nia1.me/1sj
[71] Water and Sewerage Services (Amendment) Act (Northern Ireland) 2013 [online] available from: http://nia1.me/1s9
[72] Page 11 – NI Executive (2011) Programme for Government 2011-15 [online] available from: http://nia1.me/1s6

5.6 Hybrid business model

While NIW continues to operate as a GoCo, the fact that it depends on a government subsidy for around 76% of its revenue[73] meant that in March 2009 it was designated as a Non-Departmental Public Body (NDPB) for Public Expenditure purposes. As a NDPB, NIW is now subject to the full suite of public sector governance and compliance measures which affect the day-to-day operation of the company.[74]

5.6.1 Financial Management

Operating under this new 'hybrid model' means financial management is made more complex by the need to comply with, and be audited against, government accounting standards, as well as regulatory and statutory accounting standards. This dual status adds a layer of complexity and administrative burden to the company's governance framework.

The utility regulator considered a number of problems with the current governance framework for NIW when considering its Price Control Determination:[75]

- **No 'end of year flexibility' –** This in effect means that the budget allocation for a specific year must be spent in that year. This encourages expenditure on smaller scale projects, such as water mains and sewers, rather than larger scale capital projects which may bring more sustainable benefits.
- **Uncertainty of the public expenditure budget –** The public expenditure process operates a number of monitoring rounds during the financial year. At each monitoring round, Departments are required to assess expenditure and, where necessary, surrender excess funds. There is also the potential for funding levels to be cut or indeed increased depending on pressures or surpluses elsewhere in the Department or Northern Ireland budgets. This absence of a hard budget brings much uncertainty and dilutes the pressure on NIW to outperform the regulatory price control contract.
- **Profile of public expenditure –** NIW must follow the public expenditure profile of funding. The current PE capital profile is up and down with significant jumps and drops year-on-year. This is inefficient, limiting NIW's ability to deliver large-scale, priority projects that span a number of years.
- **Operational expenditure and incentives –** Contrary to the regulatory price control regime, which incentivises a regulated company to outperform its targets, the public expenditure regime incentivises spending to budget. This is because any savings or under spend that NIW achieves in any year must be handed back in the same year, and such returns of funding late in the financial year are unwelcome.

[73] UREGNI (2012) PC13 Final Determination Main Report [online] available from: http://nia1.me/1sm
[74] NIAO (2010) Measuring the performance of NI Water [online] available from: http://nia1.me/1sh
[75] Ibid.

- **Management of risk** – Under this governance model a degree of risk has been transferred back to taxpayers. This is because NIW has no access to reserves and the capital budget is restricted by the allocation from public expenditure, rather than being informed by the company's investment needs.

5.7 Management Statement and Financial Memorandum (MSFM)

In January 2010, an independent review team was commissioned to investigate governance arrangements at Northern Ireland Water (NI Water). This prompted an inquiry held by the Northern Ireland Assembly's Public Accounts Committee (PAC) in 2011, which considered the governance arrangements at NIW. The report stated:

> *"Governance arrangements established by DRD for NI Water represented the worst of all possible worlds – NI Water was not a fully-fledged commercial organisation subject to the usual market disciplines, nor was it a conventional public body operating under tried and tested public sector rules and procedures."*[76]

The Committee then recommended a "…*a new governance agreement in the form of a Management Statement/Financial Memorandum should be put in place between DRD and NI Water for as long as NI Water continues to receive large amounts of public funding."*

In response to this a MSFM was drawn up and agreed by DRD and NIW. This came into effect on the 1st April 2012 and will remain valid for as long as NIW continues to rely on public subsidy.[77]

The adoption of the MSFM has brought the company closer towards central government oversight and further away from the commercial freedoms envisaged when the GoCo was formed and that enjoyed by comparative companies in England, Wales and Scotland.[78]

The MSFM sets out the principles underpinning the relationship between NIW and DRD as shareholder. It includes a number of objectives, key targets and performance measures for NI Water set by the DRD Minister. The MSFM also defines the roles and accountability relationships between the Minister; Accounting Officer; the Water Shareholder Unit; The NIW Board; The Chairman of NIW; and the Chief Executive of NIW (these are summarised in Figure one).

[76] PAC (2011) Measuring the Performance of NI Water and Procurement and Governance in NI Water. Volume One [online] available from: http://nia1.me/1so
[77] Management Statement and Financial Memorandum between the DRD and NIW [online] available from: http://nia1.me/1sc
[78] NI Water (2012) The NI Water Response to the PC13 Draft Determination [online] available from: http://nia1.me/1sl

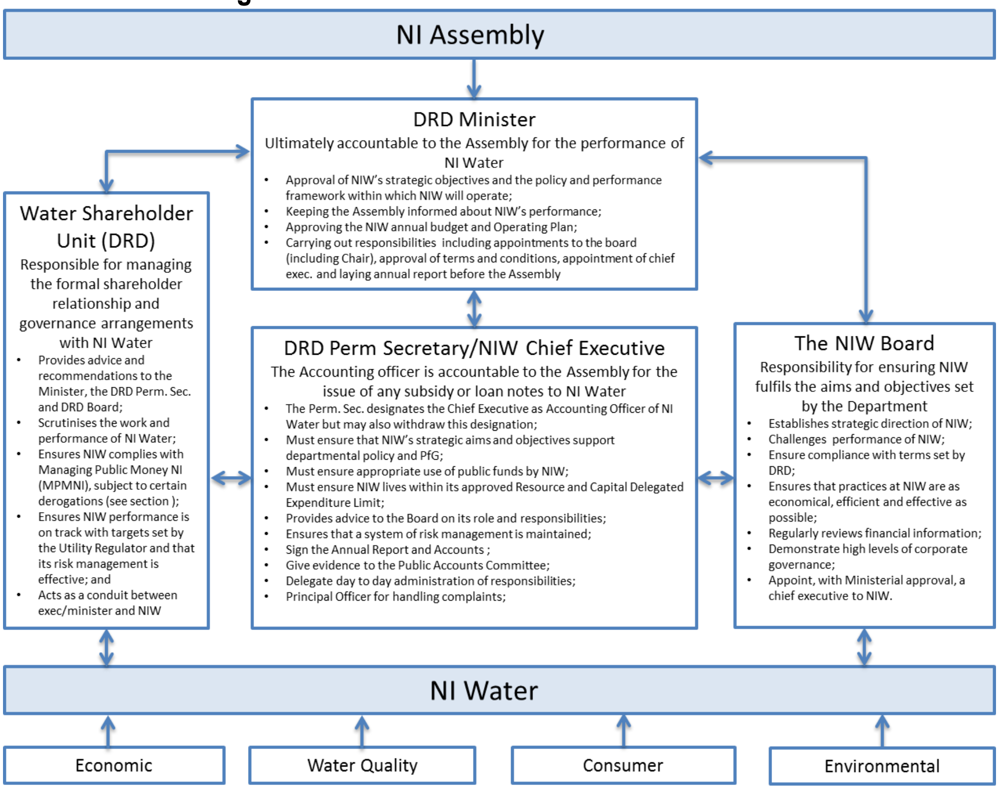
5.8 Performance

Since economic regulation was first introduced in 2007, NI Water has steadily improved its operational performance while at the same time reducing its operating costs.

- NI Water outperformed its operational efficiency objective for 2010-11, delivering savings of £6.1 million more than projected;
- NI Water exceeded its operational efficiency targets, and as a result has reduced the gap with comparative water companies in England and Wales from 49% in the PC10 base year to 38% for the PC13 base year – this means that instead of spending £1.96 (2007-08 PC10 base year) for every £1 spent by its comparative companies, NI Water now spend £1.62 (2010-11 PC13 base year); [79]
- Despite improvements in terms of both delivering efficiencies together with improved service a significant efficiency gap remains between NI Water and equivalent service providers in England, Wales and Scotland.

The difficulties of operating with a hybrid status were highlighted during the PC10 period as there was a net underspend of £31 million (in nominal terms). Rather than carrying this forward, NI Water's classification as a Non-Departmental Public Body (NDPB) meant it to be handed back to the DFP. Further difficulties arose when the budget allocation for NI Water did not match the level of investment identified by the regulator meaning they had to reassess outputs and agree a revised monitoring plan for years 2 and 3 of PC10.

Figure 8: Governance Framework for NI Water



[79] UREGNI (2012) Water and sewerage service Price Control 2013-15 [online] available at: http://nia1.me/1sm

6 Irish Water

Irish Water is a new state owned company established in March 2013 (under the Water Services Act 2013) to bring the water and wastewater services currently provided by the 34 Local Authorities together under one national service provider.

Irish Water will gradually take over the responsibilities from these Local Authorities on a phased basis from January 2014, taking approximately five years for Irish Water to be fully established. When the ‘hand over’ is complete Irish Water will be responsible for the operation of public water services including management of national water assets, maintenance of the water system, investment and planning, managing capital projects and customer care and billing.

As well as responsibility for public water services, Irish Water will also be making capital and investment decisions regarding the country’s water infrastructure on a national basis.[80]

6.1 Water Sector Reform

The Irish Government faces the same challenges in providing high quality water and sewerage services as those which prompted reforms in the United Kingdom:

- Demand for water and waste water services is increasing;
- The costs of provision are unsustainable: water and wastewater services cost approximately €1.2bn per annum, of which around €1bn is funded by the Government, with other sources, including non-domestic water charges, contributing just over €200m.
- There has been a substantial and historic under-investment in water and wastewater services in Ireland and although there has been significant investment in the last decade, there is still a substantial backlog of capital investment; and
- The Water Framework Directive (WFD) sets strict guidelines for water quality. It is estimated that full compliance will run to several billion euro over the period to 2027.

Fundamentally the issue for the Irish Government, as it was for the UK legislatures, is that it is simply unsustainable to fund these services from the public purse, particularly given the wider economic context in which Ireland finds itself. Indeed, Ireland is the only OECD country yet to introduce water charges.[81]

This has meant that the reform process will proceed on the basis that Irish Water will become self-financing through being able to access third party finance and the introduction of charges to domestic customers.[82]

[80] Environment, Community and Local Government (2012) Water Sector Reform: Implementation Report [online] available from: http://nia1.me/1te

[81] Irish Water [online] About Irish Water. Available from: http://nia1.me/1tg

[82] Environment, Community and Local Government (2012) Water Sector Reform: Implementation Report [online] available from: http://nia1.me/1te

In addition to funding, the fragmented nature of the Irish water sector created its own problems:

- Variability of service – absence of consistent policies, processes and standards and variable standards of performance;
- Inability to realise economies of scale, duplication of management and absence of/limited industry standard IT and management information systems;
- limited asset data to support strategic planning;
- Local authority boundaries do not reflect river basin districts making integrated river basin management difficult to implement;
- A funding regime exposed to variation and significant reductions in development levies, limited ability to access alternative sources of funding (e.g. Capital markets) and low recovery rates of non-domestic water charges;
- Higher operational costs relative to international comparators (with, for example, operating expenditure per connection more expensive than UK or NI by 50% to 100%); and
- Leakage levels that are double the UK average (41% as compared to 20%).

6.2 Business Model

Having taken the decision to establish a national public water utility company to take over the operational and capital delivery functions of local authorities, it then had to decide whether this new company should be established as a new State Agency or whether the role of Irish Water should be assigned to an existing State Agency in order to ensure that existing resources and capabilities in the State sector were used to best effect.

The Government decided in April 2012 that Irish Water should be established as an independent state owned company within the Bord Gáis Group. The Government believe that Bord Gáis Group has key capabilities that can assist in the successful establishment and operation of Irish Water, including:

- experience in operating as a utility in a regulated environment;
- a track record in raising finance;
- specific skills from its own experience of transformation;
- experience in customer relations customer relations;
- network management;
- metering; and
- utility operation

6.3 Funding

One of the key requirements in the success of Irish Water will be the development of a new funding model which includes the introduction of domestic water charges. Currently W&SS are largely State funded, through a combination of Exchequer grants and local authority resources, including the Local Government Fund. However, The Irish Government's capacity to fund the future water/waste water investment requirements from the exchequer is severally constrained with capital funding for water services under the Government's plan for Infrastructure and Capital Investment 2012-16 showing a reduction of almost 32% between 2011 and 2014.

Like the other state owned utilities in Ireland it would be expected that Irish Water will have the ability to raise debt on the financial markets. As with the regulated companies in the UK, the regulator will set a limit on the amount that Irish Water will be able to borrow and it will only be able to exceed this limit with the approval of their parent department and the Department of Finance is necessary. Alternatively, the relevant legislation must be changed. EU legislation determines that national governments no longer guarantee loans taken out by state owned enterprises.[83] Therefore the rate which money can be borrowed will be determined by the risk factor of the company.

6.3.1 Start of charging scheme

Water charges are due to commence in Quarter four 2014, with customers due to receive their first bills in Quarter one 2015. The rates and pricing structures will be decided by the regulator, the Commission for Energy Regulation (CER) through a process involving public consultation. The pricing structure is not yet available. [84]

It is the intention of the Irish Government to install meters in all households (one million+) connected to the public water supply. This means customers will pay only for what they use (volumetric rate), measured in in cubic metres (1 cubic metre =m^3). In households where a meter has not yet been installed an assessed fee will be charged, based on the determination of the regulator.[85]

Irish Water will be responsible for the management of the metering programme although Initial work on the programme was developed by the DECLG with input from local authorities.

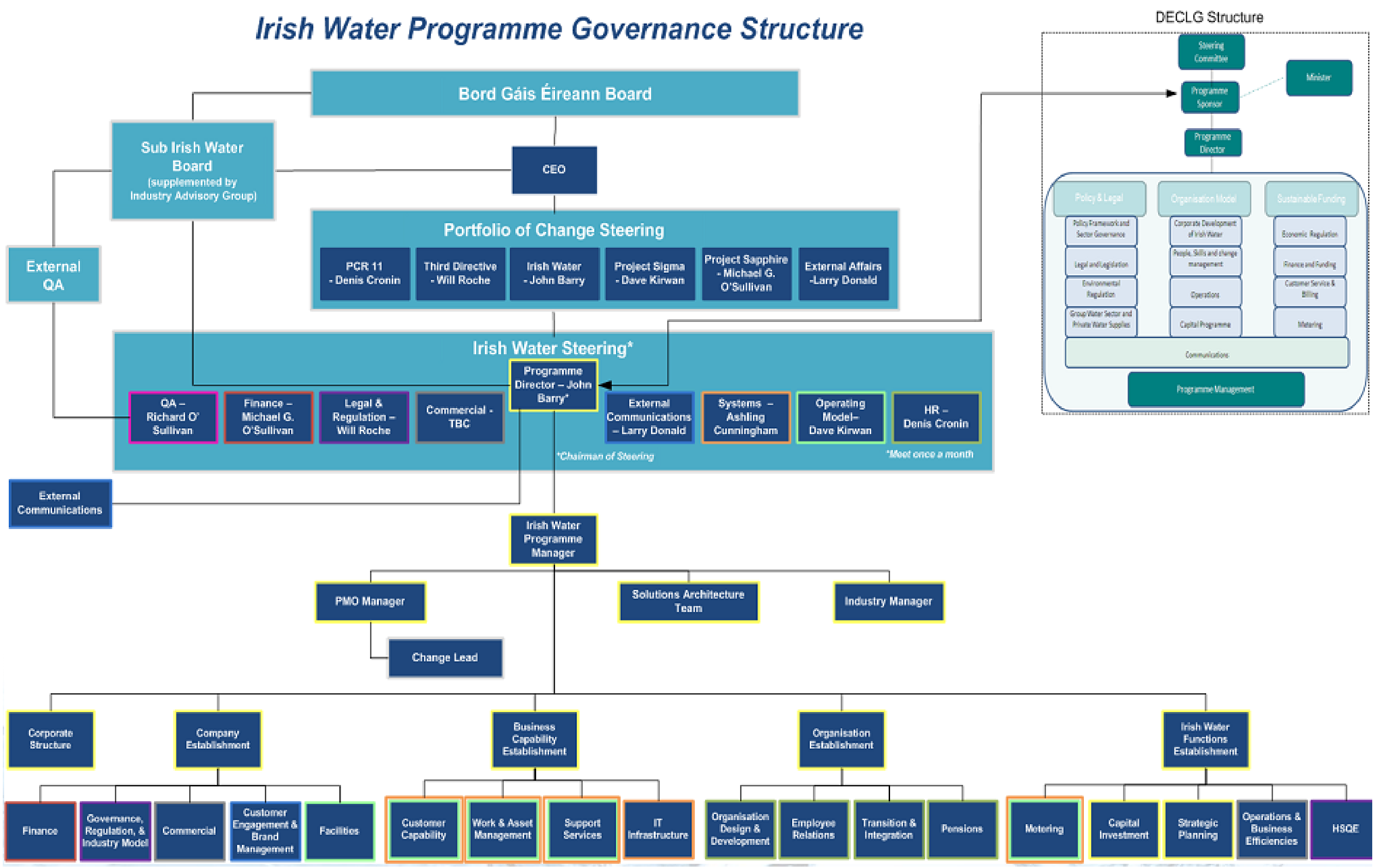
[83] MacCarthaigh, M. (2012) The Corporate Governance of Commercial State-owned Enterprises in Ireland. Institute of Public Administration [online] available from: http://nia1.me/1tf
[84] Irish Water [online] About Irish Water. Available from: http://nia1.me/1tg
[85] Ibid

6.4 Governance arrangements

Irish Water is accountable to the Minister for the Environment, Community and Local Government.

- The minister appoints a Board of Directors to run the state enterprise;
- The Board then decides upon the policy of the enterprise and place executives in charge of day to day business.

There is currently no board on Irish Water rather the Board of Bord Gáis fulfilling this role in the interim. During 2012 an Irish Water Committee (sub-board) was established to monitor and evaluate the strategic establishment of Irish Water and to make recommendations to the Board as appropriate with particular emphasis on strategy, framework policies and implementation plans for the establishment of Irish Water. In addition, amongst other responsibilities, the Committee reviews and considers status reports on material issues relating to risk, financial reporting, funding and the enduring business structure of Irish Water.



7 Discussion and conclusions

The privatisation of the water industry in England and Wales and subsequent structural reforms in Scotland, Northern Ireland and ROI have all been predicated on the need to generate revenue, through charging, in order to meet massive capital requirements of the industry. However, each jurisdiction has taken a different approach to reform reflecting the different policy and legislative contexts.

7.1 Privatisation

The UK Government's decision to privatise the water industry was controversial with commentators arguing the assertion that privatisation would stimulate competition and result in better outcomes for consumers was flawed and indeed there is a growing body of evidence to support the view that privatisation is not suited to the naturally monopolistic water industry.

The privatisation of the water authorities in England and Wales was supposed to improve the economics and governance of the industry, by comparison with public ownership, however that simply has not been the case as the private owned monopolies in the water sector are not any more subject to competitive pressures and the incentives these can provide than Government owned ones.[86]

This is not saying privatisation is necessarily a bad thing, only that when the water industry was privatised there was a great deal of scope for efficiency, which was later achieved. However, the case of Scottish Water clearly demonstrates that the positive outcomes achieved under privatisation which were theoretically only achievable under this model are in fact achievable under public ownership. Indeed, the evidence from Wales and France where major private contracts have been taken back in-house to improve efficiency further serve to demonstrate that a well-run public company can match and even exceed the performance of private sector companies.

7.2 Not-for-profit

Welsh Water is a Company Limited by Guarantee (CLG) and as such it must comply with the same legal rules and regulations as other limited companies. The main differences between a PLC and a CLG are that its members are guarantors as opposed to shareholders, with no financial self-interest in the company which is run on a 'not-for-profit' basis in the interest of its customers.

This model has distinct advantages over both the PLC (private model in England) and the public corporations in NI and Scotland:

[86] Abbott, M. and Cohen, B. (2009) Productivity and efficiency in the water industry. Utilities Policy vol.17 pp.233-244

- the CLG status of Welsh Water ensures that there is a level of public accountability, whereby members are appointed as guarantors of the company based on their knowledge, expertise and experience across a range of related disciplines;
- In the absence of political influence a CLG still provides a democratic structure - the members elect the board and have the right to remove them;
- As Welsh Water does not have to pay dividends to shareholders it has the ability to build cash reserves which provide a financial buffer – these reserves have enabled Welsh Water to reduce its level of borrowing from 93% in 2001 to 63% in 2013;
- Welsh Water requires no Government support; therefore there is no burden on the public purse; and
- Due to its strong financial position and low risk profile Welsh Water enjoys a strong credit rating which enables it to borrow money at a relatively low rate of interest, enabling it to keep bills down.

This model has been proposed as a potential solution to the on-going debate about water governance in Northern Ireland. The IWRP strand two report recommended this business model on the basis that it is likely to secure public confidence; keep costs down; and minimise any negative impacts on other areas of public expenditure. It states:

> *"…the Minister should consider what potential there might be for reducing bills by restructuring NI Water as a company limited by guarantee working in the interest of its customers, a model which we have called the "Customers' Company". We believe that such a restructuring could in the right circumstances have the potential both to reduce financing costs and to strengthen customers' sense of community ownership. The transformation could be implemented with relatively little disruption by retaining NI Water as fully as practicable as it is but establishing the Customers' Company with the specific purpose of taking over the Minister's shareholding interest."*

The difference between a Companies Limited by Guarantee (CLG) and a Company Limited by Shares (CLS) is that members are guarantors as opposed to shareholders; therefore as guarantors their only incentive is to ensure the vitality of the business as they are liable for its failure, although as the case with most CLGs liability is limited to £1. The incentive for members to become involved is commitment to the company's objectives rather than profit, as with shareholder companies and herein lays an inherent strength of this model.

As NI Water is currently listed as a CLS, a legislative change would be required for the Minister to dispose of his shares, relinquishing his control and effectively privatising NI Water. It remains to be seen whether or not there is an appetite for such a move.

The other significant factor on which this model is almost completely reliant is revenue. Fundamental to the business model designed by Glas Cymru was the ability to raise cheap finance by clearly demonstrating to bond investors that Welsh Water is very low risk and that there are virtually no circumstances under which Welsh Water could get into a position where it could not pay interest or principle or the bonds.

A number of factors contribute to the low risk status of Welsh Water including, the fact that there is no competition, there is a guaranteed customer base and perhaps most importantly there is a guaranteed and predictable revenue stream. Therefore, any desire to adopt this model in NI would require the introduction of water charges.

7.2.1 Community Interest Company

There are now some variations on the CLG model which may be equally applicable within the NI context. Community Interest Company (CIC) status was introduced by the UK Government in 2005 under the Companies (Audit, Investigations and Community Enterprise) Act 2004. Their primary purpose is to provide benefits to the community, rather than to the individuals, who own, run or work in them.

In the legislation, this core principle is set out in terms of the "community interest test". A company satisfies the community interest test if a reasonable person might consider that its activities (or proposed activities) are carried on for the benefit of the community. All companies applying to be registered as CICs must provide the Regulator with evidence that they will satisfy the community interest test.

In order to determine whether your company satisfies (or will satisfy) the test, consideration must be given to:

- the purposes for which it is set up;
- the range of activities in which it will engage; and
- who will be seen as benefiting from its activities. [87]

If the purpose of NI Water is to provide high quality drinking water and sewerage services at the lowest possible costs in consumers then it is reasonable to consider this beneficial to the community.

7.2.2 Governance and Finance

A CIC would have the familiar governance structure of other companies such as the CLG, PLC and GoCo models discussed in this paper. In effect this means there is a board appointed to oversee strategic direction and performance of the business with an executive team in charge of day-to-day operations. Ultimately these will be accountable to the shareholders or members for the success or failure of the company.

Like other companies a CIC's principal source of financing will usually be its trading income and it can build up cash reserves from profits which are available for the benefit of the community or reinvestment in the business. There are however a range of other

[87] BIS (2010) Information Pack: Community Interest Companies [online] available from: http://nia1.me/1tp

ways in which a CIC can raise capital, including grants, borrowing and employee share issues.[88]

7.3 Statutory Corporation

The Scottish Government did not follow the privatisation route however Scottish Water is run very much like a private company, driven to achieve efficiencies through an incentive-based regulatory framework which is modelled on the regulatory framework developed for W&SS companies to in England and Wales.

Although managed and operated like a company Scottish Water is a part of the public sector and as such is subject to annual revenue and borrowing caps set by Scottish Ministers. This though has not inhibited Scottish Water's ability to compete (on a comparative basis) with the private companies in England and Wales:

- In 2012/13 SW's income from in its customers exceeded £1bn;
- During the current Strategic Review of Charges (2010-15), the Scottish Government expected to spend around £2.5bn (in real terms) – in 2012/13 alone, it spent £481m;
- By 2010 Scottish Water's operating costs were 35% lower than they were in 2002-03 whereas over the same period the water industry in England and Wales has seen its operating costs increase by 13%;
- The average combined bill for W&SS across Scotland was £324 in 2010/11, this is £15 lower than the average household bill in England and Wales; and
- Scottish Water's OPA score is now on par with the English and Welsh average of 290.

Despite the success of Scottish Water critics have called on the Scottish Government to consider changing the ownership model to give it more financial freedom.[89] This would suggest that a change from a GoCo to Statutory Corporation would bring few substantive benefits to NIW.

Both these models are statutory bodies, controlled by central government and intended to recover their costs from consumers. Given that the NIW GoCo has never operated as it was intended to means it cannot be fairly assessed in comparison to the Scottish Model.

The main difference between the two is the fact that as a GoCo NIW operates under companies' law and has its constitution set out in a Memorandum and Articles and Association as opposed to the founding legislation. Therefore, an effectively run NIW GoCo would have greater operational and financial flexibility than Scottish Water – factors which are vital to an effective and efficient business of this type.

[88] BIS (2010) Information Pack: Community Interest Companies [online] available from: http://nia1.me/1tp
[89] BBC News Scotland [online] Scottish Water plugs more leaks, available from: http://nia1.me/1to

Commentators who have taken note of the perceived failures of privatisation in England and the level of opposition to privatisation in Scotland have suggested the "democratisation of Scottish Water". This is akin to the Welsh model or the CIC model discussed previously and again it is acceptable based on the retention of public accountability.[90]

7.4 The best model for Northern Ireland

The Minister for Regional Development was asked in September (2013) to outline the best model for NI Water governance. He stated:

> ***"****The best model for Northern Ireland Water (NIW) governance is one that supports and ensures the provision of high quality water services to the people of Northern Ireland. It should be sustainable, affordable and efficient. It should meet our EU obligations, support economic growth and protect the environment".*[91]

This has been a recurring question since the reform of the water service in 2007 but clearly it remains very much unanswered, with NIW continuing to operate under a hybrid framework described as suboptimal.

Assessments of the different models have been done in the past: The IWRP Strand two report addressed issues of legal structure, governance, capital investment and affordability. It identified that one of the biggest problems with the reform process in Northern Ireland carried out under direct rule Ministers was that it failed to secure public confidence due largely to a lack of openness and transparency in their decision-making and accountability processes.

Aside from that, The Strand Two report was not overly critical of the chosen GoCo model, suggesting that if there was some greater clarity with the governance arrangements then it could work, indeed having compared four options this report stated: "What matters is not so much which legal form is adopted as the content that is put in place in practice. Each model has the potential in principle to meet all of its objectives:

- public confidence
- effective delivery of high quality services
- maximum cost-effectiveness for customers
- affordability; and
- sustainability"

[90] Cooper, C., Dinan, W., Kane, T., Miller, D. and Russell, S. (2006) Scottish Water: The drift to privatisation and how democratisation could improve efficiency and
lower costs
[91] AQO 4472/11-15 [online] available from: http://nia1.me/1t4

There are however some clear differences between the models, most notably accountability (the role of Government) and financing (income and cost of borrowing).

The ability to operate without the operational and financial restrictions imposed by NIWs status as a NDPB is essential to the future well-being of NIW. However the only way this can be made possible is through the introduction of water charges for domestic customers that will lead to NIW becoming ‘self-financing’ or at the very least bring it to a stage where at least 51% of its revenue comes from charges.

This conclusion gives rise to two key questions:

- Is the Executive/Assembly prepared to oversee the introduction of water charges for domestic consumers? and
- Should water and sewerage services be delivered within government (an executive agency) at arms-length from government (GoCo or Statutory Corporation) or completely divorced from government (PLC, CLG or CIC)?