Regulating Public and Private Partnerships for the Poor

Cranfield UNIVERSITY

Case Study:

ENGLAND & WALES

KEY FACTS (UK)

Population
59.1 million

Urban population
89.0%

GDP per capita 2002
26,150 US$

HDI rank
12/177

Population living < $11/day
15.7%

Exchange rate
$1 = 0.53 United Kingdom Pounds

Urban household water connections
100%

Urban improved sanitation
100%

Water Poverty Index
71.5

Study city
Central Region

Population
8,514,000

Regulator
Ofwat

Service Providers
Severn Trent Water

South Staffs Water

REGULATING PRIVATE PROVIDERS: English Midlands

England and Wales, high-income countries with universal coverage for water supply and sanitation (mainly sewerage), privatized the water industry in 1989 and introduced an economic regulator, Ofwat. With an initial sole primary duty to ensure that the private companies could finance their investments, one of the drivers for E&W privatisation, government has subsequently amended legislation in 2003 to require, as an additional primary duty, the regulator to 'further the consumer objective'. In addition the new 'Water Services Regulation Authority' (replacing the Director General of Ofwat) must 'have regard to the interests of—
Individuals who are disabled or chronically sick;
Individuals of pensionable age;
Individuals with low incomes;
Individuals residing in rural areas'

'Being regulated is a privilege'

Severn Trent Managing Director to WaterVoice Central, July 2005

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Research Summary

Incentive based, economic regulation of monopoly water and sanitation providers is a powerful tool for improving services. Regulators determine the maximum water price ('price cap') to finance a desired level of outputs. Prices in high-income countries have tended to increase faster than inflation as society demands higher standards. The total revenue requirement (from which the price cap is derived) is determined by adding anticipated operating expenditure to planned capital expenditure (for capital maintenance as well as for improvements in quality, security of supply, service standards and service extensions), plus an acceptable cost of capital. Both opex and capex plans include efficiency targets derived from comparisons between a number of providers. Water companies are allowed to retain any further efficiency savings achieved within the price cap for a period (five years for example), an incentive to achieve even higher efficiency, before the benefits are shared with customers in reduced prices for the future.

This model has been adapted around the world with varying degrees of success, usually in the context of a Public Private Partnership, but until recently it has tended to be reactive rather than proactive regarding early service to the poor. There is now a recognised need for adequate economic regulation of public providers, as well as private companies, in lower-income countries, to deliver similar mechanisms for financeability and efficiency and as a prerequisite for developing effective pro-poor urban services.

The purpose of this DFID research project is to give water regulators the necessary technical, social, financial, economic and legal tools to require the direct providers to work under a *Universal Service Obligation*, to ensure service to the poorest, even in informal, unplanned and illegal areas, acknowledging the techniques of service and pricing differentiation to meet demand.

Looking to achieve early universal service, the research also considers how the role of small scale, *alternative providers* can be recognised in the regulatory process. *Customer involvement*, at an appropriate level, is seen as the third key aspect. The research investigates mechanisms for poor customers, and most importantly potential poor customers, to achieve a valid input to regulatory decision-making to achieve better watsan services within the context of social empowerment and sustainable development

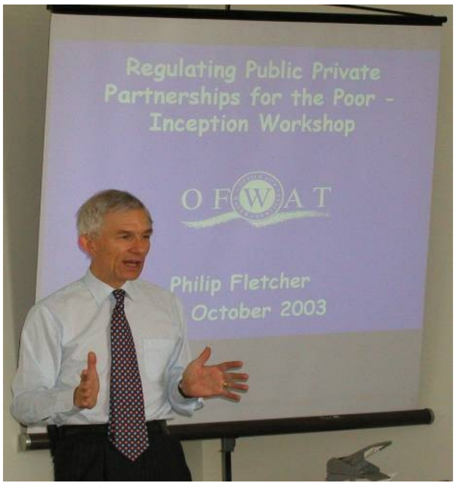
The Water Sector and Institutional Framework

The example of economic regulation of the 1989 divested (privatised) water sector in England and Wales relates to a high-income country. However, many aspects of the experience in forming and developing some level of partnership between government, an 'independent' regulator, civil society, the private sector and consumers, particularly with regard to serving the poor, are instructive.

When the government-owned infrastructure was initially sold to the private sector (through a sale of shares to the public and to staff) it had been starved of investment. The perception was that service was poor. Water consumers 'knew' that the water quality was inadequate (although the statistics did not always support this belief) and, with more reason, knew that the environment was suffering. Civil society was - and remains (MORI, 2002) - deeply sceptical of private sector involvement in the provision of such a vital basic need.

Serving the poor was not a significant driver in the privatization. The reform was designed to meet various political goals as well as to deliver better water supply and wastewater disposal, as required by upcoming European Directives, without affecting the public sector borrowing requirement. However, the case of England and Wales demonstrates how important the needs of the poor and the vulnerable became as the process developed. The case also demonstrates how it is possible to adjust partnerships significantly, through regulation and license amendments in a continuous process of change, long after contracts have been agreed.

The privatization of water and sanitation in England and Wales continues to evolve. The balance of power and benefits between the various stakeholders continues to change as the socio-political culture evolves under pressure from consumer demands, environmental legislation and political change. The privatization is still susceptible to new stakeholder pressure as evidenced by several successful nongovernmental organization (NGO) campaigns as well as by an incoming government wanting to make good on its criticisms developed when in opposition.



Director General of Water Services, Philip Fletcher, speaking at the Inception Workshop for this research

With the monopoly companies to be sold off completely (though operating under a 25-year license—so not that much different from a concession contract? - the fixed term license subsequently changed to a rolling license without much discussion) regulation became necessary. Environmental concerns over abstraction and wastewater discharge were managed by the Environment Agency (initially the National Rivers Authority) and drinking water quality by the Drinking Water Inspectorate. The Office of Water Services (Ofwat) was established as economic regulator to oversee the price of water and service levels, both critical for low-income customers. Ofwat (to be renamed the Water Services Regulation Authority in 2006 with a board rather than single regulator) is relatively independent from central Government, funded by a charge on the private water companies and accountable to Parliament. Ofwat's primary responsibility has been to ensure that the private companies can finance their water supply and sanitation responsibilities while achieving operating and capital efficiencies within a price cap. Any increase in "excess" profits - the reward of companies that outperform regulatory expectations of efficiency gains - is shared with customers at the end of each incentive period, when profitability is reset to the presumed cost of capital.

Besides tackling the investment backlog by constructing new fixed assets, the newly private companies had to remodel themselves as customer service organizations. Many of their staff members were described as having had a "local council mentality." Investing in training and information technology was necessary at the same time as rationalizing operations (closing local depots, running works unmanned) and cutting staff. Some companies also began to diversify into other activities to escape regulatory control, although without any early profitability (Ogden and Glaisster 1996).

Overall these changes have significantly improved water quality, customer service and wastewater treatment and the companies have become increasingly efficient. Prices had to rise to support the necessary investment programme and, although unpopular with consumers, privatization appeared to be delivering benefits. The regulator has had to institute many systems to monitor that progress. Initial annual reports of the regulator were minimal compared with the hundreds of pages that became normal ten years later. Ofwat has always proclaimed its belief in 'light-handed regulation', proclaiming that regulation costs each customer less than $0.95 per year (Ofwat, 2005). The 22 water companies that have to supply the information to Ofwat believe it is more costly to them, costing one company (Wessex) more than $5.50 per person per year by their estimation. Ofwat has used the information given by the companies to promote the concept of "comparative competition," using the data to show up one company against others as a powerful way of forcing improvements. Incentive based regulation has

Service to the Poor

Within a couple of years of privatization, trouble began with a drought in 1992 (which would not have been recognized as a "drought" in many parts of the world) that coincided with a significant rise in disconnections for non-payment. The poor were responding to higher prices in an economic recession by failing to pay their bills. Water became dramatically politicized. Customers thought the water was of poor quality, tasted bad, and was too expensive (although the expensive bottled water they bought, by some measures of a poorer quality, lost out to tap water in blind tasting). At the same time, there was a debate over excessively generous salary increases for directors of privatized utilities.

The regulator undertook the first price review in 1994 but, rather than clawing back all the impressive efficiency gains immediately (characterized as the sawtooth effect of price cap regulation), he planned for the cost of capital to shrink from its average 12% peak to its target rate of about 5 or 6% over a 10-year "glide path". This gentle reduction in profitability quickly came to be seen as overly generous. In fact, it probably represented $7 billion additional profit to the water companies over the following 5-year period (author's analysis). Regulation is very difficult to get "right." Meanwhile the media were portraying their own version of events as shown in the box (right) which transcribes a conversation with a poor household, which was included in a television documentary in 1993. Although there was a time lag of four years before changes were introduced by a new government, the pressure that civil society exerted on the process through such programmes was significant.

The incoming government in 1997 subsequently charged a "windfall tax" on all privatized utilities, which fell hardest on water, based on the idea that they had been sold too cheaply. The new government also demanded 'free metering installation' (eventually enforced by legislation, including the right to reversal to unmetered supply if metering proved more expensive to that particular householder), free leak repairs on customers' premises, that is on customers' own external pipes, and the banning of domestic disconnections.

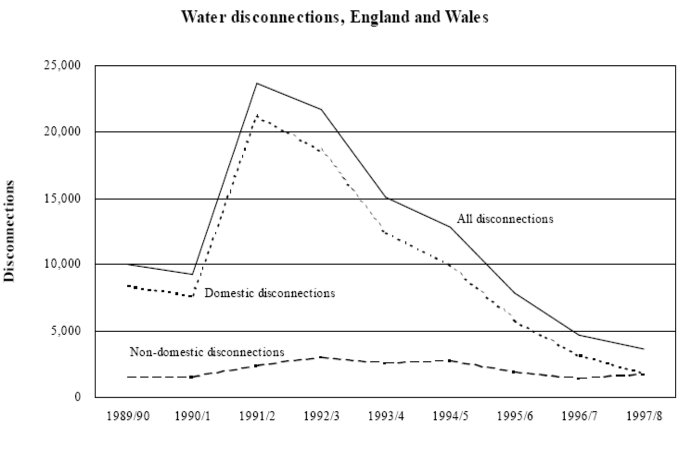
The private water companies responded to the political climate and dramatically reduced disconnections, if only to look better in the annual comparative figures Ofwat was publishing. But it was the combination of a second embarrassing drought - which led to one company having to hire every suitable tanker in the country to transport water to a rapidly emptying reservoir - and the threat of having standpipes in the streets, coupled with ever increasing

"Water, Profits and Poverty"

"Nick Blandford is a refuse worker with Rochester City Council in Kent. Even in the era of plastic bags it remains dirty job. One consolation after a day handling other people's garbage is the thought of a long, hot bath. But one Tuesday earlier this year he was in for a shock when he got home. His wife, Rose, a part-time cleaner, had been off work after a hysterectomy, and their income had dropped sharply. They had failed to pay a £253 ($477) water bill and Southern Water had decided "enough was enough."

"They just turned up and said the water was off because of non-payment of the bill. And there wasn't a lot I could do as I have just been off work for three months—no money coming in, only my husband's, which is a dead-set wage, doesn't vary at all. I went round to John next door—I was in tears and told him what had happened and he sat me down and offered to supply water. When we needed it John filled up a five gallon drum with water and also three big buckets which he passed over the fence and I carried into the house." That went on for three days until Southern Water were persuaded to turn them back on.

Rose Blandford, who was forced to carry heavy buckets after a major abdominal operation, remains bitter about Southern Water: "I think they are really low to have done such a thing to anybody, not only myself, but that could have been someone with children or a pensioner. It is not very nice." In a statement Southern Water said it cuts people off only after an extensive procedure; that it keeps a "Special Needs Register"; and reconnects most homes within 24 hours."



Above: Water disconnection from 1989/90 to 1997/98, England and Wales (House of Commons, 1998)

Tariffs and Disconnections

prices, which led to regulatory tightening.

The first regulator, Ian Byatt, was always aware of the wider issues of water privatization, stating that "while regulation has clearly delivered in economic terms, there are a number of social issues which have met with varying degrees of success" (Byatt 1997).

Through guidelines issued to the companies in 1992, the director general of Water Services brought the number of disconnections down to pre-privatization levels. The regulator observed: "It was necessary to push the companies into much better procedures and better payment methods for customers who have difficulty in budgeting. The fact remains that there are some customers who cannot afford to pay their bills—and they need a sympathetic approach by the water companies" (Byatt 1997).

Some private companies experimented with prepayment water meters, which allow use of water over a fixed time period (not based on volume). Poor customers seemed to prefer to budget for their water this way, although some reportedly had to store water in baths and buckets to tide them over until they could afford to pay for the connection again. However, after appeals by local councils to the courts, prepayment meters were declared illegal as they caused 'disconnection without due consideration' by the companies and welfare authorities.

The National Consumer Council report that the majority of poor consumers with 'basic skills difficulties' or 'families with young children' use payment cards or token meters for non-water utilities which are still valued as they enabled consumers to control their expenditure (NCC, 2003). Water customer committees who would like to reinstate this option for the people

Metering Debate…

England and Wales have been moving from 2% domestic metering in 1989 to about 27% now, costing at least $30 per household per year but with no noticeable reduction in water use. One water company official privately asks *'Why not charge those with sprinklers a £100 ($189) additional fee and remove the need for meters?'*

The Power Sector and the Poor

Disconnections are still permissible in the gas and electricity sectors along with much appreciated 'pre-payment meters'
The government has also introduced £200 ($377) winter fuel payments, free TV licenses for over-75's and a £100 ($189) payment to over-70s towards council tax bills.' (The Times, 2004)
Gas and electricity payments can also be deducted before payment of state social benefits, removing the risk of non-payment and subsequent disconnection.
There is no such allowance for water.

Above: typical suburban/'peri-urban' housing

Debt and Bailiffs

In order to collect bad debts it is now necessary to give advance notice of the bailiffs arriving due to Data Protection Act etc … which of course rather defeats the objective of collecting goods to sell to pay off the bad debts as householders remove all valuable items!

Pictured left: The Water Regulators for England and Wales, left to right: Dame Yves Buckland, Chair, Consumer Council for Water, Philip Fletcher, Director General of Water Services; Professor Jeni Colbourne, Chief Inspector, Drinking Water Inspectorate, Sir John Harman, Chair, Environment Agency

Adapting Service Provision for the Poor

In their own attempts to help the poor, and of course maximise revenue, companies have adopted much more flexible payment systems that allow customers to pay small amounts weekly or monthly rather than the established pattern of twice yearly. The companies have also established "PayPoint" terminals in small shops, where those on low incomes can pay small amounts without expensive bank charges. They have also had to invest significantly in debt collection techniques which include tens of thousands of court summons for non-payment.

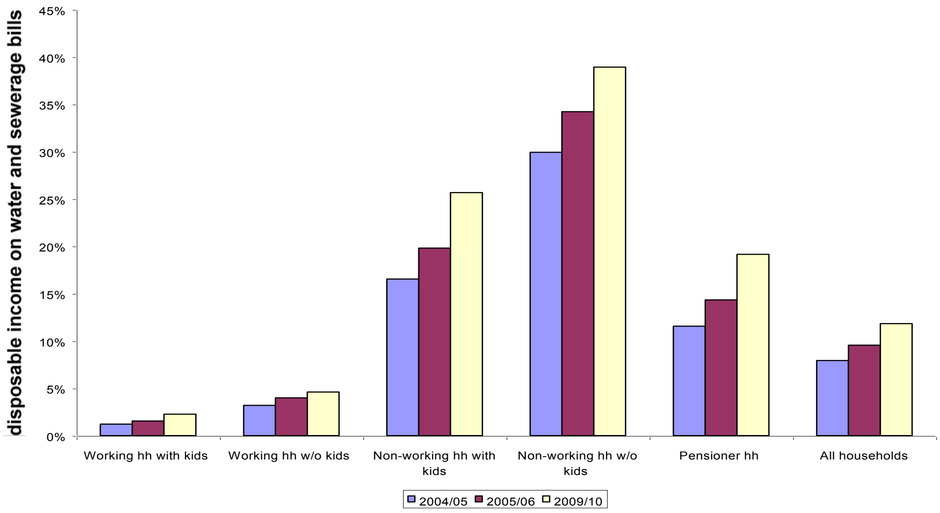
In response to the demands of the newly elected Government the 'Vulnerable Groups' scheme was introduced, which limits metered bills to the average of the water company area. The scheme was focused upon metered households on low incomes (receiving income-related state benefits) with three or more children under 16 or with a specified medical condition that required above average use of water. However, the scheme is only being used by 0.4% of the perhaps 440,000 eligible population (Fitch and Price, 2002), 7,202 households by 2003/04 (EA, 2005) and is now being reviewed with consideration to extending the range of medical conditions and to changing the age limit and number of children in order to qualify (DEFRA, 2003a).

The poor also benefit from the ban on domestic disconnections, although it is uncertain who "won't" and who "can't" pay. This leads to perverse incentives such that some Citizen's Advice Bureaux are reportedly recommending that users pay their cable and satellite television bills before their water bills. There is concern that the ban on disconnections is leading to an increase in debt and bad debts which the companies will have to write off at the expense of other customers. In fact, the average size of household debt fell initially but subsequently has risen to £188 ($355) per indebted household customer (Ofwat, 2005) along with an increase in revenue necessarily, though extremely reluctantly written off as a proportion of household revenue, rising from an average of 1.3% in 1998-99 to 1.65% in 2001-2002 to 2.2% by 2004/05.

Severn Trent Trust Fund

To address 'water poverty', now that the private water companies have no right to disconnect, six of them have set up charitable trusts, funded by donations from the companies with $5.25 million contributed in 2001-02. Poor customers who run into debt are referred to these charities for advice and for direct financial support. The Severn Trent Trust Fund, which has been receiving an average grant of $3.5m per year from Severn Trent Water, but is managed completely independently, has helped over 30,000 families in five years. More than 70% of those receiving help are receiving money as well as money advice with an average grant in 2000/01 of $590 towards water arrears (STTF, 2001). The charity, with an average of 5,600 new applications per year, has now begun a 'Partnership Payment Scheme' for clients with high water debts. The client agrees to pay an affordable amount each and every week and if they manage to stick to the plan and make all the payments for 13 weeks the first grant is given. Similarly for the next 13 weeks for the second grant and if they complete for a final 13 weeks the final grant for the final third of the debt is given. If payments are missed the scheme is cancelled and no further grants awarded. SSTF report a positive response to this pilot scheme.
Eight other water companies formally reported donations to charitable trusts during 2004-05 and a number of others also make donations to organisations such as Money Advice Centres or offer similar schemes such as 'restart' schemes (Ofwat, 2005).

Inability to pay, even in a high-income country remains an important issue. The Public Utilities Access Forum investigation found that around four million households in England and Wales could be spending more than 3% of their income on water charges, a level above which they describe as constituting 'water poverty.' The average charge for all households in England and Wales is about 1% of household income whereas single [state] pensioner customers of South West Water can pay up to 6.2% of their household income on



Left: Affordability challenges as presented by Philip Fletcher to the Adam Smith Institute, 16 June 2005

Customer Involvement

WaterVoice Central Meeting in Public

As part of the stakeholders partnership, the Government established 10 regional customer service committees (CSCs), under Ofwat control, to give customers a voice. With part-time independent chairs and a dozen volunteer members, each committee had to work out its own role in its own region, according to its members various interests, as well as addressing national issues.

Supported by Ofwat, which always promoted customer involvement, the CSCs (first renamed WaterVoice, most recently relaunched as the independent (of Ofwat) Consumer Council for Water) actively questioned the performance of private companies in serving all their customers, acted as a place of appeal for customer complaints, and audited private companies' customer complaint procedures. By 2002 the customer committees had secured over $11.4 m in compensation and rebates for customers (WaterVoice, 2002). CSCs pressured the companies to behave like public service organizations, albeit with a profit incentive.

Membership of WaterVoice is typically 'competent middle-class professional early retirees'. Members therefore are not representative (were never intended to be) and tend to have a limited 'feel' for the issues regarding low-income customers.

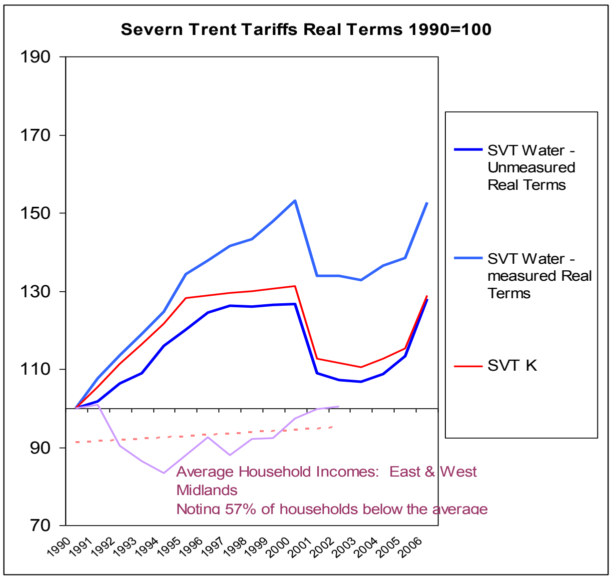
WaterVoice Central, one of the 10 statutory committees, highlighted the continuing concern that the poorest paying the most common fixed tariff (unmeasured, based on property values) have been paying higher-than-average price rises due to the effects of rebalancing on the "tariff basket." The committee welcomed the 1999 price cut, but although known as regulation by price cap, the England and Wales system is, in effect, a revenue cap: companies can claim within their "cap" to make up for the higher-income customers who can transfer to pay smaller bills through metering of actual volume used.

It is impossible to achieve a "perfect system": there will always be winners and losers, and those who win with some adjustments appear to lose with others. However, the poorest in the central region, whose average real incomes were static, have suffered real price increases of over 60% since privatization, very significantly above the headline 'K' factor which is meant to drive price changes

A survey of WaterVoice Central meeting minutes undertaken by Narracott (2003) found that in a period of 6 years and 2 months, between 20th March 1997 - 15th May 2003, 48 regional CSC meetings were held on a bi-monthly basis. In that time, there were 32 'counts' of the poor being brought up and documented as a topic of discussion. Of these 32 'counts', 7 were initiated by the Companies. Similarly, from April 1997 to October 2002, 60 regional CSC managers' meetings were held. In that time, 33 'counts' were recorded where the poor are mentioned in the minutes.

Poverty-focused issues being discussed were: the vulnerable customer scheme (tariffs) "Both companies have now received further guidance from the DETR on how to administer schemes to benefit vulnerable customers" (16/3/02); charitable trusts (subsidies): "The CSC suggested that the independent Severn Trent Charitable Trust, in promoting their work, contacts organisations other than Citizens Advice Bureaux (eg. Law Centres/Money Advice centres…."(20/11/97); and dealing with customers in debt (civil rights): Ofwat's debt recovery guidelines now published – the aim was protection of vulnerable customers and consistency of auditing by WaterVoice offices. (28/11/02). Throughout the minutes, the poor were referred to in the following terms: *low-income customers, needy customers, 'can't pays,' customers who struggle to pay their bills, customer declaring hardship, vulnerable customers, poorer customers, the poor, vulnerable household, customers helped by the charitable trust, those in the lower socio-economic group, customers in need, families in financial difficulty.*

The water regulator continues to consider the extent to which "the generality of customers" should have to pay for some environmental benefits. About alleviating low flow in rivers, Philip Fletcher asks: "What about the effects on those with below average income, who will often coincide with those who have least access to the



Above: Increases in Severn Trent tariffs in real terms, 1990 to 2006, relative to changes in average household incomes, East and West Midlands, England

Conclusions

Divestiture in England and Wales has delivered high-quality services. The private water providers under pressure from the regulatory process have become extremely efficient. However, even with these significant gains, the ever-increasing quality and environmental spend has necessarily led to higher water bills which are creating problems for the poor. The incentive based regulatory system has made divestiture highly transparent, with reams of information available to drive comparative competition. The inclusion of customer committees as partners may have helped individual complainants and public meetings held regularly to question the companies may have helped to make private companies more aware of customers' concerns. However they have not had a significant effect on the needs of the poor, except perhaps as an additional driver for overall price cuts.

The involvement of other, non-governmental stakeholders, whether concerned for the environment or for the poor, in addition to the various interests of the media, has perhaps been a more powerful tool for change. The ability of NGO's to experiment and pilot new approaches such as the charitable trust funds and the lobbying NGOs to promote awareness and transparency have been a crucial element in the process of improving water and sanitation to all.

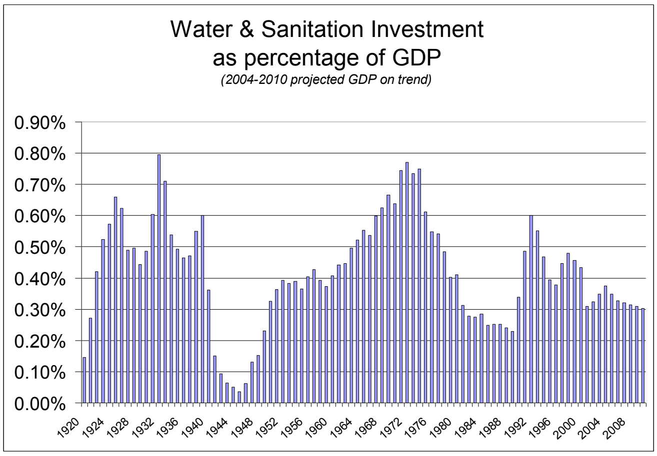
The example of England and Wales suggests that regulated public-private partnerships can deliver improved services. Agreements or contracts between partners can be adjusted after they have been signed. There is always a price to be paid however in any such adjustments, in reduced regulatory freedom and through a sense of diminishing returns as the companies experience reduced profits and, thus, their freedom to be flexible. However, perhaps crucially, in England and Wales the government, in its new Water Act 2003, has maintained the duty of the regulator to ensure that private water companies can 'secure reasonable returns on their capital to finance the proper carrying out of their functions' as well as enhancing the regulatory duty to further the consumer objective.

This new requirement that the new 'Water Services Regulation Authority' must 'have regard to the interests of—

Individuals who are disabled or chronically sick;
Individuals of pensionable age;
Individuals with low incomes;
Individuals residing in rural areas;'

should lead to significant improvements in the process. In the meantime the industry and other stakeholders watch the ever-increasing levels of debt with anxiety.

The necessarily imperfect process of regulation appears to be giving customers as well as government far more influence and even control over the supply of water and sanitation than was previously possible. However, to what extent improvement in services and the environment is possible to replicate in an economy where average annual household incomes are $1,000 rather than $34,000, is a different issue. Most importantly, can privatisation be fair? The ban on disconnections and the limits on tariffs for vulnerable customers are measures which promote equity. But the overall price the lowest-income groups are expected to pay, partly to fund wider environmental benefits, partly to rebalance the tariff basket as the rich benefit from savings through metering, is unaffordable for some. However, the system has always been willing to evolve under pressure from its various partners, particularly the media. If the next generation of television programs starts showing bailiffs entering poor homes and removing household goods because of unpaid bills for



Above: Water and Sanitation Investment, England & Wales as percentage of GDP Source: author's analysis

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