A Rejoinder to Midwinter and Simpson: and how their notes raise further concerns about the financing of the water industry in Scotland

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1. In separate notes in the last issue of this Commentary, Midwinter and Simpson attempted to allay concerns we had raised about, respectively, the strategic review of water charges for 2002-06 and 2006-10: (Midwinter, 2006 and Simpson, 2006). Here, we show how their notes do nothing to allay the concerns we have raised, and indeed, in certain respects, give rise to further causes for concern.

a. Paper by Midwinter

2. First, it is useful to recapitulate on the normal principle of equity and prudence as regards borrowing: an equitable and prudent level of borrowing would normally equate to the amount of new capital assets being created: that is, to the quantity (Investment - Depreciation). This is a principle with which the Executive are in accord: for example, "Ministers want to ensure that the balance between charges and borrowing remains appropriate, and hence the total borrowing should approximate to the value of new assets over the strategic review period": (internal Scottish Executive memo, dated 3rd February 2004, obtained under Freedom of Information.)

We do not argue, and have not argued, that this is a mechanistic principle which should be rigidly applied in all circumstances: but any large departure of borrowing from the level of new investment does raise serious questions about prudence or equity.

3. In 2003, the basic concern we raised in our original paper was that the planned level of borrowing in the Strategic Review of Charges 2002-2006, (SR2002), at £293.3 million in total over the four years, was apparently much less than what would, on the above principle, normally have been regarded as appropriate for the industry - implying significant over-charging of customers. The Executive's reaction, in evidence given to the Finance Committee on 3rd February 2004, was that the normal principle of prudence would indeed apply: planned investment in total over the 4 years was £1.8 billion, depreciation would be £1.2 billion, giving a level of creation of new capital assets of £600 million: and borrowing would be at around this level. In fact, the outturn figures from Scottish Water's accounts, which are now available (SW Annual Accounts), show that the Executive was wrong on both counts: with outturn investment at £1.915 billion, and depreciation at £1.017 billion, the creation of net new capital assets has been almost exactly £900 million: but net new borrowing over the period was only £337 million. (Note that depreciation here is used in the wide sense, including both conventional depreciation of fixed assets, and infrastructure renewal.) Hence the outturn figures show that we, and not the Executive, were right about what was going to happen: counter to the Executive's claim, the normal principle of equity was grossly violated.

Further, by 2006, we had uncovered much more evidence, and in Cuthbert and Cuthbert (2006a) we identified, gave full supporting references to, and quantified the effects of, no less than five fundamental errors in the application of Resource Accounting and Budgeting (RAB), and in the conduct of SR2002, which had led to the basic problem. For details of these errors, and their effects see the article referred to.

4. It is against this background that we can now see how bizarre Midwinter's latest note is. He does not mention the outturn figures from Scottish Water, which show that about £600 million of net new capital formation had been funded from revenue: and of the five errors we identified in our 2006 paper, he attempts a detailed rebuttal of only one of these, which in itself would account for around £180 million of the total £600 million: and, as we shall see, he fails to rebut this particular error.

In terms of an analogy, as the lumbering plane that was SR2002 took to the air in 2003, we said that the plane was going to crash, and we duly provided five reasons why. The Scottish Executive, for their part, said everything would be fine. In 2006, Midwinter stands, studiously ignoring the smouldering wreckage in terms of the outturn figures at the end of the runway, and tries to convince us that everything is OK, by attempting to refute just one of the reasons we had given why this machine was not airworthy.

5. We now consider in more detail the only one of the errors identified in Cuthbert and Cuthbert (2006a) which Midwinter attempts to rebut: technically, this related to the effects of double-counting infrastructure renewal expenditure (IRE) within the combined limit for public expenditure set in SR2002. Again, full details are set out in the paper referred to.

6. Midwinter's attempted refutation essentially hinges on three assertions:

a. First of all, that the Treasury specifically endorsed the Scottish Executive's approach: so there could be no double

counting. This argument has been disposed of by work we have already done. In correspondence between ourselves and the Treasury, which can be found at on the Finance Committee website, (under the papers for the meeting of 28 June 2005, doc ref F1/S2/05/17/5), the final letter from the Treasury makes it clear that their endorsement extends only to the Scottish Executive's treatment of the water industry in the Scottish Executive's overall Departmental Expenditure Limit accounts, and not to any specific financial controls the Scottish Executive may have devised for Scottish Water. So the Treasury letters Midwinter cites are totally irrelevant to the present argument;

b. Midwinter's second argument is that there was no double counting because the Executive's control over Scottish Water was not in fact through a combined limit, since, to quote, "the Commissioning Letter of 2001 simply states that the Executive's limit is on borrowing of £314 million *plus* profits. This is *not* a combined figure, as the controls on each element are separate and can be varied, e.g., through supplementary borrowing consents or increased profits."

The crucial point is that the Scottish Executive did not make any supplementary adjustment to the public expenditure control limit for Scottish Water during the critical period when the Water Industry Commissioner was setting the revenue caps, even though the WIC was predicting a substantial increase in the IRE element of depreciation: (and incidentally, also in the non-IRE element). Hence, the double counting squeeze on borrowing, resulting from the combined control, did apply, invalidating Midwinter's second argument.
(Midwinter actually makes another mistake in this quotation, in that the figure of £314 million does not represent borrowing);

c. Midwinter's third assertion is that IRE is not in fact part of depreciation: to quote, "The authors' assumption that spending on infrastructure renewal expenditure was part of depreciation was mistaken as it was a cash item of expenditure in the capital budget." It is interesting that Midwinter gives no authority for this assertion, and this is a point we return to below. Midwinter's statement, however, is demonstrably untrue: for example, the Annex to Cuthbert and Cuthbert (2006a) sets out a detailed audit trail, showing how IRE scores both in capital expenditure, and in the depreciation figure used for calculating profit, in the WIC's calculation of the public expenditure implications of his revenue caps. Further, Scottish Water's accounts for 2002-03 contain calculations of outturn against the public expenditure RAB control total where what is calculated is (investment - profit), and where IRE is both included in investment and, as part of depreciation, scores against profit.

7. As noted above, Midwinter quotes no authority for his assertion that IRE did not count against depreciation. The following excerpt from a document which we obtained from the Scottish Executive under Freedom of Information may be relevant to this:

Internal Scottish Executive memo, Scott to Egdell and Greenhill, 3rd March 2004, Finance Committee: Water

"1) I need to go back to Arthur Midwinter - *sotto voce* - on his latest briefing paper to the Finance Committee by the end of the week. Please could you take a look at his paper, coming round to you in hard copy, and let me have the text of a reply by close tomorrow. Arthur showed me this draft in confidence.

2) Arthur has also given me a copy of the Cuthberts' latest paper. At a glance there seems to be nothing new in it. But again, I would like you to take a look at it in more detail, and set out where it goes wrong. …."

We do not know what briefing Midwinter may have received from the Executive, *sotto voce* or otherwise, before advising the Finance Committee on these issues. But we do now know, from the Scottish Executive papers released under FoI, that some of the internal views being circulated within the Executive at this time were patently wrong. So any briefing which Midwinter received from the Executive at this stage could have been wrong or misleading. Midwinter should now consider whether he wishes to make public the content of any briefing he received on this topic from the Executive.

It is a matter of concern to us, and may be to others, that at the time when the crucial arguments on this topic were going on in the Finance Committee, it was certainly not clear to us that the advisor to the Committee, namely Arthur Midwinter, may have been being privately briefed on this subject by the Scottish Executive.

8. Overall, our conclusion on the Midwinter note is that he bizarrely ignores the outturn figures which are available: only attempts to address one of the five substantive errors we have uncovered: and fails on each of his arguments on that specific error.

b. Paper by Simpson

9. In our paper Cuthbert and Cuthbert (2006b) we argued that it was inappropriate for the Water Industry Commission, in carrying out the strategic review of charges for 2006-10, to apply to a publicly owned body like Scottish Water the same financial ratios and targets which Ofwat applied to the privatised water and sewage companies in England.

10. Much of the argumentation in Simpson's paper involves setting up a series of straw men, which he then knocks down. Let us dispose of some of these relatively quickly.

In paragraph 2 of his paper, Simpson says that "their main assertion … appears to be based on a general proposition

that net new capital formation should always be wholly funded from borrowing." In fact, we have never said this - though, as noted above, gross departures from this principle need to be justified.

Again in paragraph 2, Simpson says "few householders, for example, would think it prudent in all circumstances to borrow 100% of the cost of their new home", implying that we might advocate such a course of action. But Simpson neglects to point out that the private householder, facing grave individual uncertainties regarding income and health, is in a very different situation from a monopoly supplier of an essential commodity. So, a water company would be much less likely to depart from the normal prudential principle on borrowing than an individual would.

Again in paragraph 2, "the Cuthberts' view seems to be that Scottish Water should borrow whatever monies are available from the Executive." We have in fact never said anything like this.

In paragraph 3, "the Cuthberts appear to take the view that either (a) investment in the public sector is risk free, or (b) that the water industry is a risk free area." We certainly do not think this, nor have we ever said anything like this. However, it is interesting to note that Simpson quotes examples like Yorkshire Water - but fails to mention something which we see daily in the newspapers, namely, the levels of profit in the water and sewage companies which make them such attractive takeover propositions
In paragraph 5, "they appear to suggest that in Scotland water charges should be set artificially low". Absolutely not: but we do argue (see below), that prices could be set at a lower level on a sustainable basis.

11. Straw men aside, Simpson puts forward essentially three main arguments to justify the revenue caps in SR2006, as follows:

a) There is a very unsophisticated dismissal of the inter-generational problem, which can be summed up in the following two quotations:

"The Cuthberts' criticisms can be summarised in the proposition that Scottish Water should be allowed to borrow more money", and "Of course, if the level of borrowing is increased, this just means that charges must go up in the future to make the deferred repayments of capital plus interest on the borrowing."

The two quotations taken together imply an altogether too simplistic treatment of the genuinely difficult problem of balancing the interests of current and future consumers. Taking Simpson's approach to its logical conclusion would imply borrowing nothing at all, and funding all capital expenditure from current revenue. (While this may seem ridiculous, it was in fact exactly the position which would have been reached by 2006 in the projected figures in SR2002: see Table 32.4 in that document.)

In fact, the second quotation is in itself staggering, as well as being misleading, because it implies that Professor Simpson does not understand that, under the model used by the WIC, future customers will have to pay the equivalent of repayment of capital, (and at current prices), whether the original investment had been funded from revenue or borrowing.

b) There is an argument which boils down to saying, trust us, we know what we are doing. One particular paragraph begins "These numbers are not just plucked out of thin air. They are the result of three years hard work…" This sort of special pleading is really out of place if this purports to be a serious paper: and it is quite incredible that, despite three years work, SR2006 contains such limited discussion on the vital issue, which we attempted to address, as to whether it is appropriate to apply the unmodified Ofwat ratios and targets to Scottish Water.

c) There is an argument that "Ofwat applies its financial ratios equally to Welsh Water, although that company has only a nominal equity layer, and can therefore only be financed by a mixture of debt and revenue". Aside from assuming a degree of infallibility for Ofwat which may well be unjustified, this argument neglects the fact that Welsh Water has to borrow at market rates, rather than at privileged public sector borrowing rates - one of the key differences whose implications are quantified in our paper. This argument also neglects the fact that, as Ofwat themselves say, (Ofwat 2005), "Public sector companies can often support much lower levels of interest cover than private concerns because of the lower risks".

12. We conclude, therefore, that Simpson's arguments carry no weight. There is little else in Simpson's paper which bears on the substantive concerns we had raised. Simpson's paper fails in its attempt to rebut our arguments.

13. Two further aspects of Simpson's paper raise wider concerns.

The first is illustrated by the following quotation: "So far as price is concerned, most households probably do not know the amounts that they pay annually for water and waste water services, which are combined with their council tax bill. And there are not many businesses for whom water is one of their major costs."

There is plenty of evidence that, despite this quotation, water charges are a matter of immense significance to many businesses, both large and small: and also to many domestic users. So this quotation, coming from the Deputy Chairman of the Water Industry Commission for Scotland, the body responsible for price setting, is seriously worrying.

14. The second relates to the quotation "Finally, they appear to suggest that in Scotland water charges should be set artificially low to attract water intensive industries. To

do this would be likely to invite the disapproval of both the environmental and the competition authorities in Europe". As already noted, we have never advocated that water prices should be subsidised: so this statement is, at one level, simply factually wrong. But at another level, it betrays a worrying ignorance of the price setting regime options which are potentially open to the Water Industry Commission. SR2006 represents a move to the Regulatory Capital Value method of pricing, as implemented by Ofwat for the water industry in England since the mid 1990s. However, there are in fact two basic versions of the RCV method, one (like that used by Ofwat) based on current cost accounting, the other on historic cost accounting. Both versions are approved by the World Bank, and both are applied in different parts of the European Union, (though interestingly, it appears to be the UK which is the stronghold of the current cost version). There would therefore be no problem, from an EU perspective, in applying either version anywhere in the EU.
There is, however, increasing evidence that the current cost version of the RCV is fundamentally flawed, generating excess profits on capital investment, and leading to overcharging of customers, and distortions in the capital programmes of the affected utilities. Evidence for these effects of the current cost RCV approach can be found in the excess profits of the water and sewage companies in England: but see Cuthbert (2006) and Cuthbert and Cuthbert (2007) for a more technical analysis. What we are arguing is not that water charges in Scotland should be subsidised: but that consideration should be given to moving towards the application of historic cost RCV in setting water charges in Scotland. In the longer term, this would lead to significantly lower charges, and would be fully sustainable in the public sector, well within the current levels of public expenditure provision.

15. But to go back to Simpson's paper, what is extremely worrying is his apparent ignorance of the issues and options surrounding the possible implementation of different versions of the RCV approach: and the complete lack in SR2006, and in his paper, of any discussion of the resulting issues and choices which need to be faced. So we draw the additional conclusion, that there needs to be a complete shake up of the regulatory system for the water industry in Scotland.

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