Water Boarding

14th February 2018

The water industry is in play - with the regulators, and with the politicians. Labour proposes to renationalise the water companies, and the government and the regulators are determined to toughen up the regulation to show that privatisation works for customers. The companies are being water-boarded, and the investors are taking fright at the possible return of the publically owned Water Boards.

As a result, a host of features of the industry are now under intense scrutiny. The easy assumption that private is more efficient than public, the appropriate cost of capital, the use and misuse of balance sheets, corporate salaries, tax and the environmental records are all up for debate.

The opening shots have come from Labour, and its proposal for renationalisation is popular with the electorate. Next up are the previous regulators, who presided over some of the questionable conduct featuring in the media, but somehow think that they have the solutions to problems, some of which they have some responsibility for. OFWAT, caught in the crossfire, has come up with its "methodology" for the forthcoming price review, and now the Secretary of State, Michael Gove has threatened legislation. Water is suddenly anything but boring.

Two competing simplistic stories

Before unpacking all this, it is worth separating the reality from the two polar ideologies entertained by some on the Left and the Right. Some on the Left live in a glorious past in which the public Water Boards were well run, stunningly efficient and the Treasury provided them with all the capital they needed. Water quality in this fantasy world was good, and getting better, and the wider environment was protected. Bathing beaches were in great condition, sewerage

wasn't discharged from storm overflows and directed into the sea. It was also not being transported by barges to be dumped in the North Sea.

Some on the Right promote a radically different model. In this fantasy, water is just like any other commodity. All it needs is a price and a set of private owners motivated by profits. Whilst waiting for competition to take over from regulation, the residual job of regulators is to fix prices and then, as price takers, the companies will maximise profits by minimising costs. If the companies find new ways of raising money, and ways of minimising tax, then that shows the model is working. High profits equal public as well as private benefit. If the companies are inefficient then the takeover mechanism will discipline them.

It is not hard to see that both these models are – dangerous fantasies. Simplistic answers to complex problems can be beguiling and corrupt the public debate, analogous to the growing prevalence of fake news. These are fake models. Lobbyists trot them out. All is for the best in the best possible world for Water UK and some of the water company directors, whilst for Corbyn and MacDonnell the private companies can do no right.

Does ownership really matter?

Both the Left and the Right assume that what really matters is *ownership*, and that by changing ownership, the performance will be better. Clement Attlee's great nationalising government in the 1940s claimed that state ownership would replace private greed with public interest, and for good measure public planning needed statutory monopolies to prevent short-term competition. Margaret Thatcher agreed that the two key issues were ownership and competition. She just took the opposite line: private ownership was the road to efficiency and meeting the public interest, regulated by competition, not monopoly.

Few outside the political bubbles on the Left and Right think that ownership and competition are all that matters, or indeed that they are even the most important issues facing the utilities now. Ownership does not convey complete control to

shareholders, and competition is not always the complete answer, especially where there is natural monopoly, public goods, externalities and issues of citizens' entitlements and poverty. Indeed sometimes it is not even a good idea. Water has all these market failures and distributional issues in spades. Neither nationalisation nor privatisation, nor monopoly nor competition solves any of these. What they do is set the context within which regulation operates.

It is about public *control*. And it is the regulatory failures to properly address these market failures and distributional problems, that have given rise to the current state of affairs. Expecting companies to maximise profits and then castigating them for doing so is just the sort of confusion that raises the cost of capital and blunts the underlying incentives.

When it comes to control, there is a further twist. It is often better not to own something if you want to control it. Across the economy, supermarkets do not tend to own farms. Clothing retailers do not own manufacturers. Applied to the water companies, it may be better for governments not to own them if what they want is control. Why? Because if the government owns the companies, it is vulnerable to capture by their workforces and by their management. In the history of the nationalised industries, problems of union control have been noticeable, and indeed a prime motive for general restructuring with privatisation has been to break this control. It is perhaps no accident that whilst claiming nationalisation is the answer to climate change, the Labour leader let slip that not only would the workers be in control, but such a model would have protected jobs in the coal mining industry in the 1980s and 1990s. How does protecting jobs in the dirtiest and most pollution industry help to address climate change? Analogous to the way some on the Right think that private directors can do no wrong, Labour makes the mistake of thinking union interests are the same as the public interest. Sometimes they are, and sometimes they are not.

Regulatory failures

The regulators started off with very clear and simple duties and the task of setting the price caps. Originally the water price caps were to run for 10 years, but this was quickly reduced to five. At the first periodic review in 1995, the critical decisions, made then by the first Director General Ian Byatt, cast the dye for the following quarter of a century. The regulator fixed the cost of capital, fixed the regulatory asset base, and decided what efficiency measures to use. The regulator did not index the cost of debt, did not say anything about ownership or corporate governance, and did nothing about offshore accounts and key tax matters, and not much to say about balance sheets, debt and gearing. What he did opine on was what he thought of as excessively green environmental standards.

The regulator made serious, fundamental and long lasting mistakes in 1994, which have bedevilled the industry ever since, and they are the basis of the attacks on the subsequent conduct and performance of the industry ever since. The companies realised that the regulator would not do much to protect the balance sheets. The companies had been privatised with green dowries – positive cash injections to help finance investment. The clear intention in creating private balance sheets was that they would be used to finance current investment not paid for by current customers, and that the model would be one of *pay-when-delivered* rather than the public sector *pay-as-you-go*. This switch was perhaps the most important change ushered in by the Conservatives, and Labour appears to be proposing staying with it – borrowing against future revenues.

The ability to engage in financial engineering and to depart from the rule that borrowing was only for investment not paid for by current bills is where the private ownership incentives really matter, and some of what followed would probably not have happened under public ownership. Without any serious attempt by the first regulator to protect the balance sheets for these investment purposes, the companies started a massive exercise in financial engineering. The

balance sheet could be stripped out, and special dividends and share buy backs appeared, sometimes accompanied by takeovers. The gearing shot up as the companies mortgaged their assets and replaced equity with debt.

When accompanied with an un-indexed cost of debt, and as interest rates fell, the companies started on an uninterrupted period of excess returns based upon the arbitrage between the allowed and actual interest rates, between the cost of equity and cost of debt, which the average cost of capital offered, and the mortgaging of the assets. There would be no split cost of capital.

To be fair to the then regulator, he did say that the companies might have to put the equity back later, but for a quarter of a century a (and in some cases the) main source of (excess) profits was from this sort of financial engineering and from lower interest rates. The main gains were not from the outperformance on OPEX or CAPEX, though these did materialise as a result of the regulatory incentives and the profit motive, and some of this was due to digitalisation, some of the benefits of which would have happened in the public sector. How much is the unanswered question. Just how the investors who benefitted from the financial engineering are to put the money back, when they were long gone, was never explained.

It took time for the companies to realise just what an open financial goal the first regulator had allowed to open up, and in some cases it would take takeovers to fully realise these gains which had not been anticipated at privatisation. In companies like Anglian Water, the full extent of the opportunities would be grasped, in this case led by the current chairman of OFWAT in his former role as Anglia's chief executive.

Almost none of this was inevitable. It happened largely because regulators let it happen.

Corporate governance

Having sold the pass in the mid 1990s, the subsequent years have been spent by the successor regulators trying to row back from the most glaring mistakes. A core part of this process has been to bear down on corporate governance, as if this was the cause of the financial engineering. The directors of licenced water companies were made increasingly personally responsible, and regulators convinced themselves that non-executives would take decisions which would challenge to the purely profit maximising decisions of the owners.

The logic here is that there is something wrong with pure private ownership, where directors pursue profit maximisation in the interests of the shareholders. It is an admission that all is not perfect in the perfect world of private ownership, tempered by competition. The directors, it is argued, have to be controlled so that they do not prioritise the owners. It is a clear admission that privatisation is not a solution in itself, and that ownership has to be tempered by other non-profit maximising incentives. Capitalism has to be controlled, so that the sorts of financial engineering carried out in the Anglian Water example mentioned above are ruled out by the boards of the companies themselves.

Jonson Cox in his role as a regulator is a great believer in changing corporate governance, and this is something he would share with the great nationalisers of the past. Labour thought in the 1930s and the 1940s that public ownership would not be enough, and sought to impose corporate governance structures upon the nationalised industries. Even Michael Gove appears to share this view. All of them therefore admit that ownership does not solve governance – whether it is the state or private shareholders.

Like the current regulator, Herbert Morrison's model of the great nationalised industries had the non-executives on the boards as the instrument for the social purposes. These non-executives would pursue the public interest, whilst the executives would make sure the businesses were efficiently run. They would be the "right chaps" (and almost all of them were male) and for Morrison it is to these exemplar individuals that the public should look to make sure their

interests dominated. Substitute Cox's "independent directors" for Morrison's "non-executives" and the text is remarkably similar.

The similarities persist. Morrison's non-executives turned out to be largely political appointments, and they disappointed. Cox's independent directors have turned out to be similarly. It has not made much noticeable difference so far, though this has not broken faith in this idea as, most recently, the government has decided that the independent directors on the board of Openreach will stand up to their owner, BT (though it may soon change its mind). Instead of doing the obvious – which is to tie the balance sheets to the actual investments not paid for by customers, indexing the cost of debt to the market rates, using a split cost of capital and developing tradeable RABs, the water regulators decided that it would be better to try to wrap rules and regulations around the independent directors, to make sure they did not exploit the obvious financial incentives that poor regulation had allowed. The goal was open, and the solution of asking the strikers not to shoot at it, was (and remains) laughable. The goal should not have been open in the first place. The goalkeeper should have put the financial rules in place to close it. Much of the current mess is the inevitable result.

Many directors continued to increase their salaries, share options, pensions and other forms of remuneration through the decades that followed privatisation. It became acceptable to earn literally millions per annum for running the water businesses, and the share prices and dividends were the underpinning. It became possible to get rich by running a water company.

The directors not only increased their salaries, but engaged in lots of acquisitions. In the early days many of these destroyed shareholder value, with company boards spending the new found cash on their ungeared balance sheets on a host of activities, domestic and overseas, over which they had little obvious comparative advantage.

Infrastructure funds and new investors attracted into the businesses, not least because they were good as investing in the mortgaged assets – the RABs, put a

stop to some of these managerial excesses. The wild west of the first decades of privatisation has given way to something more subdued now, not least because the mortgaging has been done, and the interest cycle has begun to turn.

The easy bit: Carrying out nationalisation

Contrary to much media speculation, and in particular contrary to a very poor and superficial paper by the Social Market Foundation (SMF) *The cost of nationalising the water industry in England February 2018,* paid for by a number of water companies, the actual nationalisation process is relatively straightforward. John McDonnell, the shadow Chancellor, has rightly pointed out that in the main it is a swap of private for public debt. The SMF seems to think that this is a great burden, even suggesting it will result in the crowding out of other public expenditure (or crowding out for water investments) and it will even raise the cost of public borrowing generally. This is nonsense, and it surprising that the SMF with its history of careful analysis of the boundaries between the state and the market, could make such superficial arguments.

For what the SMF and other fail to pay due attention to is that there are assets as well as liabilities, and the assets currently yield more than enough to reward the debt (and the equity too). That indeed is part of the problem. Arguing that the country is worse off because it buys assets, with a significant yield to finance the accompanied assets, is simply wrong. If indeed this was the disaster to the government's finances that the SMF seem to suggest, then presumably the original nationalisations of the core utilities in the 1940s should have led to government collapse. In 1945 the debt to GDP ratio was around 245%. Up until well into the 1970s, it was 100%. The period from 1945 to 1970 remains the golden age for British economic growth for its entire history. Why could nationalisation be achieved so easily by Labour in the 1940s but be a disaster in the 2020s with the ratio below 100%. The SMF does not seem to understand the difference between a balance sheet and current unfunded expenditure.

The next mistake the SMF makes is to argue that future investments will be a great burden on the state. Why? These new assets will create new revenue streams, which should finance them. And how exactly does the SMF think that the partially and in some cases completely state-owned utilities in Europe are able to function without the collapse of governments?

Almost all utility investments for the last 100 years in Europe have been provided by the state in one form or another. Yet where exactly are the financial disasters that these should induce on the SMF argument? Does anyone really think that investments in new revenue–bearing assets in water are could reduce expenditure on health and education in Britain? Apparently the SMF think this is a real risk – and therefore thinks that water investment might have to be curtailed. Public expenditure is for the SMF a zero sum game. McDonnell, to his credit, has pointed out just how economically illiterate this idea is. The Conservatives too are crossing the Rubicon of direct investments. Presumably, for the SMF, HS2 and Crossrail should be private companies raising their finance on financial markets, and the fact that they are state financed is another financial disaster? The NHS and schools too? Would the SMF favour more PFIs?

Next the SMF argue that renationalisation is going to cost around £90 billion, and that over a long period investment will be about £100 billion. Neither of these numbers should be taken seriously. The first just assumes that asset valuations premiums of 30% are somehow justified, rather than explained by regulatory failures. The SMF suggests that the fact that some takeovers have valued the companies on this basis is evidence of their actual value in nationalisation. Even if (and it is not) this was a legitimate argument, is the SMF unaware of the very considerable evidence that acquirers tend to overpay the acquired in M&A? And that the typical overpayment is around 25%? Second, the £100 billion on an annual basis is quite modest. Indeed, some (all?) of it could be financed by retained earnings if the consumer prices were set on the same basis as in the private sector. The SMF seems to count investment as a public expenditure, whilst neglecting to count revenue as public income.

The 30% premium is merely a reflection of valuations at the top of a market asset bubble and at the high earning part of the regulatory cycle. These values have since fallen well below that level. Presumably the SMF think that because some transactions took place at what now look like inflated prices, the acquirers should be bailed out at whatever they paid? It is a sad reflection of the current state of media coverage that the erroneous £90 billion has nevertheless been widely reported.

A better way of looking at this is to think what sort of *abnormal* profit premium could be expected from genuine out-performance on OPEX and CAPEX against the full information judgment at the periodic reviews. RAB + 10% would seem an altogether more reasonable upper number. It is hard to think of how a company could outperform by more than this if the regulator has set the prices at the periodic review correctly. If the periodic review internalises all *expected* efficiency gains, the result would be a spread around the RAB at the end of the period – say + or – 10%. Note that this is not automatically a one-way bet: underperformances as well as outperformances should be expected.

The evidence – or lack of it - on efficiency

Those who defend privatisation make claims about the superior efficiency of the private over the public ownership models. This is typically an argument by *assumption*. They do this in the absence of very much evidence, either way. They might be right, and there are *a priori* reasons for claiming this, but it does need proof.

There are various evidence bases that might be used. The usual one is the least interesting - to compare companies' performance now with what happened under nationalisation three or more decades ago – to claim that nationalisation now is "going back to the 1970s". This is of negligible use, since the organisation, costs and information bases over 30 to 40 years ago are of limited relevance to those that would prevail today if the companies remained in the state sector. The world of the 1970s and 1980s was a pre-information technology world, and with

much more manual labour in the total cost mix. It is the old counterfactual problem – comparing what is with what would have happened.

In this very limited empirical exercise, the only relevant studies are those at the time, in particular those made by the then Monopolies and Mergers Commission investigations into for example the CEGB and the area electricity and gas board and showrooms. These did claim to demonstrate inefficiencies. There were also studies at the time by Richard Pryke, and some work by the Institute for Fiscal Studies (IFS) in the early 1980s. It is all old and based on a bygone era.

Much more relevant would be comparative studies *now* between UK privatised companies and European mixed ownership and nationalised companies. In the water sector, with a small number of exceptions, almost all the European water industry is owned partly or completely by the state, whether through municipalities or the central government. The amazing fact is that there have been very few comparisons and studies *at all* – even by the British regulators in setting prices at periodic reviews.

To be fair, part of the problem is that all companies are different, and supplying water in different catchments and cities in different countries come up against different costs, and different inherited infrastructure. For example, if London had not inherited Victorian sewers it would have different costs compared to a world where sewers are present. But this cuts both ways: if comparisons are difficult on a case-by-case basis, then so is the claim that state-owned companies are performing less well than private ones.

The consequence of the absence of these comparative efficiency studies is that the claim that the private sector is more efficient is just that – a claim. Asserting something does not make it true. It is, for example, perfectly possible to assert that Transport for London is more efficient that private rail operators, or indeed Network Rail. It might be, it might not be, but it would be altogether better to actually have some evidence. Is it really true that British privatised water

companies are more efficient that French or German ones? The honest answer is we don’t know.

The cost of capital

Labour argues that since the government can borrow at lower costs than the private sector, therefore its cost of capital is lower. It then claims that this means that public ownership will lead to lower water bills.

The first part of this argument is obviously true. Government can borrow at a lower cost. But the second part is more contentious, because it ignores the utility equity risk element, and assumes implicitly that this magically disappears, which it does not.

So what happens to the equity risk? The answer is that the taxpayers absorb this – or it is passed through to customers. Thus it could be argued that what is being compared is apples and pears, not apples and apples. To see what is really going on we need to unpack the equity risk a bit further. It turns out that quite a bit of this is in fact regulatory risk, and a core principle of efficient finance is that risk should be assigned to those who are best able to manage them – in the case of regulatory risk, the government.

What about the equity risk in running the businesses and new capital projects – in OPEX and CAPEX? Here it depends on whether the works are being contracted out, or done internally. If they are contracted out – as is the case for most CAPEX and quite a lot of OPEX – the risk is borne by the contractor, not the company. Hence the company’s cost of capital should not include an equity risk premium for these elements (a point most regulators seem to miss). This equity risk shows up in the bid prices of the contracts the contractors enter into. Thus, whether the water companies should receive an equity risk premium only arises if they do the works themselves, and even if they do, it should show up in the CAPEX cost that enters the RAB, and is rewarded by the regulator.

If the cost of equity risk is in the CAPEX (and OPEX) contracts, then nationalisation will not make much difference. It will stay in the contract prices – just as it did for the CEGB in contracting for power stations to be built and for the Water Boards contracting for their projects. So there is not some magic saving here for Labour to pass to customers as a bonus for financial alchemy. If the OPEX and CAPEX is all brought in house, then this would be a radical change, but it would then increase the internal cost of capital.

There is little gain too on the cost of debt. It turns out that in the case of water, the guarantee that the companies can finance their functions has led to a private cost of debt that is very low – higher than the cost of gilts, but not much. The debt swap that Labour has in mind will not actually make much difference. Debt owners have got the guarantee, and they have got control over real physical assets.

The cost of capital argument is less than it seems. What matters is the allocation of risk to those best able to bear it – business risk to businesses, regulator risk to government. All roads lead to the crucial role of regulation.

The periodic reviews and the alternative regulatory options

So far the arguments are that it is control rather than ownership that matters, and that the popular assertions about the relative merits of public versus private are hamstrung by a lack of empirical evidence and by confusions about the cost of capital. Whenever two alternatives are offered – nationalisation or privatisation – it is always worth asking if there are other alternatives. In the case of water there clearly are, and all require attention to the regulatory framework. Might it just be the case that the problems in water to which nationalisation is proposed as an answer are actually the result of poor regulation, and the periodic review process in particular? Above the regulatory failures in allowing widespread financial engineering were outlined. But they arise in a context, and that is the fixed-priced, fixed-period regulatory contracts awarded to the companies in periodic reviews.

The basic idea in RPI-X regulation is deceptively (and naively) simple. The companies are given fixed prices to deliver fixed outputs for fixed five-year periods. They maximise profits by minimising costs, and reveal the lower costs for rebasing at the next periodic review. This simple process relies on a lot of information, and as the decades have passed, regulators have added ever more scaffolding onto this simple formula. In the current periodic review, the Draft Methodology is over 1000 pages (!), and the Final Methodology 3000 pages (!). Note this is *just* the Methodology, not the contents of the periodic review itself.

If more and more detail, and more and more pages, produced better answers, there might be some excuse for this growth of regulation and the bureaucracy that goes with it. But there is in fact no evidence that regulators are getting better at their jobs. Regulating just one utility now takes up in staff on both sides nearly as many people as it took to run the Indian part of the British Empire in the early nineteenth century, and significantly more than the entire Foreign Office in this period. It is out of all proportion to the task. As the regulatory state has grown, there is little evidence that performance has improved. Instead regulation has become an industry in its own right, with not just the regulatory bodies' employees, but civil servants, company regulatory departments, and a new industry of consultants and advisers, with financial institutions in on the game too.

The reason for felling so many trees each periodic review is that the regulators have gradually lost the plot. They have encroached further and further into management decisions, about which they have no comparative advantage. It is not all their fault. Politicians have piled on the duties and obligations, and a host of lobbyists, profiting from the regulatory rents, have pushed hard. Contrary to the assumption that private firms want as little regulation as possible, the reality is that business is as much responsible for pushing regulators to intervene in their particular interests as the politicians. Regulation is not neutral, and detailed regulation is open to capture by vested interests.

Could this be done differently and better? The answer is almost certainly yes. When the reality has got into such a complex muddle it is wise to stand back and sort out what the questions are to which regulation is supposed to be the answer.

The obvious starting point is to define what it is that is required – the outputs. These are pretty straightforward – secure, continuous, safe water, and safe and environmentally sensitive disposal of waste. Next, who should pay? The answer is less obvious, since water has very high fixed and sunk costs and very low marginal costs. There is a real choice about who should pay what contributions to the fixed costs. There are several possible answers – on the basis of ability to pay, on the basis of need, and discriminating in favour of industry or of the poor. All of the above is for the government and its agencies to determine.

Who should deliver these outputs? The obvious answer is whoever can deliver them most efficiently, and an obvious way to do this is to auction the requirements. This can be done at one level by franchises and concessions, as for example in France. But it could be more disaggregated. To do this, one model is to put in place *catchment system operators* (CSOs), and to place the requirements for the outputs with these bodies that then contract through auctions and other mechanisms with various providers.

The catchment system operator model combines public control in the public sector, with private competitive provisions. It does not need 5 year fixed periods and it can bring in lots of other parties, including farmers and flood defence contractors and other managers of the catchment's natural capital, including public, private, trusts and other providers.

As set out in my paper - *Catchment Management, Abstraction and Flooding: The case for a catchment system operator and coordinated competition- February 2015*, the architecture for the system operator model is one that clearly separates out assets, asset-ownership, and asset-control. It is for the CSO to own the catchment plans – in effect the outputs that form the basis of the company

business plans under the current periodic review frameworks. These are based upon public not private decisions on the basis of the Water Framework Directive and its British successors post BREXIT, the flood defence protection standards as decided from time to time by government, and pollution limits placed upon agriculture. For the catchments this is a whole integrated plan, and not limited to discrete and specific water outputs.

The job of the CSO, like the SO in National Grid, is to auction these outputs to providers. Some very tightly defined outputs can go into individual contracts, but in practice there will also be bundled contracts. It is likely for some time most of the current water company activities would remain with the incumbents, and then gradually there will be elements of unbundling as new innovative businesses come into the auctions. The water companies may also be able to bid for flood defence works, as may natural capital delivery organisations looking to natural approaches to contain water upstream in catchments.

The fundamental difference between the periodic reviews and the CSO model is that in the CSO, the costs are determined by auctions, open to all, and that there is a clear separation between ownership and control. The CSO does the public bit, and a host of private companies, trusts and other organisations do the delivery. The success of the capacity and the renewables auctions in electricity can be replicated in water.

The transition from the periodic review approach to the CSO model is a gradual and pragmatic one. Similar transitions apply to the application of the model to decentralised electricity systems as set out in the *Cost of Energy Review*. The incumbent water companies will have obvious advantages over rivals, though they might directly bid for each others' catchments. Handling market power will require some fall-back protections, but it can also be addressed through innovative approaches to bundled contracts. For example, a bundled contract may have to demonstrate that its costs have been market tested.

Contrast the clarity of the CSO model and its use of auctions and competition with the periodic review, OFWAT finds itself mired in the detail – the 1000 pages for the Draft Methodology and the 3000 pages for the actual Methodology mentioned above are just the start. One intervention has led on to others, and each time OFWAT adds new mechanisms. This time it is two new mechanisms on customer measurements. OFWAT is dragged into corporate governance issues, intervening in board composition, intervening on tax arrangements and directly commenting on dividends. All of these areas may be matters of concerns, but like quicksand, the process leads into a deeper and deeper hole from which there is no obvious escape. In many ways OFWAT is already more engaged in the detailed matters of the water companies than any government official ever was in the nationalised industries.

A better way forward

It is too early to tell whether water privatisation is a qualified success or a qualified failure. There simply is not the evidence – either way. State ownership in Europe is not an obvious disaster, and almost no one argues that there are no problems with the costs and performance of British privatised companies.

Here is a radical and controversial claim: *it does not really much matter much who owns the water companies and hence it is not worth bothering to change it*. Labour's nationalisation will not solve the many challenges that the industry faces; and privatisation has not proved a panacea. The water industry could function reasonably well under either ownership model – *provided* it was properly regulated. Labour is hot on changing ownership, but very cold on what happens afterwards, except to "put the workers in charge". To be fair to Labour, some in its ranks would want to follow this through and put workers in control of most companies in the economy. (Whether such general socialism works is well beyond the scope of this paper).

A better approach from obsessing about the less important issue of who owns water companies, is to come up with ways of organising and regulating the

industry fit for the new challenges of the coming decades. One question is about how the companies can play a key role in the transformation of the river catchments, water supplies and sewerage systems that is mandated in the 25-year Environment Plan. In front of us we have the very real possibility of ending the Common Agricultural Policy, of organising the land and farming in an integrated way with the rivers and the water supplies, and integrating flood defences in also. With a growing population, with climate change and with the great urban challenges, what is needed is a focus on catchments as a whole, with planning for better catchment outcomes, and with addressing the declining life in our rivers (whatever the narrow "water quality" numbers suggest). These are the questions that we should be addressing, and the nationalisation vs. privatisation argument is at best a sideshow and a very British political obsession.

The answers to these much more important questions do not turn on ownership. They turn on control, and on regulation. The CSO model places control firmly in the public domain for the specification of the key outputs (and for environmental protection and enforcement). It integrates water, farming and floods into a coherent overall framework, and it leaves it to competitive firms to get on with delivering what the public interest demands. How to implement this CSO model is what a grown up debate about water should be all about, not revisiting the less important obsessions of the past. Subsequent papers will flesh out this new model.