Section 6
Governance Issues

Section 6: Chapter 26
Governance: Corporate Governance and Incentives

a) Challenging times ahead for Scottish Water

Scottish Ministers are committed to keeping the Scottish water industry in the public sector. The industry is, however, entering challenging times with investment to deliver, efficiency targets to achieve and the proposed integration of the three authorities.

To meet these challenges will require the framework of corporate governance to be strengthened. A stronger governance framework will provide significant reassurance to customers that the existing authorities or the proposed Scottish Water are genuinely accountable. Such high standards of corporate governance can only be delivered by an experienced, commercially orientated board and by high-quality senior management.

It will also be necessary to review and adapt the available incentives, to ensure that management actively pursues the customer interest. The focus must always be on delivering value for money to all customers in Scotland. This means providing excellent customer service at the lowest sustainable cost. Customers want to be confident that the service provided by the Scottish water industry bears comparison with the very best water and sewerage providers, nationally and internationally.

The highest standards of corporate governance will be part of this, as the framework will underpin efforts to deliver value for money to customers. The consequences to customers of not meeting the efficiency targets are significant. The increase in customers' bills would be in excess of £150 per average household.

Moreover, as I discussed in Chapter 11, competition will be a threat only if the service provider does not address the significant efficiency gap that exists between Scotland and other suppliers in England and Wales. Inefficiency will encourage competitive new entry and will lead to pressure on revenue (particularly from the non-domestic sector), which is wholly avoidable. In the public sector model, the customer will have to look primarily to the board to challenge management and ensure that there is a focus on providing long-term value to customers. It is for the board to develop the strategy of the organisation and to determine how best to deliver services to customers. As regulator, my role is simply to set high-level targets in the customer interest and to monitor achievement of these targets.

Following a brief look at how Scottish Ministers have voiced their commitment to the public sector, I will examine what is meant by 'public' and 'private' sector. I then highlight the lessons that can be learned from best practice in the water sector in England and Wales.

b) Commitment to public sector

Most commentary about the Scottish water industry relates to whether or not the industry should be privatised. I believe that Scottish Ministers are committed to keeping the Scottish water industry in the public sector. Since the establishment of the Scottish Parliament, Scottish Ministers have confirmed this intention on a number of occasions.

At the Water Forum, held in November 2000 at BP Amoco, Grangemouth, Sam Galbraith, then Minister for Environment, stated this promise clearly to over 100 of the largest water and sewerage business customers in Scotland. He confirmed this again when he appeared before the Transport and Environment Committee in February 2001. He said 'The (Water Services) Bill will be based on . . . . our continuing commitment to retaining the water industry in the public sector. So that there can be no doubt, let me repeat that: one of the pillars of the bill will be our continuing commitment to retaining the industry in the public sector".

There have also been numerous Parliamentary Questions about the possible privatisation of the industry. Recently Mr John Farquhar Munro (Ross, Skye and Inverness West) (LD) asked the Scottish Executive "whether it will give an assurance that the creation of a single water authority will not lead to the privatisation of the water industry." The Minister for the Environment and Rural Development, Ross Finnie, MSP, replied "Yes"[1].

c) The 'public sector' water industry

The Scottish Executive has overall responsibility for policy issues in water and the environment on behalf of the Scottish Parliament. This includes the setting and administration of standards. The Scottish Executive also has responsibility for

[1] (S1W-16477)

proposing to Parliament the public spending that is to be made available to the industry. My office is one of three regulators. My focus is on customer and economic issues. The Scottish Environment Protection Agency and the Water Quality Section of the Scottish Executive's Water Services Unit are responsible respectively for environmental and water quality issues.

One of my principal functions is to advise Scottish Ministers on the revenue needs of the industry. A major element of this advice is my view on the efficiency levels of the water authorities that are responsible for delivering the service.

The water authorities, as economic entities, are classified as 'public corporations of a trading nature'. The three Scottish water authorities are public bodies answerable to the Scottish Parliament. They are created by statute to fulfil a specific function - the provision of water and sewerage services. The authorities are not owned by the Parliament, the Scottish Executive or customers. However, Scottish Ministers do have a power of direction and, while this is not ownership in the sense of the Companies Act or tax law, this power allows Ministers, de facto, to perform the public ownership/shareholder function on behalf of the Parliament. If the Scottish Parliament approves the formation of the proposed Scottish Water, the legal status of the new entity will be the same. This would suggest that customer interests may require Ministers to lay down some very clear ground-rules on financial and management accountability.

Each of the current authorities comprises 12 members. The members are the authority, but are often referred to as the 'Board'. The authority members, including their Chairman, but excluding their Chief Executive, are appointed by Scottish Ministers, following the Guidance issued by the Commissioner for Public Appointments. The other members of the authority appoint the Chief Executive, with the Minister's approval. Following the 1997 Scottish Water Industry Review by the new Labour Government, the Secretary of State for Scotland appointed 16 local councillors to be members of the authorities[2]. The remaining members come from a variety of backgrounds, including engineering, education, utilities, business and finance.

In order to understand the commercial implications of this governance structure, it is probably best to compare the organisational structure with the private companies, with whom the industry in Scotland will have to compete. At a superficial level, the organisational structure of a Scottish public sector water authority is not too dissimilar from most privately owned water and sewerage companies in England and Wales. Both models have a board of directors and senior management. However, there are marked differences in the roles and responsibilities of the boards within the two models.

d) Roles and responsibilities

i) Structure

The Local Government etc. (Scotland) Act, 1994, which established the three authorities, defined their broad responsibilities. The authorities are the owners of the assets and are responsible for the delivery of the service to customers. The authority members are responsible for meeting these statutory duties. Scottish Ministers have a power of direction over the authorities and this allows them, de facto, to exercise functions similar to that of the owner of a company. The roles of the authority members and management of the three Scottish water authorities were set out by the Secretary of State for Scotland in 1997 in the 'Management and Financial Memoranda'[3].

Figure 26.1 shows the structure of the Scottish water industry and the relationship between the Scottish Parliament, the members of the authorities and the management.

The de facto ownership responsibilities are delegated through the Scottish Parliament to the Scottish Executive's Environment and Rural Affairs Department (SEERAD). On a day-to-day basis the civil servants of the Water Services Unit, part of SEERAD, implement the policy of Scottish Ministers.

The Secretary of State for Scotland had a number of powers, which were transferred to Scottish Ministers on 1 July 1999, on the establishment of the Scottish Parliament. These included:

- appointment and removal of board members;
- decisions on members' remuneration;
- approval of the authority members' selection of a Chief Executive;
- approval of staff terms and conditions.

[2] The Scottish Office: Scottish Water Industry Review Outcome 1997 and oral statement by Secretary of State for Scotland in House of Commons, Tuesday 16 December 1997.

[3] Management and Financial Memoranda Secretary of State, January 1997.

Figure 26.1: Structure of the Scottish Water Industry

Scottish Parliament
Representing interests of Scottish people

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Scottish Ministers
Power of direction over the authorities

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Scottish Executive
Environment and Rural Affairs Department
Implement policies of Scottish Ministers

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Water Authority
12 members known as the 'Board'
Appointment by Scottish Ministers with statutory duty to deliver a water and sewerage service and owner of assets

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Senior Management Team
Selected by Members to effiently manage the authority

The role of Scottish Ministers also includes establishing the broad financial regime within which the authorities operate, and the appointment of auditors.

The role of the Water Services Unit is to ensure that the authorities observe the provisions of the Management and Financial Memoranda and that they operate in a way "consistent with the requirements of a public body". According to the Memoranda, the Unit's responsibilities are:

- to advise Ministers on the priorities to be applied to the authorities' activities in the light of Government policy;
- to represent the interests of the authorities within Government and EU institutions;
- to guide the authorities on the application of Government policy;
- to monitor the performance of the authorities;
- to account for the payment of voted provision to the authorities and for control over the non-voted public expenditure of the authorities;
- to advise the authorities when asked.

The Memoranda establish that the Chairman is the principal point of contact between Scottish Ministers and the members. His main role is:

- to give strategic direction to the work of the authority;
- to establish the ethos of the authority;
- to represent the authority to the media and the public.

He is also expected to ensure that the authority develops and acts upon policies to fulfil its statutory duties. In particular, the Chairman should be satisfied that the Chief Executive has in place proper controls and procedures to secure the proper use of public funds and value for money to customers.

According to the Memoranda, the members should "bring their independent judgement to bear on issues of strategy, resources and standards of conduct". In particular, members are responsible for:[4]

- agreeing the broad strategy of the authority in a manner consistent with the statutory obligations placed on the authority and any guidance or directions given by Scottish Ministers;
- ensuring that the requirements of propriety, regularity and value for money are met;
- developing a statement of what matters are reserved for decision by members and what matters staff may undertake on their own authority;
- agreeing the Annual Corporate Plan;
- agreeing the procedures of the authority;
- identifying and setting measurable performance indicators against which the effectiveness of the authority in achieving their goals can be measured;
- monitoring the authority's performance against performance indicators;
- appointing the Chief Executive (after the first) and seeking Scottish Ministers' approval;
- assisting the Chief Executive in the appointment of senior managers;
- ensuring that the authority and employees follow the Memoranda.

[4] Management and Financial Memoranda Secretary of State, January 1997

There are two principal committees of members: Audit and Remuneration.

The Chief Executive is accountable for the efficient management of the authority. In particular he is responsible for ensuring:

- that the accounts are properly presented;
- that there is a high standard of financial management in the authority;
- that its management systems and procedures, including financial monitoring and control systems, are appropriate for the achievement of the authority's objectives;
- the promotion of efficient and economical conduct of business and that financial propriety and regularity are safeguarded;
- appropriate contact with business and finance communities is maintained;
- that the public are informed about the authority's policies and activities.

The management teams typically meet once a week to monitor and guide the authorities' performance.

ii) Accountability

The key feature of any governance system is not simply the roles and responsibilities of the various actors. It is the method and effectiveness of their accountability. I now therefore move to consider the accountability that exists within the existing system.

The first level of accountability - that of authority members - is the most difficult to define. They are principally responsible for the delivery of the statutory obligations of the authority, as defined by the 1994 Local Government, etc. (Scotland) Act. Ultimately, there is an unstated accountability of the authority to the Scottish Parliament. If events and performance are not satisfactory in the eyes of Parliament, there are two ways in which this accountability can be made effective: either by legislative change or by Parliament requesting Ministers to issue a direction to the authority.

Authority members can therefore be called to attend Scottish Parliament Committee meetings. Most recently, the three Chairmen appeared before the Transport and Environment Committee Water Inquiry.

The most direct accountability is that which results from the agreed Management and Financial Memoranda. These establish the delegated limits of authority to the members and the sort of decision upon which they should consult Scottish Ministers before taking action. The performance of each authority can be measured against performance indicators, agreed as a result of the Memoranda, to assess how successfully it is achieving its aims and objectives. The main performance indicators cover compliance with quality standards in delivery of services, customer services standards, financial targets and controls, and targets for managerial and organisational efficiency. Accountability for performance is through annual meetings that are held between members and the Minister for Environment and Rural Development and Water Services Unit officials.

In practice, however, there is considerable contact between the management of the authority and officials within the Water Services Unit of the Scottish Executive. While this has undoubtedly resulted in better and more timely information being made available to the Scottish Executive, it has meant that the lines of accountability for the management are less clear than is perhaps desirable. In effect, managers have dual accountability – directly to the de facto owner and to the members.

There would also appear to be a greater emphasis placed on accountability at a local level than on accountability between de facto owner, members and management. Each of the three authorities holds meetings in public throughout their area of operation. This is an opportunity for members of the public to listen to the business of the meeting and to ask questions. These meetings are held approximately every eight weeks. Attendance at meetings by the public is usually not high. If a customer were not happy with the discussions of the members, he would have recourse only to his MSP, the Scottish Executive or, in the event that it were a customer service issue, to me as regulator.

An authority's members are in place according to a letter of appointment. Scottish Ministers can withdraw this letter of appointment in the event that a member was in breach of their obligations. The salary paid to members ranges from £6,000 to £7,000 per annum. The Chairmen have annual salaries of between £25 and 28,000[5].

According to the authorities' Annual Reports, the boards meet regularly to discuss financial, strategic, budgetary and

[5] Annual Report and Accounts 1999-2000

organisational issues. They also receive reports from senior management on risk management, internal audit, and on quality, environmental, regulatory and Health and Safety issues. Members are able to question the senior management on any issue within their area of responsibility. The boards meet in public and private. Whilst an examination of the papers submitted to members at the public meetings shows that a range of issues are presented for discussion, the information contained in the papers and the record of the discussion as noted in the minutes would not suggest that in-depth scrutiny of any particular issues is conducted by the members. Each authority reports on its internal and financial control systems in its annual report and accounts. However, little financial information seems to be presented to the members and my experience suggests that the quality of forecasting of costs and revenues is not good.

iii) Issues to be addressed in the customer interest

There are four aspects of the existing method of accountability, which, from a customer value-for-money perspective, ought to be addressed. These are the time that is available to members; the profile and experience of the members; their level of remuneration, and their relationship with the Scottish Executive.

The Chairman of the authority is contracted to spend on average 1.5 days per week working on water authority business. Each of the other non-executive members are contracted to spend on average 2-3 days per month. This means that the authority is able to muster just over one full man month per month of operation of the authority. In practice, it is common for the Chairmen and members to spend more time on authority work than their contracted hours. Even taking this into account, the limited time available inevitably limits their ability to hold management fully to account, especially given the background of members.

This is especially relevant as members of the authority will increasingly have to deal with complex business issues. These include the pursuit of efficiency targets, the potential for competition, the opportunities for new business, and improving and differentiating the service provided to customers. These issues are likely to be better managed by members with significant relevant experience. This could come from roles in business management or expertise in, for example, human resources or finance. The operating environment of the authorities has evolved substantially in the past year or so and it will be important for the role of members to reflect these developments.

This is not a criticism of current practice or of current members, but is directed at avoiding future problems in maintaining the competitiveness of the public sector model. It is, therefore, important from a customer perspective that the members of the authorities or of the proposed Scottish Water are chosen to reflect the new roles and responsibilities that they have. Ultimately, value for money for customers depends at least as much on the members as it does upon me as regulator.

If members are not properly remunerated and do not have a sufficiently well defined role, then it will be difficult to attract the expertise that is required. This issue will be important to address, especially if the proposed Scottish Water is approved by the Scottish Parliament.

Clarity in the role of the members is at least as important as their remuneration. The role of owner should be about setting targets and expecting outputs. The owner should then hold members to account for the achievement of the agreed goals. If the existing authorities or the proposed Scottish Water are to be successful and sustainable (both of which are fundamental to customers' interests), it will be essential that the Scottish Executive sets very clear and measurable outputs for the authority and then holds them to account for their achievement. This will strengthen the hand of members, both in their function of scrutineer of management and in their function of advisor to management.

Salaries for the most senior management are lower than equivalent posts in the private sector. However, the remuneration levels below the most senior posts compare quite favourably. The recent announcement by Ross Finnie, MSP, of the prospective terms of appointment of the new Chair and Chief Executive of Scottish Water indicate a recognition of the challenges that lie ahead. The availability of a significant bonus for achievement, (provided it is available only for achievement), is in customers' interests. I believe that this has established sufficient incentive for managers to perform and to achieve the current efficiency targets. This, however, will also require proper scrutiny by experienced members.

Executive directors should be incentivised to meet customer service, environmental and public health outputs within the revenue cap. The efficiency targets, assumed contribution from new business and the proceeds of property disposals are a means to an end, not an end in themselves. It is not in the customer interest that management be judged against the means to an end rather than the achievement of the agreed levels of service for customers.

e) Corporate governance in a 'private sector' water company

i) Structure

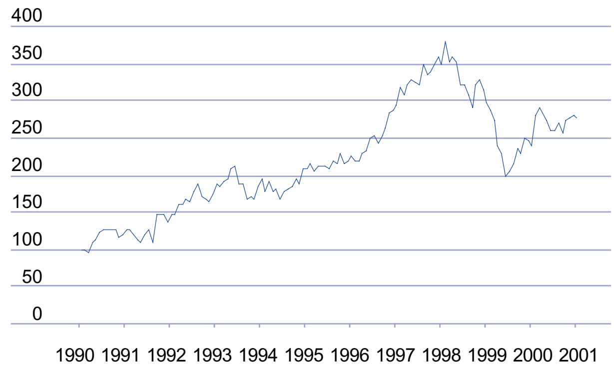
The regulatory structure in England and Wales is essentially the same as in Scotland. There are three regulators covering water quality (The Drinking Water Inspectorate), the environment (The Environment Agency) and the economic regulator (Ofwat). Policy issues are managed by Department for Environment, Food and Rural Affairs (DEFRA) and Department of Trade and Industry (DTI). The two principal differences in the system is that the service is provided by private companies which have a license to provide services to customers, and that the economic regulator has the power to determine and not advise on revenue levels.

I have opted to use Thames Water plc (Thames) to illustrate the main features of the corporate governance within the private water sector. Although Thames is now a subsidiary of RWE, It is useful to compare its former governance structure with that in the public sector.

According to the 1999-2000 Annual Report and Accounts, Thames Water had over 193,000 shareholders, 183,891 of whom were individuals. Most of these shareholdings were small, but four shareholders accounted for nearly 20% of the total company. All of these shareholders (from the largest to the smallest) invest in the company in order to receive dividends and capital growth. The return to a shareholder is equal to the capital growth plus the value of the dividend. The return to a shareholder is maximised if the company exceeds the profit expectations of analysts and does better than the stockmarket expects; returns are lower if the performance of the company is worse than is expected by the market.

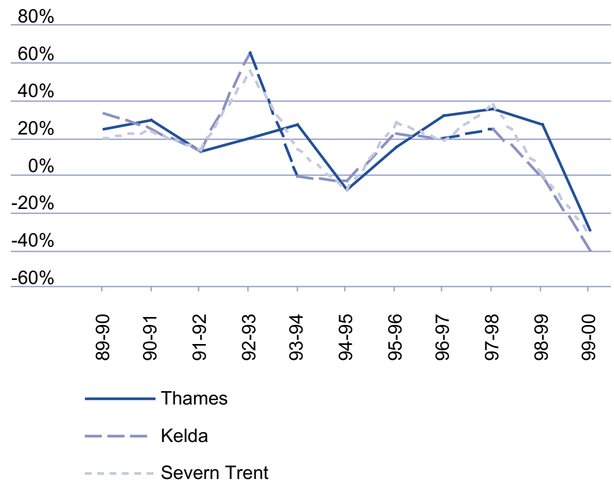
The movements in water share prices since privatisation to the current time are a useful illustration of the role of the market. Actual financial performance is less important than the market's perception of what is happening. Figure 26.2 illustrates this:

Figure 26.2: UK Water Sector Index[6]



In the first years after privatisation, the water companies were able to perform better than analysts had expected. The share prices of the companies therefore showed a very healthy return, as Figure 26.3 illustrates.

Figure 26.3: Return on Equity 1992-00[7]



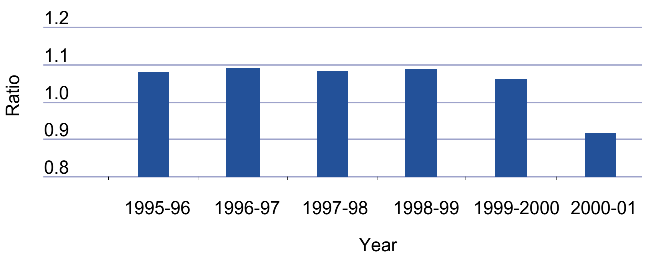
This continued until 1994 when uncertainty relating to the price review caused share prices to decline. Optimism about prospects at the conclusion of the price review quickly led to a high return on equity in the mid 1990s.

[6] Source: ING Barings Charterhouse Securities

[7] Source: FT.com and company annual reports and accounts and websites

This continued until 1998, when it became clear that a tougher regulatory regime was in store. At this time, share prices began to perform worse than the market. This was in contrast to the progress that was being made by the companies in improving their profitability to quite a dramatic extent, as Figure 26.4 shows. Although profitability was improving and way ahead of market expectations, the market was valuing the companies less highly. Expectations had been set at a higher level because of their continuing excellent return in the first years after privatisation and the market became disappointed by the likely return from ownership of water company equity after 1998. This decline in expectations more than outweighed the improvement in underlying financial performance.

Figure 26.4: Return on capital employed: Actual return /expected return English and Welsh water companies



Shareholders own the company, but most do not have the interest, expertise or desire to manage the company. They therefore appoint a Board of Directors to advise and to hold management to account. The members of the board are elected at the company's annual general meeting and serve for a fixed number of years (three in the case of Thames Water), unless shareholders decide at a general meeting to remove a member of the board. Both the executive directors (the most senior managers in the company) and the non-executive directors are elected to the board by the shareholders. The voting power of the shareholder reflects the size of that shareholder's interest in the equity of the company.

The Chairman is responsible for the effective running of the board and for ensuring that all directors, executive and non-executive, are consulted so that they can play their full part in the supervision of the company's activities.

The primary responsibility of the board is to determine the strategic direction of the company and oversee its implementation[8]. There are six formal committees of the Thames board: Nomination, Audit, Remuneration, Environment Review, Charities and Share Dealing. All committees have specific terms of reference, which establish their authority and duties. In particular, the board and its committees are responsible for:

- the adequacy and effectiveness of the company's system of internal control and risk management;
- reviewing board membership and the balance and appointment of directors;
- determining executive directors' contracts of service and remuneration;
- reviewing the company's environmental strategy, performance and reporting systems;
- considering directors' share dealing requests and the implementation of the company's employee share schemes;
- keeping proper accounting records which disclose at any time the financial position of the Group;
- safeguarding the assets of the Group.

As in the public authority model, members of the board are responsible for the appointment of the Chief Executive and the other executive directors. These executive directors are responsible for the day-to-day management of the company and the implementation of the policies and strategies adopted by the board. They are held to account by the board, and the board may offer advice to the executive directors and the senior managers. The remuneration and position of these directors will depend critically upon the extent to which the non-executive directors believe that the company is on track to meet or beat the expectations of its investors.

ii) Accountability

The board of Thames Water is accountable to all 193,000 shareholders. The directors will appear before the annual general meeting of the shareholders and will answer questions and make a statement on trading at that time. In addition, the directors will have an on-going series of meetings with institutional shareholders (the large financial investors). Thames also arranges open days for shareholders, which are held at various locations within the Thames Water region.

There are seven members on the board of Thames Water plc; the Chairman, three non-executive directors and three

[8] Thames Water plc Annual Report and Accounts 2000

executive directors, namely the Chief Executive, Group Finance Director and the Secretary and Legal Director. All members have significant business experience and have sat on the boards of other leading public companies, including Bass plc, Legal and General plc and Lloyds TSB Group plc.[9]

Understandably, because they are risking their savings (capital) to Thames Water, the shareholders are keen to ensure that the board is made up of the best people available. The non-executive directors are remunerated on a competitive basis and are expected to deliver for shareholders. Shareholders will not hesitate to replace a non-executive who they believe has not been guarding their interests. However, shareholders will not attempt to bypass the board and deal direct with senior management. Nor is management likely to be receptive to such a tactic, even if shareholders were to try. The primacy of the board versus the management is therefore very much clearer in this model than it is under the current public authority model. This ensures that management has only one master.

The board meets every month (except August) to monitor executive management and review the operating and financial performance of the major business units within the company. There is a formal schedule of matters specifically reserved to the board for its decision, including overall strategy, business planning, material acquisitions and disposals and approval of major projects. Appropriate management information is provided to each meeting in a systematic manner.

The board is responsible for maintaining a system of internal financial control. Following a review of the systems in 1999, a process for the identification, evaluation and management of the Group's significant risks was implemented. The procedures adopted by the Group entail risk management reviews in the operating divisions and corporate units and regular reporting of risk management issues to the Audit Committee.

iii) Incentives

Just as the shareholder is keen to ensure that the best directors are running the company, so the board is keen to ensure that it attracts, retains and rewards the best managers available.

From a shareholder perspective, it is important to try to align the interests of management as closely as possible with the interests of the shareholder. Success in achieving a high degree of alignment will focus managers on the achievement of strategic performance targets. It will ensure that management are prepared to take the difficult decisions in a timely and effective fashion and will do this with the interest of the shareholder to the fore. It is important not only that the remuneration package is set at the right level, but also that it has the right structure, combining the potential for both short, and long-term rewards for achievement of realistic yet challenging performance criteria. The level and structure of executive remuneration can affect both a company's reputation and staff morale within the company.

It is standard practice for executive remuneration to be determined by a Remuneration Committee, usually made up of non-executive directors. The recommendations made by the Greenbury and Hampel Committees have introduced a degree of self-regulation, usually including upper limits on bonuses, part-payment in shares, and disclosure and justification of contracts with notice periods exceeding one year.

The elements of remuneration other than the basic salary are earned by the achievement of challenging performance criteria or hurdles. Performance is usually judged against financial indicators such as total shareholder return, or earnings per share, as well as personal goals. It is expected that bonuses should reflect performance over and above that expected as standard.

From the perspectives of shareholders and customers, it is important that the criteria for awarding bonuses are transparent and that it is clear that bonuses have been earned when awarded.

Effective incentive schemes have several important characteristics:

- remuneration is set at the right level and is comparable with that offered by other similar organisations;
- the remuneration is structured effectively, with a sufficient proportion being performance related;
- the criteria, or hurdles, used to measure performance are clearly defined and transparent and objective evaluation of performance is possible.

These criteria are as true in the public sector as in the private sector.

[9] Thames Water plc Annual Report and Accounts 2000

f) The differences

Superficial comparison would suggest that the differences between the public sector governance and private sector governance are limited. However, this would be misleading as there are some fundamentally important differences. There is a much clearer role for the board in the private sector and it is more of a priority to attract, almost at any cost, the most qualified people to that board.

My comparison of the public and private water sectors has identified four clear differences that can be summarised as follows:

i)The experience and time commitment of members

Reflecting the emphasis on local accountability, members of the water authorities have traditionally been drawn from backgrounds including local authorities, engineering and education. This contrasts with the commercial operating environment of the private water companies, which demand significant business experience from members. (This is well illustrated by the composition of the board of Thames Water plc before it became a subsidiary of RWE.)

The background and commercial experience of members will directly affect the amount of quality time each needs to invest in order to hold management fully to account. At present, water authority members are contracted to 2-3 days a month. Given their background, this would seem in many cases to be insufficient to enable them to prepare sufficiently and to scrutinise fully all the information and technical information that should be presented by senior management at the regular public and private board meetings.

ii) The level of remuneration of both members and senior management

The average remuneration of water authority members is between £6,000 and £7,000. Thames Water plc non-executive directors receive £25,000, with an additional £2,500 when chairing a committee. There is also a significant difference in remuneration of the chairman. In 1999-2000, the chairman of Thames Water plc received an annual fee of £100,000, compared with the water authority salary of £28,000.

The levels of salary and the levels of incentive are higher in a privatised company. There is, however, a very clear price for failure to deliver fully the expectations of the market.

It is therefore appropriate that, given the greater personal risks, the rewards should be greater. It is also clear that there is greater transparency and rigour in the assessment of bonuses in the private sector. Greater transparency in bonus payments within the Scottish industry would be highly desirable.

Looking to the future, it will be important if the Scottish water industry is to attract the best managers that the remuneration package and conditions of employment are attractive and that performance for customers is prioritised. Clear incentives to drive out inefficiency are likely to be more important in the long term once the initial inefficiencies, which are always easier to implement, have been achieved.

iii) Balance of executive and non-executive directors

There are twelve water authority members, only one of whom is a full time, executive director (the Chief Executive). Private water companies have a balance of executive and non-executive directors.

iv) The relationship between members and owner.

While the role and responsibilities of water authority members are laid down in the Management and Financial Memoranda, in practice there would appear to be some confusion over who is accountable to the de facto owner for the delivery of the authorities' key deliverables. This is evidenced by the fact that there is more direct contact between the owner and senior management than between owner and members.

The board of directors of the private water companies are clearly accountable to the shareholders, who have appointed them to advise and hold the senior management to account. In contrast to the water authorities, there is minimal, if any contact, between shareholders and senior management.

g) The proposed Scottish Water must follow best practice

There is a clear consensus that the Scottish water industry should remain in the public sector. This does not mean that the customer does not want a service that is demonstrably good value for money. Arguably, the public sector should focus only on delivering value to customers and therefore improving service and reducing costs to the frontier level of efficiency. It is clearly in customers interests that the service is as efficient as possible. To achieve my challenging efficiency targets and deliver consistent, first-class customer service, the Scottish water industry will require the highest standards of corporate governance delivered through an experienced commercial 'board' and high-quality senior management. The competitors already enjoy this competitive advantage. The Scottish Executive must therefore follow the best practice of corporate governance.

From the comparison with Thames Water, there would appear to be a very strong case for Scottish Water to have the following attributes:

- Well-defined responsibilities for the Scottish Executive's de facto ownership role, the Board and the senior management, ensuring that accountability of each party is rigorous and transparent.
- High-quality, commercially experienced non-executive board members who will bring openness, thoroughness and objectivity, but will also be able to question and advise senior management when necessary about the operation of the business. In particular, the non-executive directors should have experience in finance, assets and risk management and customer management.
- The right balance of executive and non-executive directors. The boards are crucial in supervising the drive for efficiency. Ideally, the audit and remuneration committees should not have an overlap of non-executive directors; this implies six non-executives. The Water Industry (Scotland) Bill has proposed a board structure of this type.
- Transparent and appropriate incentives and penalties for both non-executive and executive board members and for senior management. This will ensure that the right calibre of professionals are attracted and stay with the proposed Scottish Water.
- Clear setting of the risk profile by the owner, followed by management of risks by the board to the criteria established by the owner. This is critical to the delivery of value for money to customers.

h) The importance of local accountability

I have emphasised the importance of accountability of the board and senior management. It is also essential that the proposed Scottish Water does not lose accountability at a local level. There will be obvious concerns that the creation of one large national authority could weaken the procedures that are currently operated by the three individual authorities to ensure they are accessible and listen to their customers at every level. When he announced the proposals for Scottish Water, the former Minister for the Environment Sam Galbraith stated, "I am committed to ensuring that Scottish Water is responsive to local needs and concerns." I am confident that this objective can be met by:

- a full and transparent programme of customer consultation by the authorities or Scottish Water, the results of which and any subsequent actions are made public, for example, on the authority's web site;
- development of the current programme of public board meetings, treatment works open days, school and community visits.

Lastly, I believe that the current system of my Consultative Committees should be strengthened and extended to ensure that customers' views are passed back to the water authorities and reflected in the development of service levels. I welcome the initiative to establish the Customer Panels in the current Water Services bill.

i) Conclusion

The proposed Scottish Water must be a first class water and sewerage service provider. There is absolutely no reason why it cannot achieve this as a public sector entity, as long as it follows the highest standards of corporate governance and achieves the efficiency targets outlined elsewhere in my Review. It will require high-quality management that are properly and transparently incentivised in order that they deliver the value for money that customers deserve. The current efficiency targets are more than achievable, but in the future, more challenging targets will take more imagination and commitment to achieve. The management must be held to account by a similarly high-quality, commercially experienced board. The Water Industry (Scotland) Bill, which was published on 27 September 2001, seems to provide a framework for improved corporate governance. If the correct structure and culture is put in place, the Scottish public sector model can thrive against the very best of it competitors.

Section 6: Chapter 27
Governance: Non-core Business

a) Introduction

The principal business activity of water and waste water providers is the provision of water and the removal of waste water through mains pipes to domestic and non-domestic customers. This can be described as core business. New business or non-core business can therefore be defined as any business other than core. This may be a business area that is very closely linked to the core business, for example, laboratory services. It may equally be an activity that is quite different, such as plumbing services or insurance.

This chapter reviews the experience of the privatised companies in England and Wales in generating additional sources of business from non-core activities. I also look at the development of non-core activities in Scotland and their success or otherwise. I conclude that investment in new business by the water authorities or, indeed, by the proposed Scottish Water, would need to be approached very cautiously. There is insufficient evidence that this has the potential to be of significant benefit to customers for the risks to be justified. These risks are not only the capital that is invested (either in cash or in capital investment) in any new venture; there are also risks associated with the diversion of management time away from the main task at hand - the improvement in relative efficiency and the development of more cost reflective tariffs.

It is easy to be distracted by thoughts of profits from non-core activities. This can overlook the extent of the sustainable revenue that will need to be generated and the costs (particularly in the early years) that have to be borne. Currently the Water Industry Act 1999 provides for my office to regulate the authorities and to provide advice on their revenue needs. This therefore requires me to monitor any non-core business activities that have the potential to affect revenue. The need to ensure that accounting separation of activities is required from the authorities is again revisited here, but it has already been discussed in more detail in Chapter 14.

In England and Wales customers' money is not used to fund non-core business. Shareholders of the privatised companies bear all the financial risk. Customer charges for the core business are retained within that core business and there can be no question that a failed venture outside the core business could impact on customer charges in the core business. The economic regulator, Ofwat, regulates the revenues of the core business and determines the allowable return on capital for the assets employed in the core business. Equally, even a successful venture by the privatised company will not immediately impact upon customers' bills. Only if the board of the company were to decide to reduce the return allowed by the regulator, because of the profit generated elsewhere, would this happen. In this way, shareholders take all the risk associated with non-core activity and, quite equitably, take all the earned return. Ofwat does not in any way regulate the activities of the privatised companies outside the core business (except in the most extreme case where an activity could threaten the company's ability to fulfil a core business license condition).

It is important that customers in Scotland enjoy similar protection, even if the mechanism for safeguarding the customer interest is slightly different. In Scotland, Section 89(2) of the 1994 Local Government (Scotland) Act currently allows the water authorities to enter into a limited range of commercial ventures, subject to the consent of Scottish Ministers. The Water Services Bill presented to Parliament in September 2001 contains provisions that will give the proposed Scottish Water the general power to pursue commercial opportunities, subject to Ministerial direction and guidance.

The financing for any new ventures in Scotland, whether a small opportunity for a start-up with potential for organic growth, or an acquisition, ultimately has to be obtained from customers of the core business or from the taxpayer. If the non-core activity is cash negative, this will consume cash that could have been used by the core business and, at the current time, would impact adversely on customer charges. Commercial opportunities have to be carefully assessed, because even if the venture appears to generate a return relatively quickly, there may be hidden costs (such as costs to exit the business), which could adversely impact on customers' bills in the future.

This area of business has to be kept under close regulatory scrutiny, because only in this way can I ensure that customers receive the best value for money. The accounting separation of the activities of the authorities into at least three areas: retail water services; networks and treatment (both core); and non-core business activities will be essential to the on-going monitoring of the authorities' activities. There would not necessarily be any need for me to regulate the non-core activities of the authorities after accounting separation, as long as there could be no question or opportunity for cross-subsidy of the non-core activities from the core business. It would also have to be clear that the public expenditure constraints on the core business were not unduly tightened because of support provided to a non-core activity.

I believe that the views expressed above are in line with those contained within the report of the Transport and Environment Committee into the water industry. Accounting separation is the only robust method of ensuring that non-core activities are ring-fenced. This does not mean that I do not support the introduction of the general power to enter into commercial relationships. I do. Indeed I believe that such powers should be contained within legislation, as a situation may arise where it is commercially necessary and advantageous to customers in general to enter into a non-core activity. My concern is related more towards prioritisation of effort within the senior management team. Ministerial Guidance is therefore critical in providing a framework that will ensure that no undue risk is taken with customers' money.

b) Background in England and Wales

In England and Wales, companies have set up non-core business lines through organic growth, acquisition, merger and joint ventures. Severn Trent Water's acquisition of the waste business Biffa can be seen as an example where development of non-core business through acquisitions appears to have been successful and to offer a return greater than in the regulated business. In May 1991, Severn Trent Water paid £212 million for Biffa Waste Services; Biffa accounted for 7.9% of Severn Trent Group's profit, before interest and tax, in the year 2000, at £31.0 million.

There have also been examples where the acquisition of a non-core activity has not been successful, as shown by the acquisition and subsequent disposal of a number of hotels by the Hyder Group. Recent press comment on the acquisition of the Morrisons Group by Anglian Water has also been critical.

Development of non-core business organically has also been undertaken by a number of the water and sewerage companies in England and Wales. This process is naturally slower, but the immediate risk in cash terms is typically lower. However, the inevitable outturn is that the time period required to generate any significant profit is likely to be lengthy.

There has been continuing investment in the development of non-core business by the privatised companies in England and Wales over the past 12 years. I have carried out extensive research into the various lines of non-core business undertaken by the majority of the companies to determine both the successful ventures and the failures. Information has been drawn from the companies' 1998-99 and 1999-00 Annual Report and Accounts, and from the financial statements released by the companies to the markets. This information has enabled me to develop an insight into the different lines of non-core business.

i) Kinds of non-core business

Table 27.1 shows the types of non-core business in which the 18 remaining water company groups are involved.

Table 27.1: Types of non-core business activities of water companies

Type of non-core business	Number of companies involved in this non-core business out of 18.
Property / construction	14
International business	11
Engineering and other consultancy	10
Energy	9
Laboratory business	9
Facilities management/ outsourcing	9
Plumbing	8
Information technology	6
Technology	6
Waste management	6
Insurance	4
Telecommunications	4
Other[1]	6

Property/construction

This category can include a number of activities, ranging from the construction of above and below ground assets for third-party clients, to revenue generated from the sale of property or

[1] Other includes bottled water, internet services, printing 'mechanical services', mail services, water related product sales e.g. dishwashers.

land. For example, Thames Water's sale of a laboratory building and its conversion into residential flats is included.

International business

International expansion has been a key part of non-core business revenue. International business takes various forms, including consultancy exercises and facilities management as well as acquiring stakes in privatised water utilities abroad. It also includes the operation of concessions and, for several of the privatised companies, this includes activities in Scotland under the PPP scheme.

Engineering and other consultancy

Several of the companies appear to have well-established consultancy divisions. Work undertaken in these divisions includes water efficiency and waste water minimisation advice, as well as consulting on other customer specific issues. Profit margins in this area have generally been small (3%-5%), although information is limited here. The consultancy business of Hyder plc was sold by WPD to the management after the completion of its acquisition.

Laboratory business/energy

Another main type of non-core business development has been revenue generated from laboratory testing services and investment in different sources of energy.

Facilities management/outsourcing

The companies in England and Wales are heavily involved in operating water and waste water facilities, as well as other types of facilities, for external customers e.g Hyder Plc had contracts with some 20% of the NHS Trusts in England and Wales to operate patient electronic records and payroll records.

Table 27.1 shows that the 18 companies surveyed were engaged in 102 areas of non-core activity. This equates to an average of around 6 for each company. While there are some potential synergies between these areas (e.g. consultancy projects in the UK and internationally), it is quite striking how far some of the companies have moved from their core business. This may well be justified, but it is the long-term return to shareholders that will be the determining factor.

The origin of the majority of non-core business relating to the years 1998-99 to 1999-2000 appears to have been the development of opportunities organically rather than through acquisition. This contrasts quite sharply with initial attempts at diversification by the privatised companies. These initial moves were often acquisitive. Yorkshire, Severn Trent, Pennon and Welsh Water all made acquisitions.

I will discuss the relative successes of the ventures below, but it is important to note how much more prepared privatised companies are now to manage their non-core activities as opposed to in the early 1990s. The companies have set up separate divisions, specialising in different areas. This has led to a more focused strategy of growth in an area through a combination of organic growth, acquisition and joint ventures. The companies have also become better at minimising the risk of their non-core activities by pursuing consultancy and international contracts through joint ventures. There has also been a greater focus recently on consulting into the use of water on site and the effluent solutions required by large industrial and commercial customers. In large part, this latter business would appear to be relatively opportunistic, as it typically relies on the tariffs of the incumbent supplier being non-reflective of the true costs of supply. It is instructive that there has been less activity in inset appointments in recent months. This almost certainly reflects the more accurate allocation of economic costs of supply to customers in the tariffs, charged by incumbents.

ii) Profitability of non-core business

There is only very limited information relating to the profitability of non-core business streams for England and Wales. Although it would seem relatively straightforward to look at the Group accounts of those still listed on the Stock Exchange and the accounts of the regulated subsidiary, this would provide a misleading picture. It would not be possible from this information to extract all those costs and revenues of the non-core activities that do not fundamentally rely upon the supply of services to the regulated business. Each of the Groups earns a significant profit from the supply of services to the regulated company and this is likely to dwarf the profit received from other sources. It has been estimated that the Thames Group earned a significant profit from providing insurance services to its subsidiary company, Thames Water Ltd, the regulated business.

Table 27.2: Profitability of non-core business in England

	Turnover for non-regulated business	Profit for non-regulated business	Operating profit/(loss) margin
Wessex 1998	£9.1 m	(£1.4 m)	(15%)
Severn Trent 2000	£698.3 m	£52 m	7%
Yorkshire 2000	£165 m	£7.3 m	4%
Anglian 1999	£94.9 m	(£1.2 m)	(1%)

Table 27.3: Experience of privatised companies in non-core activities

Severn Trent Water	"Severn Trent Systems has been running for five years in which time it generated an accumulated profit of £16.2 million. In the year 2000 this company is expected to make a loss of £2.6 million as a result of additional investment that is required. The board recognises that to realise the full sales and profitability potential that they would have to have global marketing capability."
Severn Trent Water	"Contract operations turnover grew 21% in the year, but profit before interest declined by £2.3 million largely as a result of increased marketing costs, including £1.9 million bidding for contracts in major cities in Europe and USA."
North West Water (United Utilities)	"International development projects are inherently speculative and can take several years to come to fruition".
Welsh Water (Dŵr Cymru)	"The performance of our engineering and environmental consulting business was disappointing, suffering a trading loss in highly competitive markets."
Kelda Group (Yorkshire Water)	"Group has been pursuing certain Public Finance Initiative (PFI) projects as well as researching opportunities in overseas markets. These development costs were £1.3million 1998-99."

It is also difficult to understand the exact nature of the costs allocated to non-core business, and hence to calculate the real profitability. There is limited, if any, transparency on costs such as start-up costs on unsuccessful contract bids. It is likely, therefore, that my estimates will overstate the true profit margin of the various activities. In most cases, my analysis would suggest that profit margins would appear to be less than 10%. The main category for higher margin opportunities is within the property and construction services activity. Although this area seems to report a higher margin, evidence suggests that this high margin results from property disposals. I discuss the scope for property disposals separately in Chapter 20.

Information relating to the profitability of non-core businesses is outlined for a selection of companies in Table 27.2.

Although only for four companies, these figures suggest that the development of non-core business is on the whole not a large generator of profit, and in some cases a source of significant loss. Severn Trent Water's profit largely results from the major acquisition of Biffa and should not be regarded as an example of the potential available to a Scottish authority.

I believe that the importance of this analysis should not be understated when looking at the future of the Scottish water industry. The apparent success achieved by the privatised companies does not bear up to close scrutiny and this is after 12 years of attempts and significant good management in terms of preparing the organisations for future opportunities. This analysis raises a significant question as to whether there can be any case for customers' money to be invested in non-core activities in the short term.

Even after 12 years, it appears that the privatised companies have not yet resolved issues with non-core activities. The companies in England and Wales still encounter difficulties and incur major expenditure in trying to ensure the success of their non-core business.

Table 27.3 includes some comments, which I found during my analysis of the experience of the privatised companies in non-core activities. I believe that they are self-explanatory, and would support my caution.

One of the most interesting aspects of my analysis has been the changing attitude of investors to the non-core activities of the privatised water companies. A few years ago, investors were excited by the potential of the non-regulated business of the water companies and this was reflected in their share prices. In the past two years or so, investors have preferred a "stick to the knitting" approach. This is perhaps best evidenced by the warm reaction to the Glas Cymru bond issue, especially in comparison with the cooler reactions given to other smaller issues. Investors seem to be valuing the relative certainty of the regulated business more highly than the potential of non-core activities.

Another example is that of Pennon Group and its main subsidiary, South West Water, which announced a major strategic change of direction. The UK Water Industry website reports that:

"Plans to change the structure of the company have been dropped. Instead the company is to concentrate on its core of water, sewerage and waste management. All the non-regulated businesses are to be sold except for Viridor waste and a small property management company.

The company said that the two windfall taxes in 1997 and 1998, combined with the recent regulatory review, meant that the company no longer had the resources to invest in the non-regulated business."

c) The challenges to be faced in Scotland

i) Need to fill information gaps

The information that is currently available in Scotland on costs associated with non-core business is very limited. Before the water authorities can determine if non-core projects are profitable or not, they will have to be able to allocate costs correctly between core and non-core business. A significant amount of work will need to be done before this can be completed accurately in Scotland. The appraisals of new ventures should ensure that there is no internal profit or loss declared, as this will distort the assessment of opportunities. It is imperative that these steps are in place before any new business ventures are undertaken.

ii) Need for efficiencies and delivery of capital programme

The authorities are wholly funded by public money, either through charges levied directly for water and sewerage services, or from loans from the Government (i.e. the taxes of customers). In order that customers receive the best value for money, therefore, it is important that the authorities are held to account for all monies spent.

Three factors that have suggested to me that non-core activities should have a very low priority at the current time. These are the three areas upon which management must focus if customers' interests are to be protected, namely:

- the delivery of the largest capital programme in the history of the Scottish water industry;
- the need to generate over £400 million of efficiencies annually and sustainably by 2005-6;
- the challenge and opportunity posed by the merger of the three authorities into Scottish Water (assuming this is approved by Parliament).

The scope and benefit to customers of achieving the efficiency targets is hugely more significant than even the most optimistic prognosis for non-core business. My review of the experience of the privatised companies in England and Wales clearly suggests that a significant amount of senior management time has gone into non-core opportunities; it is doubtful whether that this would be the best use of scarce management resources at this time. It may be different after 2005, as I noted above, when the efficiency frontier is being approached.

In many of my public meetings and in the quantitative research that I have commissioned, there is a clear consensus that customers want investment in the environment and in water assets. This was also confirmed by the Consultation of the Scottish Executive into the Quality and Standards options (see Chapters 4 and 15). Non-core activities cannot be allowed to distract management from the delivery of this programme. Even a fairly significant profit could not compensate the customer for non-delivery of the outputs of the capital programme.

d) Views of the Transport and Environment Committee

The issues surrounding new business were raised during the recent inquiry into water and the water industry. In a submission to the Transport and Environment Committee, the water authorities proposed the development of mechanisms to ensure that new business ventures would be effectively ring-fenced and would not act as a drain on the water authorities' core activities in terms of cash or other resources.

The Committees report states:

"In supporting the authorities' ability to invest in commercial ventures the Committee wishes to emphasise the importance of continuing to focus on core activities and fulfilment of statutory duties. The Committee notes that while different authorities indicated in evidence that they intended to fund ventures in different ways, (e.g. West of Scotland Water Authority from charges and East of Scotland Water Authority from efficiencies) in the absence of any new income stream being identified, the money would ultimately be sourced from general funds.

Consequently, it is certainly possible that customers already facing steep charge increases to fund necessary capital investment would not welcome also paying to fund speculative ventures. There is inevitably a dilemma in this difficult situation. However, the cost of not developing and retaining business must also be reckoned with – reducing industrial revenue due to lack of flexibility could lead directly to increased domestic charges greater than those required to fund the modest investment aspirations set out by the authorities.

The Committee recognises that the water authorities will require increased freedom to invest in commercial ventures. However, it supports the view that the water authorities should continue to focus on their core duties and should 'ring-fence' new ventures to ensure that they do not become a drain on resources."

I agree with the broad sentiments expressed by the Committee. From the customers' perspective, however, I believe that the real threat to revenue from on-site water management needs to be properly understood before this is used as a justification for non-core activities. I have developed my views on this in Chapter 11, where I argued that a proper understanding of costs and the setting of appropriate tariffs can mitigate much, if not all, of this risk.

e) Possible exception

One of the new situations where an authority should consider expanding beyond its core services relates to the needs of key large customers. It will be important to meet their needs in terms of levels of service, and this may involve the provision of some value-added activities. However, it is critical that in these instances customers pay a fair price for the services provided. It will not be straightforward to assess the costs of each major customer and to set appropriate tariffs, and consequently some interim measures may be required, which take the authority outside its core activities. The financial consequences of this would, however, need to be assessed very carefully by management - in advance of taking any action.

f) Assumptions in revenue cap calculations

Input assumptions for the financial model reflect my caution on non-core activities. Essentially, I am projecting a commercial return on the funds already invested or planned to be invested, and which have been taken account of elsewhere in the financial projections.

My analysis focuses on the proposed Scottish Water model, where all three authorities' information has been merged. I have assumed that the net profit attributable to non-core activity will grow to £1.8 million by 2005-06.

g) Conclusion

As outlined previously, core business in England and Wales is ring-fenced and customers' bills are unaffected by non-core business activities. A similar approach is needed in Scotland. The reaction of investors to non-core activities in England and Wales has grown increasingly negative and this is probably the most accurate reflection of the potential of these activities.

Important cautionary lessons should be learnt from the English and Welsh water and sewerage companies in their attempts to generate non-core business. Notwithstanding their limited success, it is important to note that they still represent potential competition and have made significant strides in organising themselves to compete for any opportunities that may arise.

It is my view that the authorities' main focus should be on ensuring that customers receive the best value for money.

Customers should not be exposed to any unnecessary risk, and should not be placed in a position where they are funding a loss-making project.

This will be best achieved by ensuring that the water authorities focus on the attainment of efficiency targets and delivery of the capital programme. Prices for customers are still rising during this Review period, but the positive outlook for prices for the next Review period could be threatened by a lack of focus on the major challenges during the next four years.