PLAYING WITH WATER?

The future of Anglian Water and the issues for public policy

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1. SUMMARY

This paper aims to stimulate an informed public debate about the major changes taking place at Anglian Water (AWS), the company responsible for providing water and sewerage services across much of eastern England. These changes, which were announced by its parent company, AWG plc, have two parts:

- ***A financial restructuring of AWS***, switching its capital from equity (shares) to debt (bonds). The company expects this to reduce AWS's cost of finance, some of which will feed through into lower customer bills, although not before 2007. It has not said by how much bills will come down – we guess it could be up to £20 a year per household. The restructuring, which cost £128 million (equivalent to £75 a household), is now completed.
- ***The outsourcing to contractors of most of the work currently done by AWS***, with the AWS employees currently doing that work being transferred into the contractors' employment. Although wrapped up in a single package, outsourcing is not an inevitable condition of the financial restructuring. As of mid November 2002, no announcement has been made about who the first contracts have been awarded to.

Although outsourcing is commonplace, AWS's plan is radical because it is a piecemeal outsourcing of the core water and sewerage operations to a multiplicity of companies. By contrast, in Wales (with which AWS is often compared), the great bulk of operations were contracted out to a single water company.

AWS's outsourcing plan represents a new and untested way of running water operations in Britain. It is therefore alarming to find the public documents showing:

- a confusion about the objectives of the outsourcing plan and what gains, if any, it will bring to customers;
- no serious recognition of how the proposed structure for water services in the Anglian region resembles the fragmented structure of the railway in the Railtrack period;
- an over-estimation of the similarities between Welsh Water and AWS.

Following a public consultation earlier this year, the government regulator for the water industry (Ofwat) reported widespread concern that AWS's plan could result in it losing control over its business, including from other water companies. To try to avoid this happening, Ofwat imposed a number of conditions on AWS through its licence.

Ofwat needs to make sure these conditions have real force. In particular, it has to insist that the first contracts for outsourcing are not signed until it has approved the procurement plan which AWS must present it with by 31 December. As well as details, that plan needs to address fundamental questions about the outsourcing, including:

- the objectives of outsourcing and the gains that it (as distinct from financial restructuring) will bring customers;
- why AWS has chosen to pursue a strategy that no other water company has adopted;
- how AWS will avoid the systematic problems with contractors that Railtrack faced; and
- how far management resources are being diverted from the day-to-day business of running water into the task of preparing for outsourcing.

It should also explain how far the sharp decline in 2001/02 in its 'overall performance assessment' ranking was to do with outsourcing or the preparations for it.

In truth, Ofwat, should have obtained answers to these questions months ago. AWS's proposal is an adventure into uncharted territory for the water industry. With its primary duty under the 1991 Act to ensure that the functions of a water and sewerage company are properly carried out, Ofwat should be able to reassure the public that what AWS is proposing is sensible and justified.

The public documents we have seen, though, do not point to such a comforting assessment. Rather, the way in which water services are to be run in the Anglian region is to be completely transformed in return for benefits that seem uncertain, arguable and modest in their scale. This makes it time for politicians to get involved, to seek from Ofwat and the company a properly reasoned case as to why what is proposed should go ahead.

2. INTRODUCTION AND BACKGROUND

The restructuring of AWG

This paper is concerned with the restructuring of AWG plc that was announced in November 2001 and, in particular, the changes to its wholly-owned subsidiary, Anglian Water Services Ltd (AWS).

As Anglian Water, AWS is the company responsible for providing water and sewerage services across much of the east of England, from Essex to Hartlepool. It is the largest and most prominent part of AWG.

The restructuring is a plan with two distinct parts.

- A financial restructuring in which AWS remains a wholly-owned subsidiary of AWG but financed largely by debt (bonds). At the same time, the value of AWG's shareholding in AWS is reduced. What is going on here is not that different from a homeowner (AWG) who takes out a new mortgage on their home (AWS), thereby reducing the share of it that they own.
- A programme of competitive tendering and outsourcing of most of the work that is currently carried out by AWS itself. While AWS will remain responsible for water services in the Anglian region, the great bulk of its work will be placed in the hands of contractors. As part of the outsourcing, the AWS employees doing the work now would be transferred to the contractors.

Box 1: The AWS outsourcing programme

At the time of its consultation over the proposals in January 2002, Ofwat described the plan as being 'progressively to outsource its operations and customer service functions … over the next three years', with reference elsewhere to it being *all* such operations and functions.[1]

The current understanding of the trade unions is that the intention is to tender the whole of the operations business by April 2007.

The initial outsourcing programme, up to April 2004, covers the following areas: Wastewater Pumping Stations and Networks (which itself may be divided geographically into four contracts); Biosolids logistics and disposal operation, Norfolk and Suffolk Water Treatment; and Norfolk and Suffolk Water networks.[2]

The purpose and focus of the paper

The purpose of this paper is to help stimulate an informed public debate around these changes. As of November 2002, the financial part of the restructuring has been completed. We still devote attention to it though, both because the company has always presented the two parts of the restructuring as a single package and because there are some important issues that deserve wider public attention.

By contrast, the rolling programme of outsourcing is still in its early stages and, to date, the first contracts have not yet been awarded. Partly because most of the real decisions to do with outsourcing remain to be taken, this paper devotes more attention to this part of the overall restructuring plan. But outsourcing is also the main focus of the paper because we believe that what AWS is proposing to do raises a fundamental question of public policy about what privatised utilities should be allowed to do.

What is that question? Outsourcing itself, whereby one company contracts with another to perform a task it previously did itself, is *not* the issue. It is already commonplace, including within the water industry.

But outsourcing on the scale and in the manner proposed by AWS is a different matter. As it goes ahead, AWS will gradually be reduced to a shadow of its former self, little more than a shell to administer and monitor contracts. The experience and practical know-how that currently exists within AWS will have been dispersed and diluted, day-to-day operational decisions will be taken by contractors rather than AWS, and the loyalty, commitment and sense of shared responsibility that all successful organisations depend on will have disappeared.

Box 2: Anglian Water's levels of service since 1996

Since 1996, Ofwat's annual 'Overall Performance Assessment' has provided an all-round measure of how well each company is serving its customers which allows comparisons to be made between the companies.

Over the four years from 1996-97 to 1999-00, Anglian averaged 3rd out of 10 among the water and sewerage companies, including taking 1st place in 1999-00. It was also 1st in 1999-00 when judged against all 24 water companies (only the 10 do sewerage as well).

Recent figures for 2001-02, however, (no rankings were presented for 2000-01) show a sharp decline, from 1st place to 6th among the water and sewerage companies. Even more disturbing, however, is that when judged across the industry as a whole on just water supply and customer service, the company dropped from 1st place to 23rd - out of 23.[3]

The question, then, is this: when and under what conditions should the managers of a privatised utility be permitted to embark on such fundamental change? Clearly, a failing company may require radical surgery. But at least until recently, Anglian Water was far from a failing company, being among the best performing in the water industry.

Ultimately, this is a question for the water industry regulator, Ofwat, one of whose two primary duties as laid down by the Water Industry Act 1991 is to 'ensure that the functions of a water and sewerage company [as specified in that Act] are properly carried out'.[4] But the regulator does not work in isolation but in a political framework. We believe that this is a moment when Members of Parliament, both those whose constituents are served by AWS and others, may wish to consider whether what is happening to AWS merits their attention.

Box 3: The water industry's regulators

There are three main organisations involved in the regulation of the water industry: the Office of Water Services (Ofwat); the Drinking Water Inspectorate (DWI) and the Environmental Agency (EA). They are government departments and operate in England and Wales.

Ofwat, the economic regulator, is in charge of setting prices, encouraging efficiency and promoting competition where appropriate. Under the 1991 Water Industry Act, its two primary duties are to ensure first, that the functions of a water and sewerage company are properly carried out and, second, that companies are able to finance their functions, in particular by securing a reasonable rate of return on their capital.

The DWI monitors the quality of drinking water through quality assessments provided by the water companies. It tries to ensure that water coming out of the tap is up to standard and safe to drink.

The EA is responsible for protecting and improving the quality of fresh, marine, surface and underground water. It monitors the investment made by water companies to reduce pollution, and consequent improvements in water quality. It also makes sure water companies are held responsible for the pollution they have caused. Unlike Ofwat and the DWI, the EA does not focus solely on the water industry.

The wider strategy of AWG

Although the focus of this paper is the changes to AWS, they are part of a wider set of changes to AWG. In particular, the financial restructuring of AWS helps the other five divisions within the group by largely freeing them of debt (almost all of which was transferred to AWS).[5] It is these divisions, rather than AWS, which are then expected to help AWG to grow its business.

AWG sees its business as 'infrastructure management' – "designing, arranging finance for, creating and operating the basic systems that we tend to take for granted".[6] One of the oddest things about the proposed outsourcing is that AWS is obviously in the infrastructure management business itself. One would have thought that AWG would want to retain a fully operational, as opposed to outsourced, AWS as a showcase for its skills.

Instead of valuing AWS's experience in this way, however, the strategy views the outsourced AWS operations as an opportunity for other divisions within AWG to bid for contracts. This at least means that there is some justification for the outsourcing from the point of view of the rest of AWG: AWS represents a potential market for them. By contrast, as discussed later, we struggle to find a justification for the outsourcing from the point of view of AWS's customers.

The recent history of some of the other AWG divisions has not been trouble-free. In particular, AWG had to write off almost £100 million to reflect the true worth of the former Scottish construction company, Morrisons, which it had only bought in September 2000 and which formed one of the five divisions in the group.[7] Some of the employees at Anglian see the acquisition of Morrisons as the moment when the turbulence at their company began.

The complex strategy pursued by AWG, of which the re-financing and outsourcing at AWS is but one part, stands in stark contrast to the strategy pursued by the new owners of Welsh Water, the not-for profit company Glas Cymru. The contrast is important because the strategy followed by AWG is often bracketed with the strategy followed by Glas Cymru, in both cases creating a debt-financed company in which all operations are outsourced. In reality, however, superficial similarities hide important differences.

First, debt-financing and outsourcing in Wales was a new strategy put forward by new owners who had bought the company from its previous owner. Second, something had to be done since under its previous owner, Welsh Water had gone broke. Third, ownership of Welsh Water is Glas Cymru's sole activity and its sole reason for existence. Where AWG's strategy is complex, therefore, Glas Cymru is simple and clear.

3. THE FINANCIAL RESTRUCTURING OF AWS

Who gains what, when from financial restructuring?

The basic argument advanced by the company for the financial restructuring is that it reduces the cost of the money it has to borrow. Replacing more costly equity (shares) with cheaper debt (bonds) therefore lowers one of major elements of the costs of AWS's business. Subject to the payment of a base dividend, AWS proposes to share the benefits of these lower costs equally between its customers and its shareholders.

But the company has not said what the size of this cost reduction might be, insisting that it is price sensitive information. Press reports on Welsh Water, whose business is also financed by debt rather than equity, indicate a reduction in the annual domestic water bill in Wales of first £10, and later £20, equivalent to between 4 and 8 per cent.[8] A rough guess, then, is that AWS customers might save up to £20 a year on their bills.

Although the company has not said how much customers will save, it has said that they will not see any reductions in their bills for some years - on current thinking, not before 2007.[9] But since the financial restructuring is now complete, costs must already be lower. What is the reason for delaying five years before handing something over to customers?

The answer is that the financial restructuring itself has cost a great deal of money, some £128 million,[10] of which more than £50 million went in the form of fees to the City institutions who arranged the re-financing.[11] £128 million is equivalent to £75 for each of AWS's 1.7 million domestic water customers. This is where the savings are going in the first few years. With that to pay for, it is entirely understandable that customers will have a five year wait for what is a welcome, but unspectacular, reduction in their bills.

The cost of restructuring is shocking but perhaps not surprising. A recent press article estimated that, since privatisation 12 years ago, the electricity industry had earned the City some £2 billion in fees for arranging various changes of ownership and other forms of financial restructuring, with one company, Eastern Electricity, having gone through no fewer than five changes of ownership in that period.[12]

In confirming the £128 million to its staff, AWS indicated that there were "significant benefits from this re-financing which justify this level of expenditure". Unfortunately, however, they declined to provide evidence for this claim, other than asking their staff to trust the company's judgement:

> *"As you would anticipate, we would not be undertaking this proposal if the benefits did not outweigh the costs. However, due to the price sensitive nature of the question, we are not in a position to say at this stage, how much it will save."*[13]

Others are not so sanguine. *The Financial Times* commentator, John Plender, has described the sums of money paid for the restructuring as "eye-popping", suggesting it shows that "the investment bankers seem to be bigger stakeholders in the industry than the shareholders" and insisting that, contrary to its belief that it had had value for money, AWG had in fact been "stiffed".[14]

Risks to customers from financial restructuring

Although the gains for customers from the financial restructuring are somewhat distant, they are at least gains. But are there not some risks for customers here too? Ofwat insists that it will protect customers from such risks. However, a recent report by independent consultants Oxera (on the capital structure of water companies) suggests there are grounds for doubting whether Ofwat would actually always be able to do this.[15]

The main reason why debt is cheaper than equity is that a bondholder is taking less of a financial risk than a shareholder. Bondholders get paid first, and what they get paid is fixed in advance. Shareholders, by contrast, get paid last, and only if there a profit out of which to pay them. Shareholders, unlike bondholders, can end up making a lot of money but they can also – unlike bondholders – get paid nothing if the company believes it cannot afford to pay a dividend this time.

But whatever financial risk there is in the water business does not go away as a result of financial restructuring. The worry that many economists have with bond-financed water companies is that some of that risk that previously fell on shareholders now potentially falls on customers. As a result of the restructuring, customers face the risk of having to payer higher prices at some point in the future if AWS's financial position deteriorates.

Ofwat has stated that it is determined to see that this does not happen:

> *"As Ofwat made clear in its consultation paper on the similar proposals for Southern Water, we consider that companies should be free to choose and take to the financial markets their own preferred capital structure, provided customers are protected from taking on additional risks."*[16]

While there is no doubting its determination to protect customers and ensure that the risks remain with the financial markets, the question is whether Ofwat will always be able to act as it is determined to do, especially in view of the fact that protecting customers' interests is only one of its duties. Oxera's report argues that the credibility of Ofwat's position depends on there being other firms in the market ready to purchase the water company that has failed. This might be a fair assumption if it is just one water company, but it is far less likely if several are in difficulty at the same time.[17]

It is impossible to reach a definitive conclusion here. However, there is enough doubt around to allow us to conclude that, even if the financial restructuring does eventually bring householders a £20 reduction in their bills, that gain would not come without a heightened risk that customers may, under some circumstances, have to pay something *more* to ensure AWS's financial well-being.

4. OUTSOURCING THE WORK OF AWS

Outsourcing – where one company hires another to perform a task that it once did itself – is now commonplace throughout British industry. Water companies are no exception.

But the outsourcing planned by AWS is unusual for a combination of two reasons: first, the extent of the outsourcing and second, the way in which outsourced operations are to be delivered not by a single company but – potentially - by many.

Outsourcing ‘core’ functions

AWS’s proposal is to outsource its entire operations and customer service functions by – according to the trade unions – 2007. Outsourcing on this scale means that it is not just support activities like IT, or the management of office facilities, which are put out to specialist service providers. Rather, it is the core activities of the company itself which are handed over to other firms to do.

Box 4: The growth of outsourcing

Outsourcing, or contracting out, became very popular in the 1990’s. It is based on the idea that by concentrating on their core competencies while outsourcing their non-core activities to specialist providers, companies can be come more efficient.

Catering, cleaning and building maintenance were among the first activities to be outsourced, followed by others such as IT, human resources, and legal services.[18]

Less common is the outsourcing of core activities which, when it takes place, is often in the context of a major change to the company’s structure.[19] Railtrack and Welsh Water are leading examples.

Outsourcing is currently much in fashion. Firms belonging to the Management Consultancies Association reported a 50 per cent rise in outsourcing fees in 2001 (to £1.2 billion), around one third of their total UK income.[20] Globally, the outsourcing market is said to be “worth tens of billions of dollars”[21]

It is this – the *scale and criticality* (to quote another water company)[22] of the activities being outsourced – which makes what AWS is planning quite different from the use that most companies’ make of outsourcing. It is also the thing that gives rise to the particular concern with the AWS proposal.

Ofwat has made clear that such concerns were widely held by the respondents to its consultation:

> *“A wide range of respondents expressed concern that such a strategy could potentially lead to loss of control by the regulated business or confusion over accountability. One water company respondent believed that outsourcing would increase the likelihood of compliance failures.”*[23]

Is there a precedent for AWS?

‘Loss of control’ and ‘compliance failures’ would be serious worries – but how well founded are they? In particular, does not the example of Welsh Water, which outsourced its entire operations in 2001, suggest that the responses to Ofwat were overly pessimistic?

Although one year is too short a period in which to draw firm conclusions, Welsh Water’s service level performance during the first year of outsourcing did lead to a sharp improvement in its ranking against other water companies, rising from 9th to 3rd (out of the 10 water and sewerage companies) and 20th to 11th (out of the 23 water only companies).[24]

The fact that Welsh Water has outsourced its entire operations and customer service functions is often cited as a precedent for AWS's outsourcing plan. In terms of scale, the comparison is valid. To concentrate on scale, however, is to miss a crucial difference between what could be called a *unified* model of outsourcing in Wales and a *fragmented* model in Anglian.

In Wales, the operation of the pipes, wastewater works and water treatment works were handed over to United Utilities, the principal water company in North West England. This means that operational decisions are being taken by a company with both a track record and a reputation in its 'home' region to protect.[25]

It also means that, although the outsourcing required the development of a new relationship between two companies, it did not represent a new way of running a water operation since the vast bulk of operational decisions were still in the hands of a single, vertically-integrated water company, in this case, United Utilities.

AWS is planning something quite different. Instead of a single company, there will be many contracts with potentially many companies (and groups of companies) each dealing with one particular piece of the AWS operation. This is a recipe for a fragmented model of operations, rather than the unified model used in Wales.

Thus, the first phase of the AWS outsourcing, covering Wastewater Pumping Stations and Networks, is expected to be let out under four contracts, divided along geographical lines – and this phase itself is just the first of four in the *initial* programme.

If AWS gets anywhere near outsourcing its entire operation in this fashion, it will represent a wholly new way of running water operations in Britain. AWS will certainly remain responsible both to the regulators and in law, but operations and operational decisions will be in the hands of a patchwork of companies.

Whilst this model of outsourcing has nothing in common with Welsh Water's approach, there is a precedent for it in Railtrack, where a fragmented rail industry was held together by a patchwork of contracts with a myriad of companies. Despite what must have been its intentions, Railtrack found it very difficult to hold its contractors to the standards it wanted. Indeed, it even found it difficult to monitor properly what was going on.

No doubt some of Railtrack's difficulties can be attributed to individual mistakes. The extent of the railway's failure, however, strongly suggests that there was something fundamentally wrong with the structure of the industry.

In pointing to parallels with Railtrack, it should be stressed that we are *not* claiming that AWS's plan for outsourcing will - or even might - lead to fatal accidents such as occurred at Hatfield.

What we are arguing, however, is that the plans for wholesale but piecemeal outsourcing will produce a structure for the water industry in the Anglian region that bears a strong resemblance to the structure of rail industry in the Railtrack period. Since Railtrack faced *systematic* difficulties in exercising control, it seems highly likely that AWS will too. Concerns about the potential loss of control expressed by respondents to Ofwat's consultation therefore seem to us to be well-founded.

Box 5: Fragmentation and the example of Railtrack

British Rail was responsible for all aspects of design, construction, maintenance and operation of the network. In 1992, the government decided to privatise it, choosing a model which, in the interests of stimulating competition, split track and infrastructure from operations.

The result was a highly fragmented rail structure - over 100 companies were created within three years and the railways went from being run by a single, unified structure to being run by a company with a minimal core (Railtrack).

This resulted in a series of problems which many in the rail industry think would have been avoided if the industry had remained more integrated. Christian Wolmar's book, *Broken Rails*, described them:

To win contracts with Railtrack, for example, companies competed with each other to offer the cheapest bid. Once the contract was awarded, staff numbers were cut, increasing work intensification and resulting in a fall in safety standards.[26]

The contracts were often loose. Maintenance companies, for example, had to maintain the track to an adequate level – with such general conditions, it was less likely that they would be held responsible for problems. Contracts were so weak that Railtrack found it could not withhold payment if a company failed to carry out their work.[27]

To counterbalance the weak contracts, Railtrack had to have a detailed contract on how it was to monitor the contractors' performance.[28] But with so many different interfaces, Railtrack found it did not have the resources to monitor contracted operations effectively ,especially since different contractors based their maintenance on different guidelines.[29]

One other difference between AWS and Welsh Water catches the eye. In Wales, the operation is branded as 'United Utilities working for Welsh Water'. As a result, the relationship and division of responsibility between the two companies is plainly visible to the public. By contrast:

> *"the Anglian Water brand will be the only visible standard as far as our customers are concerned. This will include our customer/marketing literature and stationery, van livery, uniforms and safety equipment."*[30]

Whatever the reason for this, its effect, unlike in Wales, will be to keep hidden from the public the profound changes in the operation of water services that AWS is making.

What is the advantage of outsourcing?

It must be assumed that changes as radical as those proposed by AWS would only be pursued either if there were some pressing necessity or if they offered significant gains which could not be had in any other way.

At the outset, large and easy to understand gains did indeed appear to be in sight. In November 2001, the month when the restructuring was announced, Mr. Pointer, AWS Managing Director, told staff via his homepage:

> *"We have made no secret of our plans to market test our services and use outsourcing more as a way of increasing efficiency within AWS. Experience elsewhere, such as the oil industry, has shown how successful this can be, making savings of 40-50% above those originally predicted."*[31]

At the same time, cost savings, which would feed through (admittedly in the long term) into lower bills were also identified by Mr. Mellor, Chief Executive of AWG, in a video for City investors, as one of the main benefits of the outsourcing for customers.[32]

Coming from a company that views itself as one of the leading water companies, it is extraordinary to suggest that costs could be so much lower if the company ceased to do the work itself. But if it is true, why cannot the management just get on with removing those costs instead of resorting to outsourcing?

Six months later, though, the prospect of such cost savings had not only receded but was even denied, at least as the primary objective of outsourcing. Thus, in response to an employee's question about how a contractor could possibly do everything that AWS did, make a profit and still save AWS money, the company's 'briefing' to employees explained that:

> *"While the CT&O [outsourcing] programme should provide some cost reductions, it is by no means the sole purpose of the programme. Our first and foremost reason, should we outsource, will be to provide greater certainty of costs to our lenders."*[33]

This emphasis on cost *certainty* rather than cost *savings* as the main reason for outsourcing is repeated elsewhere, for example in the statement that outsourcing was being considered "as a way of demonstrating to our lenders that we can transfer financial risk and obtain secure costs, not as a way of shedding directly employed employees".[34]

Cost *certainty*, though, is a less tangible idea than cost *saving*. In principle, it can be achieved at a price, with the contractor taking the risk in much exchange for a premium paid by AWS. But whether the contractor is *actually* taking the risk will often be a moot point. AWS argues that tightly defined contracts, including lists of 'who does what', can achieve the certainty it requires. This approach, it is suggested, will even be sufficient to ensure that AWS avoids Railtrack's problems:

> *"Many of you have highlighted the experience of Railtrack, where uncertainty of roles and responsibilities resulted in serious problems. We are ensuring that Anglian Water is not exposed in the same way by including detailed documentation on responsibilities."*[35]

But there are two parties to a contract, and tight definition can just as well serve the contractor by excluding certain risks and responsibilities.

AWS also argues that it can create contracts which "will clearly differentiate between incidents that are the result of asset failure and those which are affected by poor contractor performance", with penalties falling on the contractor only in the latter case.[36]

Statements like this are troubling. *If* contracts can be written that differentiate in this way, *then* contracting could potentially work. But *whether* they can does not basically depend on the skill of the contract writer but whether there is sufficient *physical* separation between the task being outsourced and the assets or activities for which AWS remains directly responsible. All the big problems arise in precisely those cases where a clear attribution of fault between the asset holder and the contractor is either not possible, or at least contestable. With that cue for the lawyers, the declared objective of cost certainty disappears altogether.

Neither does the pursuit of outsourcing reflect good recent experience within AWS; rather, as the example of 'Fast Response' (emergency repairs to critical bursts, leaks etc.) shows, the opposite is the case. Outsourced in 2001 on economic grounds,[37] its poor performance in dealing with unplanned interruptions to supply was picked out by Mr. Pointer as one of the reasons for AWS's slide down Ofwat's Overall Performance Assessment 'league table' in 2001/02.[38]

Finally, if direct gains from outsourcing are unclear, is AWS pursuing it because the lenders imposed it as a condition of the refinancing? Although employee representatives were for some time given this impression, AWS has since made it clear that it was its own decision rather than a lenders' condition.[39] What the company's lenders *did* require was that it should have secure cash flows – which makes complete sense – which in turn meant certainty over cost.[40] The decision, though, to pursue cost certainty by means of outsourcing was the company's.

The fact that there is no automatic or inevitable link between the re-financing and outsourcing is shown by the example of Southern Water, whose similar proposal for the financial restructuring of Southern Water did *not* include outsourcing.[41]

The conclusion is straightforward: unlike the financial restructuring where clear, albeit rather distant, gains can be identified, the gains that AWS expects to materialise from outsourcing remain a mystery. In practice, we strongly suspect that the most likely argument for outsourcing will be one of immediate cost reduction – although whether this is associated with higher costs either in the future or elsewhere (for example, a further decline in the level of training within the industry as a whole) is a moot point.

Box 6: Outsourcing, training and the skills shortage

A recent report from the Gas and Water Industry National Training Organisation (GWINTO) constructed a skills needs assessment in the water and gas industries.

GWINTO warns that outsourcing impacts negatively on the levels of skills of the water workforce. This is principally because contractors are reluctant to invest in skills, firstly because factoring in skills training into their contracts will increase their cost, thereby reducing their chances of winning the contract, and secondly, because contracts are only awarded on a short-term basis which makes long term investment like training less worthwhile.

This becomes a matter of concern given that the water industry is already facing a skills shortage. GWINTO estimates that the water industry needs to attract over 10,000 workers by 2010,[42] with the figure being higher still if the demands made by the EU Directive on water quality and waste water are to be met.[43]

The skills shortage is felt in a variety of areas, particularly water process management and engineering, but also asset, chain supply and contract management.[44] Contract monitoring is seen as integral to maintaining environmental and quality standards when outsourcing is used, so this shortage is a particular concern.

5. OUTSOURCING: HAS OFWAT DONE ENOUGH?

The conditions imposed by Ofwat

Whenever a proposal comes forward from a water company that would require changes to the licence under whose authority it operates, Ofwat, which makes those changes, is in a position of considerable power. In response to the proposal put forward by AWG, Ofwat required changes to the licence which the company had to agree to before the restructuring could go ahead.

The principal conditions imposed on AWS by Ofwat include:

- The setting up within Anglian Water of a water quality committee (and a similar committee for sewerage) wherever these functions are carried out by an outside contractor.[45]
- A 'Reporter' appointed by Anglian Water but subject to Ofwat's approval to "review, audit and challenge the work of these committees and report to Ofwat, the DWI and the EA upon the effectiveness of Anglian Water's internal controls."[46]
- The presentation to Ofwat of a three-year procurement plan, subject to an annual audit by the Reporter and updated every 18 months'.[47] In particular, this plan has to explain "how Anglian Water will retain control of contractors operations, including the ability to direct action and assume control of operations when necessary and to ensure the maintenance of assets so that serviceability to customers is maintained".[48]

What should we make of these conditions? First, they clearly show that Ofwat recognises that the outsourcing proposed by AWS raises issues to do with the maintenance of service quality and operational control. Those concerned with the AWS proposals are entitled to be encouraged by this.

Second, the conditions imposed by Ofwat are similar to those imposed on Welsh Water.[49] But the proposals in Welsh Water arose in a totally different situation, as an attempt by prospective new owners to find a way of rescuing Welsh Water, rather than as a radical departure by existing owners. Neither did outsourcing at Welsh Water alter the way in which day-to-day operational decisions were taken by a unified water company whereas the AWS proposals discards that principle. This raises the question of whether Ofwat's proposals go far enough in the sense of being tailored to the particular situation of AWS.

Third, the proposals came in from strong criticism from a number of water companies who saw them as bureaucratic and unnecessary. For example, "turning to the procurement of service provisions" wrote Yorkshire Water, "we regard provisions of this nature grossly over-intrusive into the management of a licensed water and sewerage undertaker. We are of the view that it is for the management of companies to manage them and not the regulators".[50]

What is significant about this sentiment is that we would expect Ofwat, along with every other economic regulator, to agree with it entirely. The fact that it is forced into imposing what do indeed look to be some very bureaucratic conditions is a sign of the contradictory position that Ofwat finds itself in.

A more robust approach towards procurement

The worry here is that it may inhibit Ofwat in its future judgements and in the vigour which it acts in this matter at precisely the moment when the opposite is required. Rather than drawing back, as some of the water companies want, Ofwat should take a more vigorous approach to AWS. A timely way to do that would be for Ofwat to signal that it attaches a high priority to the procurement plan that AWS is required to present to it before the end of the year, for its approval.

At the moment, it is unclear whether the procurement plan needs to be presented and approved before the first contracts are signed. Such clarification is urgently needed because once those contracts have been signed, the horse – at least the first few horses – will have bolted and Ofwat will have lost the opportunity to act in a protective way if it sees fit.

Questions that should already have been asked

The procurement plan, useful though it is as a check on AWS, is a document concerned with detail. The questions that really need answering are the ‘higher level’ ones about why the strategy is being pursued at all. They include:

- a clarification of the objectives of the outsourcing plan and the gains that it (as opposed to the financial restructuring) is expected to deliver to customers;
- an explanation of why AWS has chosen to pursue a strategy that no other water company has adopted;
- an explanation of how AWS will avoid the systematic problems with contractors that Railtrack faced;
- an account of the extent to which management resources are being diverted from the day-to-day business of running water into the task of preparing for outsourcing.

Ofwat should also be looking into how far the sharp decline in AWS’s overall performance assessment ranking in the year 2001/02 was to do with outsourcing or the preparations for it.

Ofwat has a primary duty under the 1991 Water Industry Act to ensure that the functions of a water and sewerage company are properly carried out. The radical and (for the water industry) unprecedented nature of the AWS proposals mean that it is less certain than usual that they will be properly carried out simply because AWS is proposing to move into uncharted territory.

In view of its statutory duty, it is Ofwat’s responsibility to know why AWS is taking this course, for whose benefit, whether it has an adequate approach to overcome the problem of a fragmented structure, and whether preparations for the journey are placing existing operations under strain.

These questions should have been asked of AWS many months ago. As guardian of this industry, they should also be asked of Ofwat. Customers and employees have a right to answers and the moment has come for the politicians to ensure that those responsible provide them.

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