

**T. Martin Blaiklock**  
*Consultant*  
*Infrastructure & Energy Project Finance*

182 Broom Road,  
Teddington,  
Middlesex TW11 9PQ, UK

Tel: (44)-208-255-3851  
E-mail: tmbaiklock@aol.com

---

February 19, 2014

**Consultation : “Board Leadership, Transparency & Governance – Holding Company Principles”**

Sir,

I wish to contribute to the above Consultation.

- 1 As I stated in my October 2013 submission on this topic, I welcome OFWAT’s initiative to tighten up on Board Leadership, Transparency and Governance of E&W Water Utilities. I also note OFWAT’s intention that Licensed Utilities should, to a great extent, be self-regulated under the proposed Principles. However, whilst that may lead to an easy life for OFWAT, it is not, in my view, the recipe for clear, robust and sustainable regulation of privately-owned, monopoly public services in the 21<sup>st</sup> century!

The past 10-15 years of E&W’s privatised water sector have not provided much evidence that the Utilities have the conscience or managerial will to put customer/public service first, as their prime corporate objective, with profit as a subordinate aim. Indeed, in many cases, - albeit not all, - the reverse has seemingly taken place.

Hence, I believe that, a firmer line needs to be taken by the Regulator than has been evidenced to date in the proposals.

As a start, given that over 60% of the sector falls under ownership of Private Equity, I was concerned to note that OFWAT chose to use as one of its reference points the Walker “Guidance for Disclosure and Transparency for Private Equity” [ref. p. 6] in this matter. To some, that is tantamount to using the “Poachers’ Manual” for issuing salmon fishing licences!!

The fact is that less than 40% of the sector is now subject to the requirements of the London Stock Exchange, and the “gold standard” of Investment Grade status for Licensed Utilities’ debt is coming under threat.

With over 60% of the sector owned by Private Equity, mostly domiciled overseas and outside UK tax jurisdiction, such Utilities can be characterised as having owners:-

- (a) who have little incentive, if any, to put service before profit;

- (b) whose investment objectives are generally short-term, whereas the underlying asset characteristics of the sector are (very) long-term.
- (c) who have no qualms about increasing the leverage in Utilities, provided they continue to provide the anticipated equity returns for investors, leaving little margin for the utility to weather any unforeseen costs and events;
- (d) who owe nothing to UK society, so feel no responsibility for being “good citizens”, e.g. paying UK taxes; and
- (e) who have assigned managerial responsibilities for their investment to third parties, who fall outside the Regulator’s remit and who seek to “churn” the investments every 3-5 years, so as to maximise their profits through management and ‘carried interest’ fees.

As a result, OFWAT needs to be proactive in protecting customers in this scenario. The standards laid down in 1991 are largely out-of-date today. All E&W water utilities are much less financially robust than they were in the early 90’s.

Hence, water companies’ licences need to be much more proscriptive as to:-

- the levels of debt which are deemed acceptable;
- the levels of investor returns which are deemed acceptable, e.g. if too high, then debt should be repaid early;
- the corporate and taxation structures adopted by the Utility; and
- the expected standards of governance and accountability imposed by the Regulator.

2 OFWAT has focussed in this Consultation on three important and interdependent characteristics: Board Leadership, Transparency and Governance.

Equally important criteria, such as Financial Control, Accountability and “Responsible Citizenship”, as mentioned in my previous submission, have been passed over.

All six characteristics overlap to some degree, but they are all equally important.

### 3 **Board Leadership:**

As before, I have nothing to add to OFWAT's proposed Principles for this criterion. My only concern is how these Principles can be policed in practice. There is a huge reliance on the good faith of mankind, and no sanctions are identified. Furthermore, the underlying complex structures of many Utilities allow directors to assume multiple roles, which in turn create the potential for conflicts of interest, .....as well as opportunities at multiple levels for the payment of director fees, etc.!!

### 4 **Transparency:**

OFWAT's Proposal remains weak in this area. With over 60% of E&W water utilities owned by non-UK shareholders, often via Limited Liability Partnerships domiciled in tax-havens, transparency is a myth. The underlying financial and managerial arrangements between, shareholders, shareholder Funds, Fund managers, and the Licensed Utility are opaque and can change without public knowledge. Further, the value of share transactions arising out of any changes in ownership are not recorded in the public domain.

For example, take Thames Water, the largest E&W Utility:-

- (a) There are 7-10 corporate layers between the E&W Licensed Utility, "TWUL", and its shareholders. Each layer requires its own administration (i.e. directors, costs/fees, lawyers, accountants, etc.).
- (b) In 2011/12, 30% of Thames Water shares changed hands (offshore, in Luxembourg) for undisclosed amounts.
- (c) Thames declares, under Condition P, an Ultimate Controller based in a tax-haven (Luxembourg), with this Ultimate Controller assigning management responsibility to a third party (i.e. General Partner, or investment bank (Macquarie) back in the City of London), over which OFWAT has no regulatory control or sanction;
- (d) the management of Thames Water not knowing, or prepared to disclose, the arrangements between Thames and the Ultimate Controller. As to the arrangements between the Ultimate Controller and the General Partner, who knows??;
- (e) Thames Waters' Accounts, as a Licensed Utility, state that "the Directors do not consider there to be an ultimate parent or controlling party", which seemingly conflicts with the Condition P requirement; and
- (f) Thames arranged a £10 bn. multicurrency bond issuance program, - which is greater than Thames' current reported long-term debt, - via a Cayman Island-domiciled subsidiary in Jun 2012. I am informed that the Registrar of Companies in Cayman can only, by law, release the name, type of company, date of registration, address of registered

office and company status. Corporate information, accounts, charter and list of directors for Cayman Island-registered companies are only available under a court order.

Many will question whether the above features (for Thames Water, as just one example) represents the standards of transparency, governance and disclosure expected of a UK private sector, public service monopoly.

The OFWAT proposals remain, therefore, weak for this criterion. I repeat, as before, that there is good reason for UK privatised public service utilities to always remain as London Stock Exchange-quoted companies, whatever their ownership, thereby ensuring a degree of, - albeit not complete, - public transparency and accountability (see below).

## 5 **Governance:**

Notwithstanding OFWAT's intentions, corporate leverages of E&W water utilities have increased across the board over the last 20 years to a level where the underlying utility is at risk against unforeseen events, i.e. they have only limited financial resources to meet unforeseen costs. They are also more vulnerable to their creditors.

Interestingly, the Jun 2012 Prospectus for the £1 bn. FRN issued by Thames Water (Kemble) Finance ("the Issuer"), supported and arranged by Barclays, Deutsche Bank, JP Morgan, Morgan Stanley, RBC Capital Markets, SocGen, BNP Paribas, HSBC, Lloyds Bank, Nat. Australia Bank, Scotiabank and RBS, stated:-

*TWUL's indebtedness is substantial in relation to its RCV. ....Accordingly, there can be no assurance of TWUL's ability to meet its financing requirements and no assurance that TWUL's high degree of leverage will not have a material adverse impact on its ability to pay distributions to its shareholders, and ultimately the Guarantor (Kemble Water Finance Ltd, another subsidiary), to enable the Issuer or the Guarantor to pay amounts due and owing in respect of the Notes.*

Additionally, Utility shareholders have oft benefited through dividend payments higher than what might have been expected for investment in monopoly public service utilities. Many Utilities have also adopted aggressive taxation policies, to enhance dividends, through the use, - quite legally, - of shareholder loans/sub-debt at excessive interest rates, e.g. 8-12%, which has short-changed the Exchequer to the benefit of non-UK domiciled shareholders and their managers.

[NB. it is understood that, under HMRC guidelines, interest on shareholder loans is allowable as a cost before tax, provided there is a good 'commercial' reason. However, many may consider that "tax optimisation" structures, such as the use of shareholder loans instead of equity, - albeit quite legal, - is a 'financial', not 'commercial', issue.]

Given these trends, OFWAT should provide Utilities with financial boundaries within which Utilities should operate.

## **6 Financial Control, Accountability & Responsible Citizenship:**

Water Utilities, as public service monopolies, should be seen to adopt policies and strategies, which represent “good citizenship”. Aggressive tax minimisation structures should be outlawed, and financial constraints on measures such as leverage and aggressive dividend policies imposed in the spirit of assuring the long-term sustainability of the utility.

I accept that, within this criterion, there is a fair degree of subjectivity. However, a prudent Regulator should err on the side of caution rather than adventure. “Lines in the sand” should be drawn as to OFWAT’s demands and expectations in this respect. If a Utility breaches these measures, then fines should be imposed, with the ultimate sanction of licence withdrawal\*.

[\* = it is of interest to note that over the last 20-25 years no significant UK privately-owned public service monopoly has yet had its licence revoked by a Regulator.]

What should be clear in any OFWAT proposal for “Responsible Citizenship” is the balance of responsibility. It should be for the Utility to demonstrate under its licence that it measures up to the Principles or standards required, and not for the Regulator to have to impose the standards and police the miscreants.

Some governments already do this (viz. Victoria Govt., Australia), where a probity condition is imposed on private entities delivering a public service.

A breach of this probity condition is described as:-

- an event which has a material adverse effect on the character, integrity or honesty of the private party or an associate;
- an event relating to the entity or an associate, which has a material adverse effect on the public interest or public confidence in the service; and
- an event which involves a material failure by the entity or an associate to achieve or maintain reasonable standards of ethical behaviour good corporate citizenship, avoidance of conflicts of interest or other standards of conduct expected of a party providing a public service.

Given that most of the modern “technology” developed in recent years, through the use of Private Equity Funds for infrastructure and investment in public service assets, has been developed by Australian banks, OFWAT should take note.

Overall, this Consultation has been a move in the right direction, but still lacks boldness and realism.

Like the Duke of Plaza-Toro, I shall follow future developments on this topic with interest. .