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OFWAT Consultation on the PR14 Reconciliation Rulebook

I wish to comment on the above Consultation.

A: The Price Review Process [e.g. PR14]:

1. Dieter Helm, Professor of Energy Policy and Fellow in Economics at Blavatnik School of Government, Oxford, Chairman of the DEFRA Natural Capital Committee, and an internationally renowned commentator on public service utilities, stated in the introduction to his Paper: *“Utility Regulation, the RAB and the Cost of Capital”*, in May 2009 that:-

“There are a number of reasons why the great British privatization experiment may have run its course. At the heart of privatization are two fundamental ideas: that equity is a necessary condition for maximizing incentives; and that private balance sheets play an important role in financing investment. Both of these have now been seriously undermined: there has been a flight of equity since the mid-1990’s, accelerating after 2000; and financial engineering has exhausted balance sheets and broken the link between physical investment and borrowing”.

2. Six years on and how true this statement is! With water and sewerage services being private sector monopolies, the argument is even more powerful today.
3. Prof. Helm concludes in his Paper:-

“In classic British pragmatic style, what began as a crude and simple fixed-price, fixed period regulatory rule has migrated into a model for a more efficient allocation of costs and risks between customers, investors and taxpayers. RPI – X is now, in practice, unrecognizable against the initial model. The process of this evolution has been driven by regulators exercising discretion, by events, and by public pressure over both the quality of service and the prices”.

“This process has had many benefits, but it has costs too, not least the degree of micro-management and the sheer complexity of the periodic review process (viz. PR14: author comment). At the limit, water companies now produce enormous submissions of their business plans. The end product is pregnant with an efficient approach to regulation, but so far it remains expensive and the end result for customers and the economy more generally is far from a satisfactory level of provision, service or costs.”

4. The recent PR14 Price Review and, now, the Reconciliation Rulebook are the culmination of this broken regulatory regime and a fine demonstration of all what Prof. Helm identified 6 years ago.

It is high time for a “root and branch” reform and revision of the regulatory regime and its underlying procedures.

5. For the last 25 years, the England and Wales (“E&W”) water sector regulation has been based primarily on economic criteria, whereas investors, - equity and bond investors, who represent the majority source of debt to the sector, - operate in a financial or “actual” world. Financial engineering, indeed, has been employed by many, usually unquoted, utilities to shareholder advantage.

Taking 2013 figures, as an example, the E&W water sector had:-

- revenues of around £11.5bn.;
- paid to HMRC corporation tax of only around £100mn, and;
- paid £2.2bn as dividends to shareholders.

It is not surprising, therefore, that PwC (also see Sec C) produced a Report in Dec 2013 entitled *“UK Water: Delivering Returns beyond Shareholder Expectations”*.

6. One concludes from such evidence that E&W water regulation to date has been somewhat benign. Rarely, if at all, has a water utility had its licence threatened or withdrawn due to breach of, or unsatisfactory, performance. Whilst licence withdrawal is the ultimate sanction, - undesirable and possibly costly to remedy in the short-term, - its perceived absence as a tool can be taken as a sign of weakness in the regulatory regime. Prima facie, the investor is favored over the customer.
7. This imbalance between investor and customer under the regulatory regime is sustained by the Regulator itself, as demonstrated by the fact that 2, if not 3, times a year OFWAT makes a presentation to investors in the City, yet fails to provide a similar public forum to meet customers, relying solely on the CCWater mechanism to represent customer interests.

Unfortunately, regional CCWater units are not equipped to challenge utilities on many regulatory and financial issues, and are themselves not immune to corporate pressures from large incumbent water utilities.

B: Flaws Underpinning the Price Review Regime:

1. Anyone reading and assessing the PR14 proposals, supporting Studies and Reports, the Final Determinations, and, now, the Reconciliation Rulebook, unless an industry insider, is faced with a barrage of unexplained acronyms and terminology.

If the regulatory regime is to gain back the confidence and trust of customers, - as the OFWAT Chairman aspired to at the Aug 2014 City Briefing, -, its output, and that of the water companies, needs to be much more user-friendly and comprehensible. That does not mean dumbed-down, but the use of clear, objective and succinct terminology in all communications should be paramount.

2. As Prof. Helm stated, the regime is burdened with complexity, which brings with it added bureaucracy and administration both for OFWAT and the water companies. It also hinders customers' ability to comprehend the system and undermines customer trust and confidence. The processes underpinning PR14 and now the Rulebook provide ample evidence of this malaise.

The result is a regulatory regime, based on proposals and recommendations proposed by legions of consultants and accountants, embracing a complexity, which assures lifetime employment for themselves, - along with the lawyers to challenge any breaches, - monitoring KPIs ("Key Performance indicators"), preparing yet more studies, and ticking boxes. It has also spawned water company annual reports littered with largely meaningless and self-congratulatory KPI analyses, rather than highlighting the hard facts of price versus cost of service delivery.

A simple, transparent and effective regime is called for [see Sec D].

3. One of the key components in OFWAT's Price Review ("PR"), which determines what the water companies can charge customers, is the Cost of Capital, i.e. for PR14, the financing costs over the period 2015-20, which the water companies will incur in undertaking investment in new assets, either for new infrastructure projects or to replace existing assets.

The way OFWAT goes about this, we are told, is to estimate the cost of capital for an imaginary, or "notional", water company. OFWAT also makes an assumption as to how much debt and how much equity, - often referred to as "gearing", or "leverage", a term which can be interpreted in a number of ways, - which makes up the capital structure of this notional water company.

4. "Gearing", in OFWAT's interpretation, is the proportion of equity against the RCV (Regulatory Capital Value), representing the enterprise value of the notional company based on economic criteria.

5. The RCV for each water company, determined annually, is derived from:
 - (a) the RAB (Regulatory Asset Base) representing the average market value for the company for the first 200 days following privatization in 1989-91, plus the value of the outstanding debt at that time;
 - (b) an adjustment to the RAB (which represents sunk costs) for inflation for the interim period since privatization, using RPI;
 - (c) plus an adjustment for the cost of renewals or new project investments undertaken in the period in question,
 - (d) less current-cost depreciation on existing assets in that period.
6. With respect to the cost of equity and debt, to which gearing is applied, OFWAT employs the economists' methodology of the CAPM ("Capital Asset Pricing Model"), which includes subjective estimates of country/market risks ("Asset Beta") and sector risks ("Equity Beta"), which may not necessarily reflect market realities. Indeed, realistic market comparators are arguably non-existent for a UK monopoly public service provider such as a water utility.
7. A final flaw arises in that OFWAT only undertakes and fixes its tariff-setting "Determinations" every 5 years. Hence, the Determination arising from the Price Review is not dynamic, or variable, in an increasingly unstable world for medium/long-term finance.
8. Logical though OFWAT's methodology might seem, 25 years on and the strains and integrity of the underlying assumptions are apparent. This is exacerbated by the fact that many of the originally privatized companies are "off-market", so there is no market measure to cross-check RCV values. The only measures available are provided by the ratings agencies, which are purely advisory and focus on debt exposures rather than corporate sustainability. The RCV, as a measure to be used for tariff-setting, has arguably reached its sell-by date.
9. Given the passage of time since privatization, a more realistic methodology might be to use debt/equity proportions as reflected in the audited company accounts, with the cost of equity and debt reflecting actual market costs. In this context, the cost of equity will always be somewhat subjective, but in the overall corporate structure equity represents a small(er) proportion than debt, so any variance is minimized.
10. Furthermore, it is not impossible to have annual adjustments for on-going, as opposed to capital, costs, as many public-private partnerships ("PPP") structures employ with some success. Further, annual incentives can be introduced through "caps" and "collars" on actual costs incurred.

11. Over the last 15 years, OFWAT has chosen a conservative equity/RCV ratio, assuming more risk capital, i.e. (costly) equity, in the water companies' structures than might otherwise have been expected if a purely accounting methodology had been employed. Hence, the water companies' actual outturn cost of capital has been less than the OFWAT Determination, allowing the water companies greater opportunity to reward shareholders.
12. Likewise, the cost of debt has steadily decreased over the period, allowing the water companies to increase their debt/equity ratio, gearing or leverage. Again, this has allowed an additional opportunity to reward water company shareholders than was foreseen through increased indebtedness.
13. From OFWAT's standpoint, their obligation is to ensure that the water companies are able to finance themselves so as to undertake the activities under their licence. Further, OFWAT is not allowed under the Regulatory regime to intervene as to how the companies actually fund themselves.
14. Sadly, privatization in 1991 did not foresee these weaknesses in the Regulatory regime, currently exploited by owners, who might hold short-term profit as a higher priority than long-term financial and corporate sustainability.

Given current circumstances and OFWAT's apparent passivity, it is time for customers to demand change and review!

C: Systemic Governance, Integrity and Conflicts of Interest.

1. The E&W water companies are private sector monopoly public services. Hence, the highest standards of corporate integrity and governance must be expected as a matter of course. Some countries, e.g. Australia, demand that private providers of public services have to pass a probity test. Not so, the UK. It is assumed that the general regime of corporate governance in the UK suffices. In my view, it does not. Conflicts of interest abound, which leaves the door open to corporate and financial abuse.
2. For instance, the same company, PricewaterhouseCoopers LLP ("PwC") :-
 - has been Auditor (2010-2014) to half of the major UK privatized water companies [i.e. 9 out of 19, e.g. Anglian; Bristol; Affinity; Southern; Bournemouth/Sembcorp; Dwr Cymru; SouthWest; Yorkshire; and Scottish], representing, in revenue terms, about 45% of the total UK water sector revenues.
 - apart from acting as Auditor to such companies, PwC has often provided advisory services to many of the water companies it audited. This included advice and guidance on tax and in the preparation of the water companies' Business Plans demanded by OFWAT's Price Determination (PR14, etc.), e.g. Anglian.

- In 2007-8 PwC undertook studies for OFWAT with respect to the financing of the proposed Thames Tideway Tunnel, albeit a project under Thames Water responsibility, not OFWAT.
- In 2008-9 PwC undertook studies for OFWAT with respect to the financing of major capital projects.
- For the 3 years, 2010-13, the formative period for PR14, PwC were the Internal Auditor for OFWAT
- For the period 2010-2013, PwC provided advice and guidance to OFWAT with respect to risk management and systems each year [ref. OFWAT Annual Reports, 2010-11, p 37; 2011-12, p. 37 & 2012-13, p. 45].
- During 2013-14, OFWAT was preparing for PR14 and employed the services of PwC, not only as Internal Auditor, but, in addition, to undertake various studies specific to PR14, since published on the OFWAT website:-
 - the WACC (Weighted Average Cost of Capital) to be chosen for PR14 [ref. *“Economic Assumptions for PR14 Risk Analysis”*, July 2013, and;
 - the impact of PR14 for customers [ref. *“Updated Price Limits Impact Assessment”*, Oct 2013].
- In July 2013, in addition to being Internal Auditor to OFWAT, PwC were appointed as OFWAT’s “Delivery Partner” for PR14. This contract had a value of up to £6.45 million [ref. OFWAT Ann. Rep. 2013-14, p 78].
- OFWAT Annual Accounts and the approval of PwC as Delivery Partner were approved by NAO [ref. OFWAT Ann Report, p. 78], and seemingly there was no reaction from CCWater either.
- In October 2013, OFWAT replaced PwC, as Internal Auditor, and appointed Grant Thornton. The reason given by OFWAT was due to *“conflicts of interest following PwC’s appointment as “PR14 Delivery Partner”* (ref. OFWAT Ann. Rep. 2013-14, p 46).
- In Dec 2014, OFWAT gave PR14 Final Determinations on tariffs 2015-20 for all E&W water companies, supporting their decision with a new PwC study: *“Updated Evidence on the WACC for PR14”*
- This Consultation on OFWAT’s proposals for the “Reconciliation Rulebook” (“RRB”), which is underpins and polices PR14, is supported, yet again, by a PwC Report, *“Recommendations for RRB for PR14”*.

The above Rulebook sets out the mechanism for rewarding or penalizing water companies should they over-, or under-, perform respectively during the Price Review period.

Within this PwC Report, recommendations are made with respect to a number of incentives and penalties, including adjustments for inflation, the time value of money, and the impact of taxation, the same topics for which PwC seemingly has the water companies as clients!.

- Finally, in March 2015, DEFRA, jointly with the Welsh Government, approved and appointed Alan Lovell as Chairman of CC Water, to take effect April 1st, 2015. Among his other appointments, Mr Lovell is “an adviser to PwC” [ref. CC Water news item].

3 Conclusion:

PwC is an LLP and is understood to have "Chinese Walls" between their advisory and auditing activities. However, as LLP's, PwC partners share in the same remuneration and bonus pool, i.e. Chinese Walls are a myth when it comes to profit share-out!

As noted above, throughout the PR14 process PwC was auditing and often advising, - albeit to what extent is undisclosed, - approximately half of the UK's water companies on their Business Plans, assumedly for PR14, whilst at the same time advising OFWAT, the Regulator, as to what should be allowed in such PR14 Business Plans, and then later how to police the water companies!!! PwC were advising both the regulated and the regulator!!

The possibilities for conflicts of interest are obvious, and, to me, unacceptable for the operation and regulation of UK privately-owned, monopoly public service utilities. Given recent Parliamentary scrutiny of some of PwC's advisory activities, PwC's relationship with the water sector needs review to protect customers.

Unfortunately, there is no public forum for customers to challenge OFWAT or the water companies over such appointments and possible conflicts of interest.

D: Transparency:

1. Transparency goes hand-in-hand with trust and confidence. However, with many of the E&W water companies now owned by overseas investors, the trend has been against transparency.
2. By way of example as to the lack of transparency in some water companies, take Anglian Water, which by coincidence is audited and advised by PwC:-

Throughout the 1990's, Anglian Water represented a simple structure:-

Anglian Water plc. [quoted on the London Stock Exchange]



Anglian Water Services Ltd. [licensed by OFWAT]

During 2000-2005, the licensed company was restructured to:-

Anglian Water Group plc.



Anglian Water Group Ltd. [UK registered]



Anglian Water Services Holdings Ltd.



Anglian Water Services Overseas Holdings Ltd.
[Cayman Islands registered; UK tax resident]



Anglian Water Services Ltd. [licensed by OFWAT]

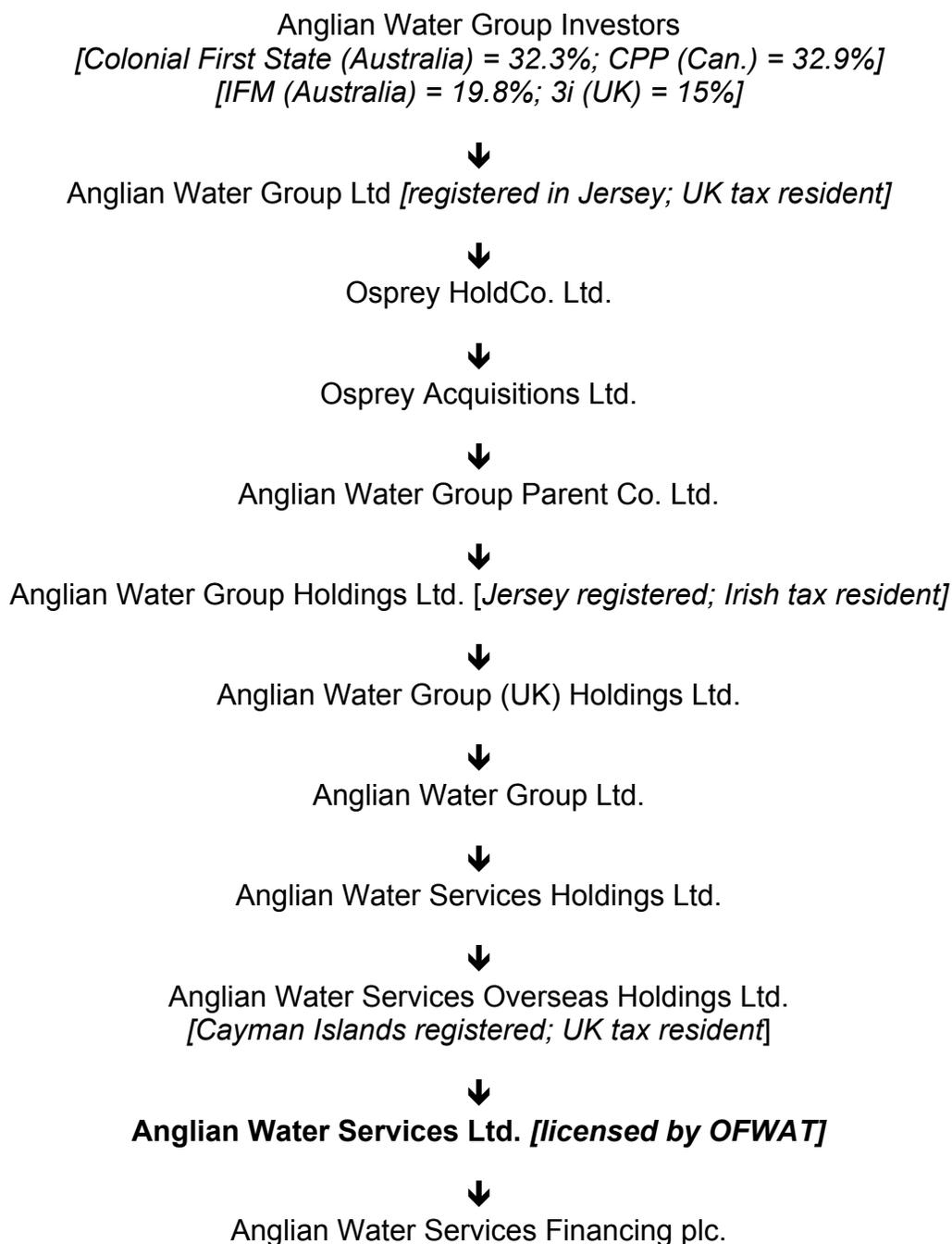


Anglian Water Services Financing plc.

[ref. Anglian Water Ann. Report 2005, p1.]

In 2006, the company was taken private, i.e. off the London Stock Exchange. After that date, Anglian being a private company, Directors remuneration was not published in the Accounts.

By 2013-14, the structure was:-



[ref. Anglian Water Services Ltd, Ann. Report 2013-14, p. 12.]

PwC has been Independent Auditor (at least) for the years 2000-2014, and oversaw the changes in corporate structure. Their audit fee for 2013/14 was £200,000, and the advisory fees £400,000, which included tax and “advisory work in relation to the business plan”, i.e. PR14.

Of course, it should be noted that PwC was also Delivery Partner and an advisor to OFWAT on the PR14 process during this period too!

Anglian Water Recent Financial Performance:

[£mn]	2010/11	2011/12	2012/13	2013/14
Revenues	1100	1092	1163	1214
Profit before Tax	397	295	302	352
Tax Paid	52	29	6	3
Dividends	281	448	310	442

Total Dividends (2011-2014) = £1481mn; (2012-14) = £752mn

Total Tax Paid (2011-2014) = £90mn. (2012-14) = £9mn

Features from the Accounts:

1. The reasons for the complex and multi-layered structure, as now pertains to Anglian, are far from clear. For every subsidiary there needs to be directors, lawyers, tax advisors and auditors, who all command fees. Such a structure can financially leak like a sieve! The overall corporate aim of ownership of an essential, privatized UK public service is lost. Such structures should be outlawed.
2. Multi-layered corporate structures allow directors' remuneration to be split between the regulated and unregulated activities. For example, with Anglian 2012/13 and 2013/14, the CEO's total remuneration was boosted at least by 150% by non-regulated activities, with the Chairman's remuneration by almost 100%. Other multi-layered E&W water utilities show similar trends.
3. The trend of increasing dividends at Anglian at the expense of tax paid is obvious. Of the E&W water companies, Anglian is not alone in exhibiting this trend.
4. The 2013/14 Accounts show that Anglian has two sub-debt / bond facilities of £100mn each, one with an interest rate of 12.375% and the other at LIBOR plus 6.75%, somewhat higher cost than normal market debt. The use of such sub-debt to minimize tax should be outlawed.
5. The 2013/14 Anglian Accounts show that in the accounting year 2009/10 the CEO, now Chairman OFWAT, was paid **£8,101,226** [ref. p 120], well in excess of what one might normally expect a CEO in the UK water sector to receive.

The explanation is not very clear, but much of this was apparently relating to a Long-Term Incentive Plan agreed in 2007 and the termination of his contract of employment in 2010.

The 2009/10 Accounts provide some additional light on this payment in that there was an “Exceptional Operating Cost”, relating to restructuring, redundancy, and one-off costs, of £8.8mn (ref. p. 78). However, the same Accounts go on to say (ref. p. 111) that: “the long-term incentive schemes for the CEO and Mr are entirely linked to the performance of the Anglian Water Group Limited and not paid for by the company”. [uch comment fits with para 2 above.]

Hence, the payment of such incentives, by whom and where is somewhat obscure and, of course, Anglian Water Group Limited is registered in Jersey.

6. It has to be assumed that such payments to Directors passed scrutiny by OFWAT at the time, as well as by CCWater on behalf of customers.

E Final Conclusion:

It is to be hoped that the above analysis provides enough information to show that all is not well with the UK privatized water sector.

The regime has been allowed to develop and fester to investors' advantage over the years, and the customers have had to pay with little, or no opportunity to challenge or constrain excesses and abuses.

The proposed Reconciliation Rulebook just institutionalizes a bust system.

Change, however, cannot come about overnight, but OFWAT should:-

- indicate to all the companies under their regulatory regime that institutional change over PR14 will be brought about by the time PR19 is introduced;
- ensure that the advisors to the Regulator and the water companies are not one and the same entity. Total independence is required;
- outlaw opaque corporate and funding structures and impose standards of probity. Further, all owners should be signatories to the UN PRI. These measures should apply not just to Anglian, but all other utilities, including Thames Water;
- ensure that the ultimate ownership and the values of any sale/transfer of shareholdings are placed in the public domain; and
- via the CCWater network, provide an opportunity, at least once per year, for customers to meet and challenge the Regulator and the incumbent regional water companies' directors as to their corporate and operational activities.