T. Martin Blaiklock
Consultant
Infrastructure & Energy Project Finance

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

Tel: (44)-208-255-3851
E-mail: tmblaiklock@me.com

October 13, 2016

Consultation: "Cost of Debt"

Sir,

I wish to contribute to the above Consultation.

1 In Jan 2016, the Public Accounts Committee ("PAC"), in response to an NAO Report on "The Economic Regulation of the Water Sector" [ref. HC 487, Oct 2015], concluded:

"The Water Services Regulation Authority's (Ofwat's) approach to setting price limits for water companies in England and Wales has not resulted in the best possible deal for customers. By consistently overestimating financing costs, Ofwat has allowed companies to make windfall gains which have not been shared in a structured way to ensure customers get a fair deal", [ref HC 505, Jan 2016].

2 This statement reflects my own conclusions, as a result of analysis of the sector over the last 10-15 years. Whilst I applaud OFWAT for reviewing the process for arriving at a cost for debt, debt represents only one component of the tariff structure, and I am saddened that this Consultation is not wider in scope.

3 The fact is, as the PAC have opined that, in effect, the basis for tariff setting for England & Wales water companies is "not fit for purpose". Root and branch reform is required. The model set up 25 years ago, at privatization:-

- has not been fully to customers' benefit (ref. PAC conclusion);
- mis-allocates some of the risks fundamental to the delivery of a public service; and
- has allowed investors in water companies to make excessive profits for the risks assumed

4 The rationale for reform is even stronger when one recognises that over the last 25 years not one, to my knowledge, water company has had its Licence revoked because of bad service, …………………… yet the owners have, as the PAC confirms, walked away with windfall profits.

The Flaws:

5 This ‘Cost of Debt’ Consultation is based on a CEPA Report, - all 258pp of it; how much did that cost? - covering and comparing approaches to setting the cost of debt in the UK water and airport sectors.

Firstly, the water and airports sectors are totally different. One is a monopoly public service, whereas the other operates in a competitive market. Secondly, most of the analysis is undertaken from an ‘economic’, as opposed to an ‘actual’, standpoint: a fatal flaw (see below).

6 **Flaw No. 1**: private water companies live in an ‘actual’ world. Their revenues and costs, including finance, are received, or paid for, in ‘actual’ money, i.e. the currency the population uses daily. Further, customers for the water services provided also live in an ‘actual’ world. Inflation, tax, etc., hit them both in the same way.

Why, then, are water tariffs calculated and based on ‘notional’ assumptions, which are, at the best of times, determined by fictional data, notwithstanding that such data may be based on sound ‘economic’ theory?

To the service providers and their customers, tariffs have “actual” or “financial”, not “economic”, impact, and should be calculated and imposed accordingly in the currency of payment.

7 **Flaw No. 2**: the financing of a water company and the inherent risks of the enterprise will be reflected by the “leverage”, a term which is oft misinterpreted, as it has a number of different definitions. In reality, - or the ‘actual’ world, - leverage reflects the amount of equity, i.e. risk capital, in the financial structure of the enterprise expressed as a ratio to debt, i.e. low risk capital, which receives a fixed reward, but also takes security over the borrower’s assets.

For a public service, (natural) monopoly, such as water and sewerage, the operational and financial risks are relatively low, compared to commercial enterprise. This assumes that the service assets are well maintained and managed efficiently, and the costs of any new investment required to rehabilitate or expand the service are similarly managed and controlled. Hence, relatively high levels of ‘actual’ debt compared to ‘actual’ equity might be expected, e.g. 70-75% debt to 20-25% of equity.

Notwithstanding the ‘reality”, OFWAT, nevertheless, bases its calculation of the proportions of debt to equity in any water company on an assumed “leverage” derived from: (i) notional costs for equity and debt, derived from a mix of economic analyses and market soundings, which may, or may not, reflect reality, and (ii) applying the results to a ‘notional ratio, or leverage. Again, the resulting leverage is based on fiction, albeit economically sound, as opposed to fact (“actuality”).

8 **Flaw No. 3**: the WACC is then calculated from:-

- an (assumed) value for the cost of risk-free equity;
- incremented by assumptions as to the equity market risk premium (when there is no “market” in water services;
- incremented by assumptions as to the ‘asset beta’
- incremented by assumptions as to the ‘equity beta’
- an assumed value for the cost of debt; and
- an assumed leverage (debt / RCV), - which does not reflect the actual level of debt in the company’s accounts relative to equity capital, - where RCV is based upon some average market values of the water company’s shares 25 years ago, updated by a consumer price index, which may or may not be relevant to water services.

Furthermore, over the last 25 years, economists and OFWAT have added various degrees of sophistication to the bases for deriving these assumptions, viz. the 250pp CEPA Report, such that the added complexity obfuscates any meaningful public scrutiny.

It is, indeed, not surprising that the Public Accounts Committee opines as it does.

There is a strong argument today to use current, or actual, data for the cost of funds and the ratios of debt-to-equity as represented in the incumbent utility’s Accounts, as presented to the World, with adjustments for investments undertaken in the past reporting period.

9 **Flaw(s) No. 4**: the mechanism for setting tariffs also includes some additional ‘financial’ flaws:-

- it takes no account of the fact that many investors inject their equity as shareholder loans, or subordinated debt, with high interest rates, so as to extract dividends, in effect, pre-tax;

- much of the equity capital in the sector is today non-UK, sometimes channelled via tax-havens, i.e. tax-free;

- similarly, some of the debt capital may also be sourced outside the UK, with different costs;

- with the owners non-UK, dividends are remitted tax-free; and

- owners take advantage of advanced depreciation allowances, which were originally intended to encourage asset investment. Licenced utilities should not require such incentive, as their investment program should be dictated by the demands of the public service Licence they have been awarded.

- **Flaw No 5**: a further flaw in the current regulatory regime is that the tariff structure compensates the incumbent utility for financing costs during the period of investment, or construction, for new service assets, **befor**e the assets become operational and can deliver a service (known as "The RAB Model"; [RAB = Regulatory Asset Base].

  One of the principles for privatization in the first place was that private capital should take responsibility and carry the risk of service delivery, which includes the risk of investment in the assets to support the delivery of such service. After all, it is only they who can manage and control the risk of project construction and completion to time and cost.

  By allowing the incumbent utility's investment costs to be compensated during this period, such risks are being passed to customers, who cannot manage or control these risks. For a major project such as Tideway, with a construction period of 7 years, this flaw is taken to an extreme. The tariff regime needs changing, so as: ***"to allocate risks to those best able to carry them".*** Financing costs should only be allowable **post-completion**.

- **Flaw No. 6:** under the Water Industry Act, the Regulator has to set tariffs such that the utilities can finance their activities and make a 'reasonable' return, and is not allowed to intervene as to how the regulated utilities finance themselves.

  Further, with around 75% of the England & Wales water companies now unquoted on the LSE, shareholders or customers have no opportunity to bring directors to account, and the water companies have minimal, or no, direct interface with customers other than through the service, as delivered.

  Hence, neither OFWAT, nor CCWater on behalf of customers, can intervene to prevent the kind of financial gymnastics as have been seen in recent years, e.g. the LBO acquisition of Thames Water 2006/7 and the raising of just under £6bn via a Thames Water Cayman Island subsidiary. Sadly, they are not equipped or resourced to do so. Customers are left exposed to corporate whim and abuse, and there is no standard of probity imposed under the Licence.

  Further, neither the CMA (Competition and Markets Authority) nor the FCA (Financial Conduct Authority) have seemingly any broad remit to police the sector, notwithstanding that the services delivered are monopolies and customers linked to the network have, by law, to pay the bills as presented by the incumbent utility.

  There is, indeed, much at fault with the current water regulatory regime, of which the issues arising at Thames Water display many such symptoms. Corporate transparency and changes to the tariff setting mechanism would be a start in the right direction.!

In conclusion, there is much work to be done, but now that PR14 settlements, however imperfect, are behind us, now is the time to introduce, - or at least warn the sector, - of potential changes to how tariffs are to be calculated and set in future, such as to reflect ‘actual’ costs incurred, so that, rather than fostering investor greed, customers receive, more closely, Value for Money.

CC

CCWater