

The Water Industry: A Case to Answer

A report by the New Policy Institute

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INTRODUCTION AND SUMMARY

The water industry in England is beginning to receive the attention that energy companies have long been used to. Whilst there has always been criticism of high water prices in some regions (notably the South West), stagnating living standards mean this is spreading. Austerity has seen more attention focused on the tax practices of large companies, water included. Water company ownership has also come under scrutiny as a result of the private equity consortium behind Thames Water being unable to finance the ‘super sewer’ project without government help.

A variety of political voices are expressing concerns with this industry. The most recent price rise moved the Daily Express to suggest that there was ‘mounting evidence of consumers being exploited by highly profitable companies’, and that the industry is ‘effectively competing for shareholders.’¹ Pointing to weakened balance sheets, high dividends and low tax payments, the Guardian declared that the industry had ‘a case to answer’.² The controversy has sparked proposals from Will Hutton on borrowing and ownership, and from former the Director General of the water regulator OFWAT, Sir Ian Byatt, on competition and prices.³

The purpose of this report, which has been commissioned by UNISON, is to present a summary picture of the main features of this industry, to help raise awareness of it and encourage a wider discussion. In broad terms, it covers three areas:

- the ownership of the industry and way that has changed since privatisation;
- the economic performance of the industry especially prices, profits, investment and debt;
- how the countries of the UK compare, with one-another and elsewhere beyond.

Except where stated otherwise, references to the ‘industry’ refer to England and Wales (this being the extent of OFWAT’s jurisdiction).

At the same time, in writing this report we have inevitably started to form our own view of this industry as it approaches the 25th anniversary of its privatisation in 1989. In short that view is that this is now a very odd industry indeed, one whose ownership is opaque, whose consumers are powerless and whose profits are high –30% (more than £100 a year) of the average water bill – yet which is also unable to finance key investment without government help. The report concludes with six questions which we summarise here:

1. Why has the ownership of this industry changed so much since privatisation?
2. Why have water bills trebled in 25 years when inflation overall has only doubled – and can the share of the average bill that goes to profit be justified?
3. What can consumers do if they are unhappy?
4. What dangers lurk in the industry’s dependence on debt finance?
5. What is the alternative to the government taking on some of the industry’s risk?
6. What would a ‘responsible’ water industry look like?

¹ ‘Water Industry drinking in the last chance saloon’, *Daily Express*, 6 February 2013.

² ‘Water companies pay billions to shareholders but little tax. Why?’, *The Guardian*, 10 November 2012.

³ Will Hutton, Thames Water – ‘A Private Equity plaything that takes us for fools’. *The Observer*, 11 November 2012; Ian Byatt, *Water: Supply, Prices, Scarcity and Regulation* (London: Institute for Economic Affairs), 2012.

1. OWNERSHIP OF THE WATER INDUSTRY SINCE PRIVATISATION

Figure 1: Water industry ownership through time: 1989 – 2012

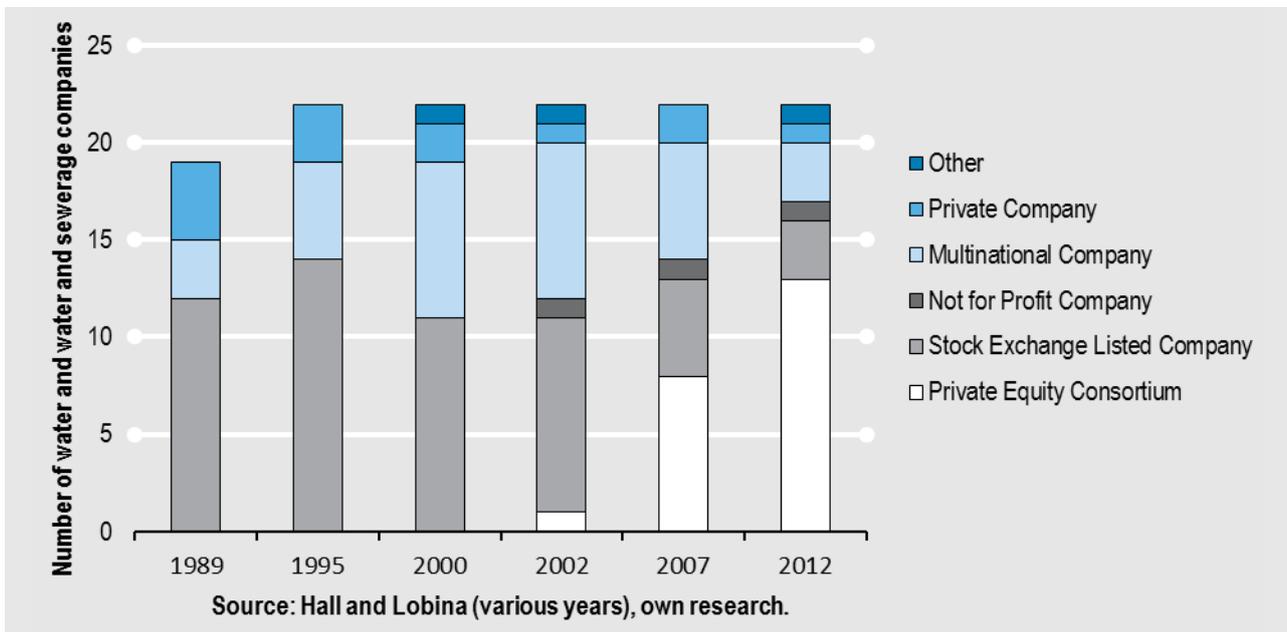


Figure 1 shows the industry in England and Wales by the ownership status of the parent company (using the system of designation used by Hall and Lobina, 2012, 2007, 2002). The companies in this graph are those that exist in 2012. Some that did not exist in their present form in 1989 are not therefore included for that year. Appendix 1 lists them by their ownership status since 1989. Appendix 2 gives the nationality in 2012.

Since privatisation in 1989, three ownership models have dominated the industry:

- Up to the mid-90s, water holding groups listed on the stock exchange dominated. These accounted for 68% of the companies in the industry in 1995. The other owners were either private companies or non-UK listed/based multinationals.
- As the share held by these stock exchange listed groups started to fall, so multinational ownership of the industry grew, reaching a peak in 2000.
- Since then, private equity consortia have taken over half the industry. These consortia, assembled by banks and other financial intermediaries, allow organisations and individuals to invest in companies without being subject to stock exchange disclosure rules. If they are based outside the UK, they also pay less UK tax.

Measured by turnover, stock exchange ownership is more important than appears the case from the number of companies owned. Although there are now only four such companies, they still account for 40% of turnover. But if rumours that the largest of them (United Utilities) is to be taken over by private equity prove correct, the stock exchange share will fall to 25% while private equity's will rise to 60%.

What is driving the change of ownership in this industry – and to whose benefit?

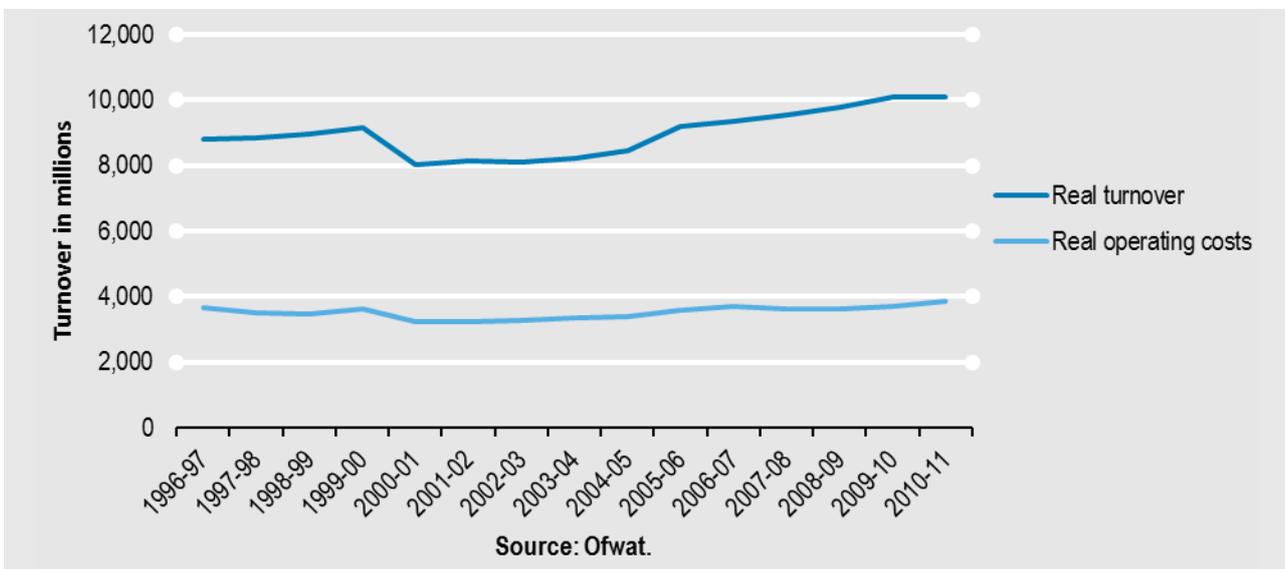
2. REASONS FOR OWNERSHIP CHANGE

There are several reasons why the firms in an industry, particular ones that have recently been privatised, might be restructured. They include:

- The need to respond to technological innovation (e.g. telecoms)
- Creating competition in the market so customers can switch supplier (e.g. energy suppliers)
- Creating competition for the market, for the opportunity to supply (e.g. rail franchises)

None of these reasons apply to water, where the product remains unchanged, where households cannot change their supplier and where prices are set by the regulator.

Figure 2. Water industry turnover and operating expenditure 1996-97 to 2010-11, adjusted for inflation



An industry in decline, with high operating costs – or one expanding fast – might also be a candidate for a different form of ownership. But figure 2 shows that water is not one of these either. ‘Real’ turnover (after allowing for inflation) has grown from around £8.5bn to £10bn. As a share of turnover, operating costs have been steady, at around 40%. The share of turnover taken by employment costs has fallen from around 18% to 13% between 1995 and 2007, according to the Annual Business Inquiry⁴, and around 14% since according to the Annual Business Survey (though they are not directly comparable).⁵

Water is subject to none of the economic pressures that usually shape an industry. What is going on looks like a game driven by the financial interests of owners, prospective owners and their banks. Does this matter?

⁴ Annual Business Inquiry, 2010.

⁵ Annual Business Survey, 2012.

3. WATER INDUSTRY OWNERSHIP ACROSS THE UK

It was only in England and Wales that the water industry was privatised. To this day, water and sewerage service provision in Scotland and Northern Ireland is undertaken by the public sector. Scottish Water is a statutory corporation with its direction and objectives set by the Scottish Parliament. Northern Ireland is a government-owned corporation. Since 2000, provision in Wales has been undertaken by a company owned by a type of mutual rather than shareholders. This too is a different ownership form. A summary of the four models is provided below.

England

- Ownership: private. As discussed above, these companies are owned by parent companies floated on the stock exchange, private individuals, multinational corporations or private equity consortia.
- Accountability: to Ofwat, the Consumer Council for Water, the Environment Agency and the Drinking Water Inspectorate.
- Charges: according to regulations set by Ofwat. The method is known as RPI + K, where RPI is the Retail Price Index inflation measure and K is some additional measure for investment and profit.

Scotland

- Ownership: public. Scottish Water is a publically owned company, with the Scottish government setting the companies objectives and appointing Directors.
- Charges: set by the Water Industry Scotland Commission, to reflect objectives set by the Scottish government, including balancing investment with consumer value.
- Accountability: to the Scottish Parliament, with performance monitored by the Water Industry Scotland Commission. There are also environmental agencies and Consumer Focus Scotland.

Northern Ireland

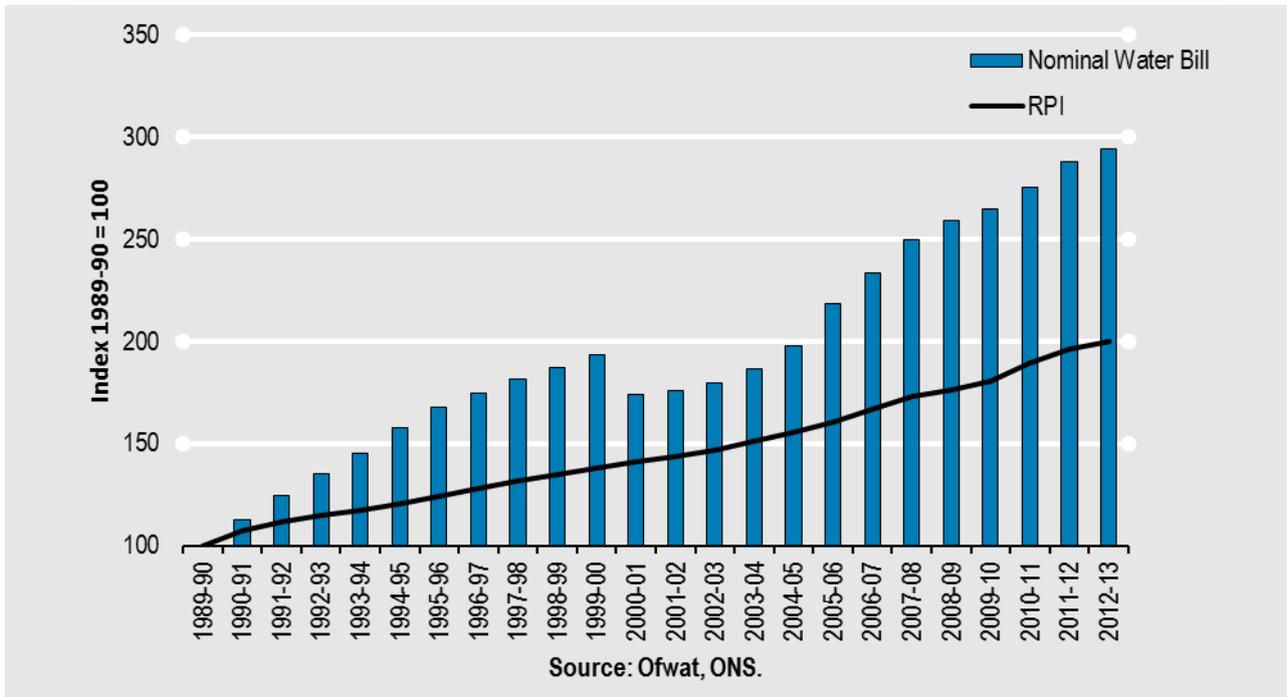
- Ownership: public. Though government-owned, Northern Ireland Water operates largely as a private company.
- Accountability: to the Northern Ireland Utility Regulator, which works with various environmental and consumer bodies.
- Charges: customers do not pay water charges, the company instead being largely funded by government subsidy. Plans to introduce water charges have been repeatedly delayed following the re-establishment of the Northern Ireland Assembly after the St Andrews peace agreement.

Wales

- Ownership: not-for-profit. Dŵr Cymru (Welsh Water) is the predominant water company in Wales, and is owned by Glas Cymru, a not-for-profit company limited by guarantee with members but not shareholders. In turn, those members are appointed by an independent board. It is not a mutual, though, being owned by neither its customers nor its workers.
- Accountability and charges: as for England.

4. HOUSEHOLD WATER BILLS

Figure 3: Average water bills and retail prices, 1989-90 - 2012-13



Unlike energy, water has not seen the sudden, big rises in household bills that provoke such a hostile public reaction. But that does not mean that water bills have not been going up. Far from it: taking account of the rise (to £388) announced for 2013-14, water bills since privatisation have trebled. Over the same period ordinary prices – ‘inflation’ – has only doubled. This means that ‘real’ water bills (after allowing for inflation) have risen 50% since 1989.

Figure 3 shows that bills were rising much faster than inflation in the 1990s. But the five yearly price review at the end of that decade slashed them. Not until the next review five years later did bills start to rise again faster than inflation. As a result, bills are now some 20% higher in real terms than ten years ago.

Rising ‘real’ water bills are one thing when earnings are growing faster than inflation too. But with earnings (at best) frozen in real terms since 2010, water bills are now taking an increasing share of income. For those on low income, the water bill can take an appreciable chunk of income: e.g. around 6% for single adults with incomes on the poverty line.

In 2010/11, approximately 30% (£101 out of £340) went on operating profit (not including tax, net interest and dividends). Is this a lot? Although comparisons with energy are tricky (there are wholesale costs involved with purchasing energy that do not exist for water), Ofgem reported in 2010⁶ that £105 out of a £1130 annual energy bill went on profits – a share of just 9%.

With profit margins high, where does that profit go?

⁶ Ofgem, *Electricity and Gas Supply Market Report February 2010* (London: Ofgem), 2010.

5. INDUSTRY PROFITS

Figure 4: Industry profit as a percentage of turnover 1996-97 to 2010-11

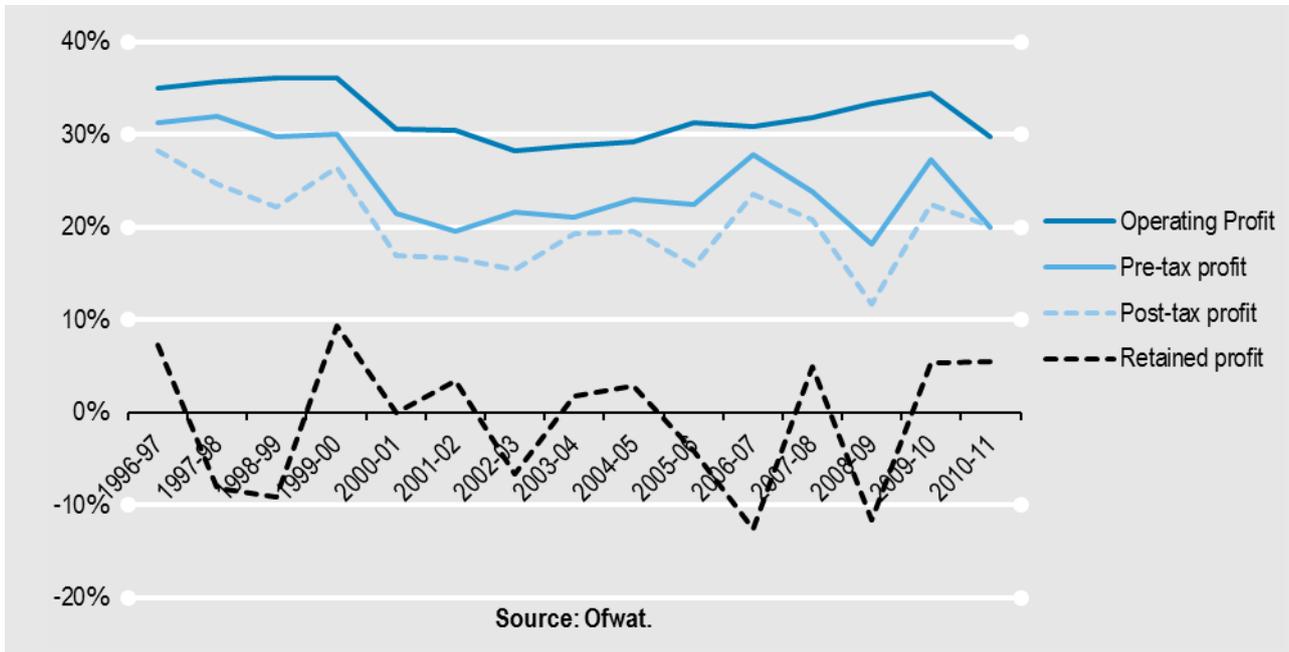


Figure 4 shows four different measures of water industry profits. Operating profit is the difference between turnover and operating costs. Pre-tax profit is operating profit plus other sources of income less interest payments and financing adjustments. Post-tax profit is pre-tax profit less tax. Retained profit is what is left over after dividends have been paid.

Operating, pre-tax and post-tax profits all fell after the 1999 price review since when they have remained broadly steady. Comparison of the four profit measures point to some important features of the industry:

- The widening gap between operating and pre-tax profits is due to rising net interest payments, up from 8% of turnover in 1996-97 to 20% in 2010/11 (some £2bn).
- The small gap between pre- and post-tax profits reflects the low share paid in tax (around 5% of turnover equivalent to some 18% of pre-tax profits).
- This small gap, along with the fact that retained profits fluctuate around zero (being negative in six of the 15 years), means that most pre-tax profit is paid out as dividends. Excluding years with high special dividends⁷, dividends average around 18% of turnover (in 2010-11, 15%, or £1.4bn).

The water industry remains profitable, though less so than in the 1990s. As a former public utility with no current scope for competition, the water industry has to justify its profits in a way other industries do not. Does the industry's record on areas such as debt and investment justify its profits?

⁷ Ofwat, *Financial performance and expenditure of the water companies in England and Wales 2006-07 report*, (Birmingham: Ofwat), 2007.

6. DEBT AND TAX

Figure 5: Industry net debt as a percentage of Regulatory Capital Value 1996-97 - 2010-11 ('Gearing')

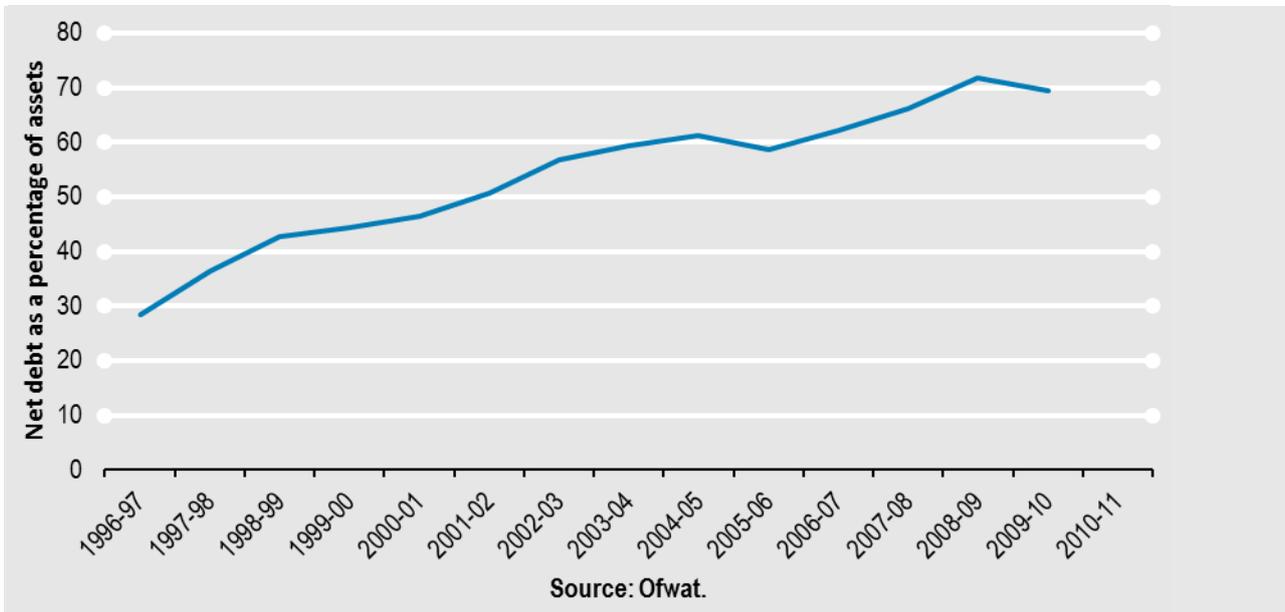


Figure 5 shows the industry's net debt relative to its assets (measured here as Regulatory Capital Value or RCV). This, the 'gearing ratio', has increased from about 30% of RCV in 1996-97 to 70% by 2009-10. Over the same period, net debt in real terms increased four-fold, from £8.2bn to £34.6bn. At privatisation in 1989, the government cancelled all the industry's long-term debt.⁸

Rising debt accounts for the rising interest payments and growing gap between operating- and pre-tax profits mentioned above. It may also account for the apparently low level of tax paid by the industry for which it has been criticised.⁹ The UK tax system treats debt favourably with interest – but not dividends – being deductible against pre-tax profits. One possible reason for higher debt and gearing is to reduce tax.

Whether higher debt has reduced the *total* tax paid on income originating in the industry also depends on how much tax the parent companies pay, as well as the banks and other financial companies lending money to the industry.

Where the ultimate owners are subject to UK tax, debt versus equity and the tax implications are second order issues. Where they are not subject to UK tax, the ownership and financing of the industry is of primary importance – with implications for the public sector deficit.

⁸ Ofwat, *The Development of the Water Industry in England and Wales* (Birmingham: Ofwat) 2006, p.38.

⁹ For example, Simon Hughes M.P., This water tax trickery in the corporate sector is unacceptable, *The Guardian*, 10 November 2012.

7. DEBT AND INVESTMENT

Figure 6: Gross investment as a percentage of turnover 1996-97 - 2009-10

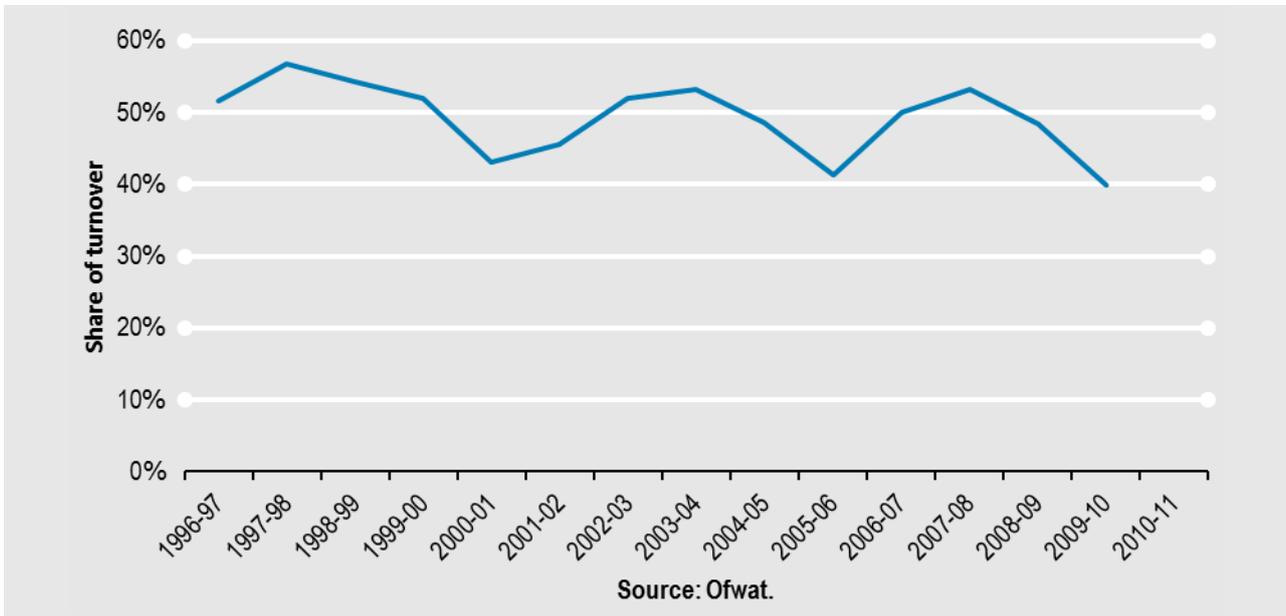


Figure 6 shows investment in the water industry as a share of turnover. The underlying trend is gently downward, from around 50% in the late 1990s to above 40% more recently, with dips in the years immediately following price reviews.

40% is very high by the standards of UK industry as a whole. Whether it is justified is debateable. Water companies have an incentive to invest because doing so increases their 'regulatory capital value': in broad terms, the higher the RCV, the higher the price that Ofwat will allow them to charge. Policy Exchange has argued that the regulatory environment biases companies towards capital intensive infrastructure investment.¹⁰ The former Ofwat Director General, Sir Ian Byatt, has argued that while a bias towards capital expenditure may have been right after privatisation to make up for past under-investment, quality and cost effectiveness should now be the priorities.¹¹

Year by year, there appears some connection between investment levels and the growth of debt. Years in which less debt is accumulated tend to have lower investment (for instance, 2003-04 to 2005-06) and vice versa. Industry figures defend the use of debt to finance investment.¹² But if dividends were lower and retained profits higher, the need for debt to finance investment would be lower too.

Is the use of debt on this level sustainable or does it pose problems?

¹⁰ Simon Less, *Untapped Potential: Better Protecting Rivers at Lower Cost* (London: Policy Exchange), 2011, p.8.

¹¹ Ian Byatt, *Water: Supply, Prices, Scarcity and Regulation* (London: Institute for Economic Affairs), 2012, p.6.

¹² See for instance the remarks attributed to the Chief Financial Officer of Thames Water quoted in *Water companies claim high ground on tax*, (Financial Times, 4 September 2012)

8. THE CASE OF THE THAMES ‘SUPER SEWER’

Figure 7: Water company gearing by ownership 2003-04 - 2009-10

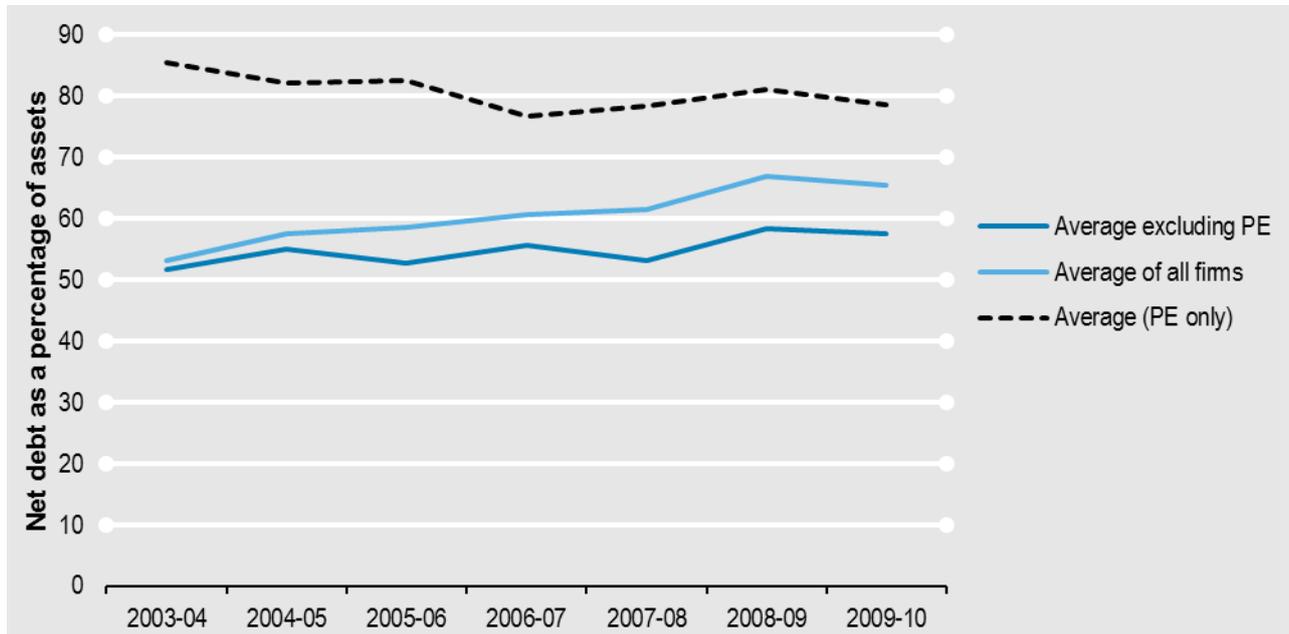


Figure 7 shows that water companies owned by private equity consortia tend to have higher gearing ratios than other firms, though the gap has narrowed slightly over time. While debt was growing before private equity became so prominent in the industry, it has certainly exacerbated the trend.

Thames Water is one of the companies owned by private equity. Thames has been arguing that a ‘super sewer’ – a pipe under the river – is needed in order to update London’s Victorian system. The idea itself has been criticised: there has for example been no independent examination of alternatives.¹³ Estimated costs have risen from £1.7bn to £4.1bn. Customer bills may have to rise by a quarter to pay for it.

But Thames cannot have any direct financial involvement because the money it would need to borrow would jeopardise its credit rating due to associated risks and existing indebtedness.¹⁴ To overcome this, a separate company has been created, supported by the Government’s ‘UK Guarantee’ for large investment projects. Government is shouldering the risk because Thames is no longer strong enough to do so.

A report by the Bank of England drew attention to risks arising from the growth of private equity in the mid-2000s and the need to refinance this debt in the near future.¹⁵ Water was not mentioned specifically but it cannot be assumed that it is just new investment – like the sewer – that would be imperilled if water companies were to start to find it difficult to borrow.

¹³ Ian Byatt and Simon Hughes, Thames Water is obliged to fund big projects, *Financial Times*, 11 November 2012.

¹⁴ Moody’s, *Moody’s Disclosures on Credit Ratings of Thames Water Utilities Ltd* (London: Moodys), 2012.

¹⁵ Bank of England Quarterly Bulletin, 2013 (1), *Private equity and financial stability*

9. WATER COMPARED WITH OTHER PRIVATE SECTOR COMPANIES

Figure 8: Comparing the water industry with the UK private non-financial sector

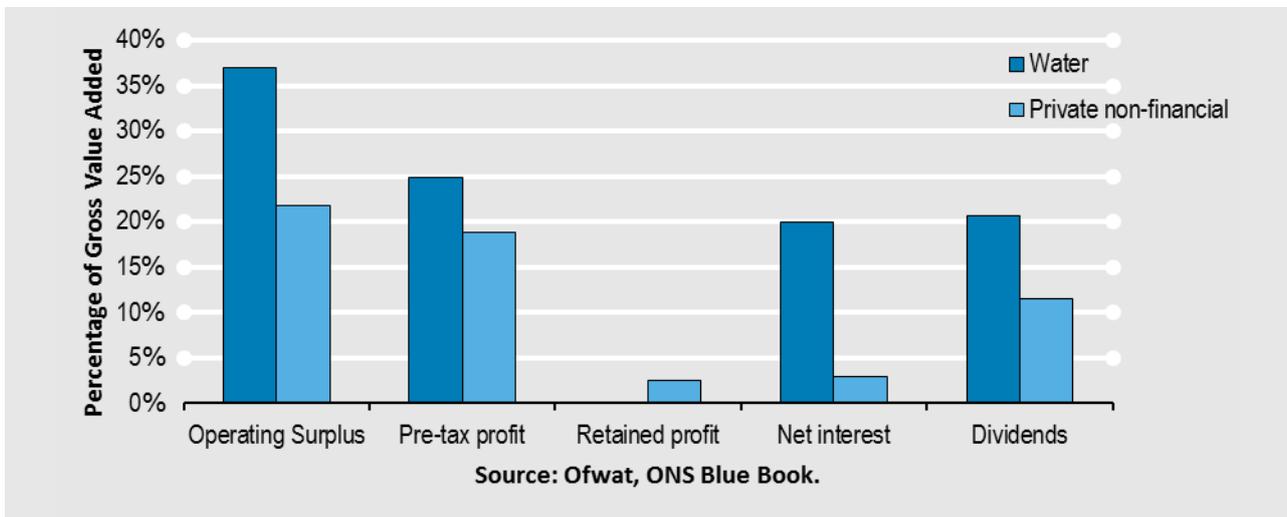


Figure 8 compares profits, dividends and interest payments for the water industry with those for UK non-financial companies as a whole. The figures, expressed as a share of gross value added (GVA), are for a three year period (respectively 2008-09 to 2010-11 and 2008 and 2010). Taken from different sources, the comparison is only approximate and can only be treated as showing broad patterns; even so, it does underline how different water is. Three points stand out:

- First, water has markedly higher operating and pre-tax profits shares than the average (37% of GVA compared with 22%, and 25% compared with 19% respectively).
- Second, despite these higher operating and pre-tax profits, water has lower retained profits.
- Third, both dividend payments (21% of GVA compared with 11%) and even more so payments of interest (20% compared with 3%) are far higher for water than for non-financial companies on average.

Water clearly is very different from industry on average. But is this to do with the nature of the water industry generally – or does it arise from the specific way that water is run in England?

10. WATER BILLS ACROSS THE UK

Figure 9: Comparing water bills in the UK 2003-04 to 2013-14

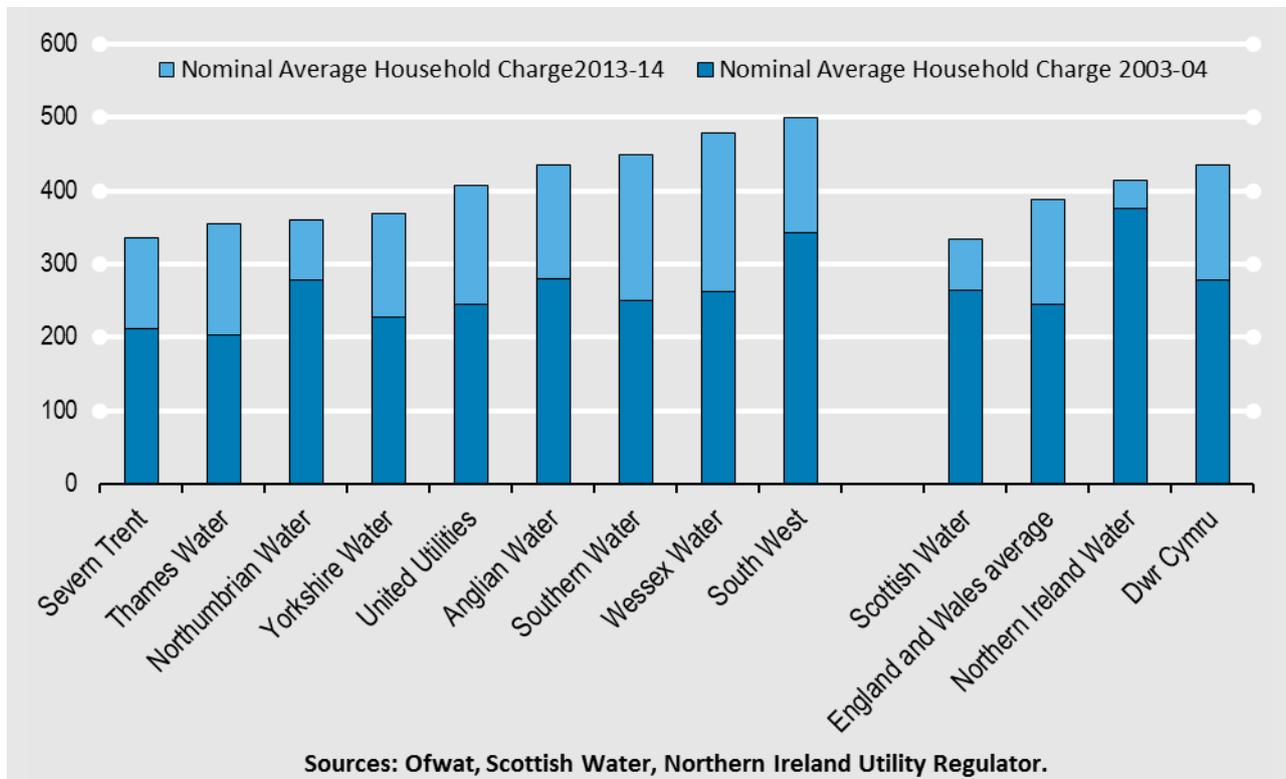


Figure 9 shows the combined water and sewerage charge for the ten water and sewerage companies in England and Wales and Scottish Water and Northern Ireland Water for 2003-04 and 2013-14. There is a large variation between areas, from £335 on average in the Severn Trent area to £499 in the South West (and this only after a special government subsidy to reduce the bills in the latter).

Both Welsh Water and Northern Ireland Water are above the average for England and Wales for 2013-14, by around £46 and £26 a year respectively (though these are only notional bills in Northern Ireland).

The larger the top bar on the graph means the larger the average bill increase over the last 10 years. Some companies, such as Northumbria Water, have seen smaller increases (around 30%), whereas others such as Wessex Water have seen large increases (83%). The smallest increase across the UK was Northern Ireland Water, though it had very high notional bills to begin with. More significant are the relatively small increases in the Scottish Water average bill, which has gone from being higher than England and Wales to being £54 lower in 2013-14. The Water Industry Commission for Scotland¹⁶ indicated in 2005-06 that Scottish bills were below English bills in 1999-00, before rising sharply above to pay for investment in the mid-2000s, before falling back again below the English average.

¹⁶ Water Industry Commission for Scotland, *Annual Report 2005-06*, (Stirling: Water Industry Commission for Scotland), 2006.

11. WATER PERFORMANCE ACROSS THE UK

Figure 10. Comparing water company performance across the UK 2009-10

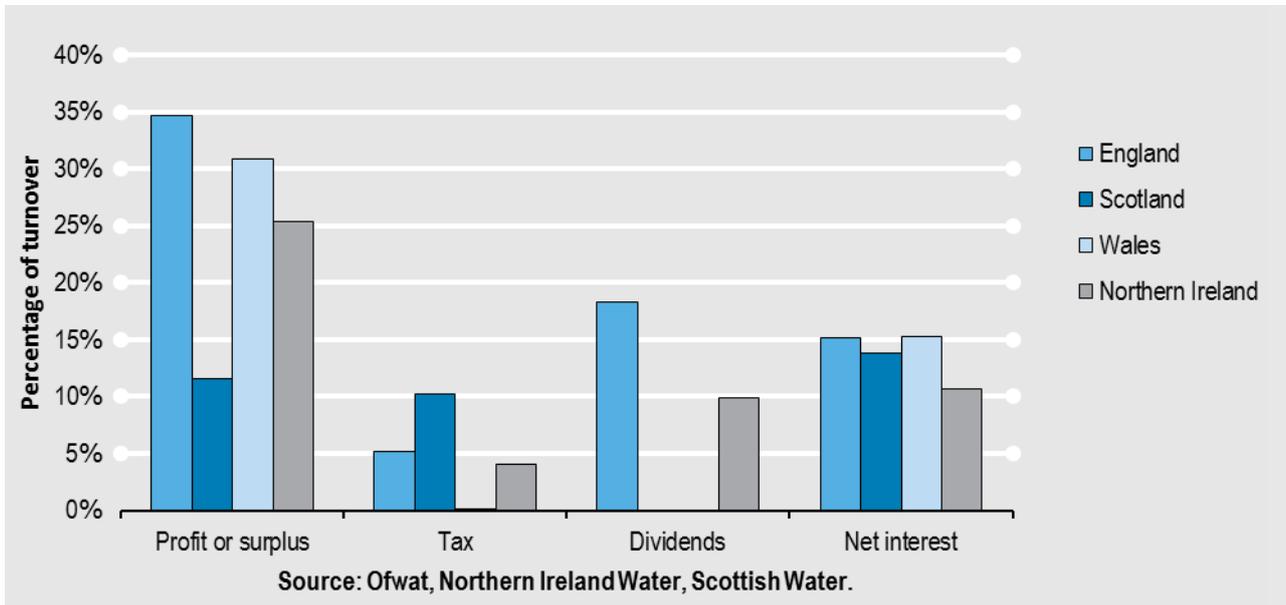


Figure 10 below shows the performance of the water companies in the four countries for 2009/10 (the last year for which data is available for all). The comparison, using a single year of data, should be treated with some caution due to both the different histories and different geographies of the four.

The operating profit (surplus) differs between the countries, with England having the highest and Scotland by far the lowest. In Scotland, the company is largely achieving the level of surplus it was set to achieve by the Scottish government. For Welsh Water, the incentives to accumulate a large surplus are arguably less important – the operating surplus is to pay interest on debt and taxes, and is then reinvested.

Interest as a share of turnover is similar in Scotland to both England and Wales. Given the increase in debt and interest payments in England and Wales since privatisation, it is telling that Scotland is little different. By contrast, tax as a share of turnover is higher in Scotland than England. With dividends, it is England that stands out, the ownership models of Scotland and Wales precluding dividends altogether while Northern Ireland dividends are payments to its sole owner the Department for Regional Development.

12. CONCLUSION: AN ODD INDUSTRY IN NEED OF SCRUTINY

The water industry in England and Wales is subject neither to consumer (market) pressure nor to government control. There is no competition. Unlike energy, it is rarely subject to political or media criticism. Of course there is an industry regulator but 'capture' of regulators by those they are regulating is a well-known and serious problem. Over several years of moderately high inflation, water bills have been allowed to rise even faster.

Such concerns are compounded by the unusual nature of the UK water industry from an international perspective. Most water systems tend to be organised on a municipality basis, like the UK was before 1973, and particularly before 1945. The UK is also unusual in having a largely private sector dominated industry, France being the only other OECD country in this position.¹⁷ It is surely for this reason that private water ownership in Europe is also increasingly concentrated within two large French-based multinational companies, Veolia and Suez. But the City of Paris re-municipalised its water supply in 2010.¹⁸ Only under the pressure of austerity are municipalities (across the southern Eurozone countries) seen to be selling off water assets.¹⁹

In short, the way it is organised means the water industry in England is very odd. It is high time it received serious scrutiny. To try to prompt that, we suggest the following half-dozen questions as pointing to the main areas of concern.

1. **Ownership.** Whose interests are served – and whose may be harmed – by the continuing changes in ownership seen since privatisation? How far is private equity itself the issue as opposed to foreign equity private ownership?
2. **Profits and prices.** Can high profits – and bills that rise go on rising faster than inflation – really be justified?
3. **Accountability.** What external pressure is the industry subject to, especially from consumers who cannot boycott water in the way they can multi-national coffee chains?
4. **Debt.** Is the dependence on debt damaging the industry's capacity to provide water services? Is the 'super sewer' a one-off in this regard or does debt justify deeper worries about the sustainability of the industry?
5. **Government support.** If government is asked to take on risk, should it and if so, what should it insist upon in return? What are there viable alternatives?
6. **Responsible capitalism.** How would the water industry need to change in order to qualify as 'responsible'? There are few more important or symbolic industries than this so if the concept is to mean anything, it has to be applicable here.

¹⁷ David Hall and Emanuele Lobina, *Water Privatisation*, (London: Public Services International Research Unit), 2008, p.3.

¹⁸ David Hall and Emanuele Lobina, *Water Companies in Europe*, (Brussels: ESPU), 2010, p.5.

¹⁹ David Hall and Emanuele Lobina, *Water Companies and Trends in Europe*, (Brussels: ESPU), 2012, p.25.

APPENDIX 1

Water Company	1989	1995	2000	2002	2007	2010	2012
Anglian Water	SEC	SEC	SEC	SEC	PE	PE	PE
Northumbrian Water	SEC	M	M	M	SEC	SEC	M
Severn Trent Water	SEC						
Southern Water	SEC	SEC	SEC	PE	PE	PE	PE
South West Water	SEC						
Thames Water	SEC	SEC	M	M	PE	PE	PE
United Utilities Water	SEC						
Welsh Water	SEC	SEC	SEC	NFPC	NFPC	NFPC	NFPC
Wessex Water	SEC	SEC	M	M	M	M	M
Yorkshire Water	SEC	SEC	SEC	SEC	PE	PE	PE
Bournemouth and W. Hants Water	P	P	M	M, P	P	M	M
Bristol Water	SEC	SEC	SEC	SEC	M	M	PE, M
Cambridge Water	P	SEC	M	M	M	M	PE
Cholderton Water	P	P	P	P	P	P	P
Dee Valley	P	P	P	SEC	SEC	SEC	SEC
Folkestone and Dover	M	M	M	M	M	M	PE
Portsmouth Water	SEC	SEC	SEC	SEC	PE	PE	PE
South East Water	X	M	M	M	PE	PE	PE
South Staffordshire Water	SEC	SEC	SEC	SEC	PE	PE	PE
Sutton and East Surrey Water	X	SEC	SEC	SEC	PE	PE	PE
Tendring Hundred	M	M	M	M	M	M	PE
Three Valleys	M	M	M	M	M	M	PE

Source: ESPU, own research. Legend: **PE** – Private Equity; **M** – Multinational; **SEC** – Stock Exchange Listed Company; **NFPC** – Not for Profit Company; **P** – Private company' **X** – did not exist

APPENDIX 2

Water Company	Owner	Country
Anglian Water	Osprey/AWG	UK
Northumbrian Water	Cheung Kong Infrastructure	China (HK)
Severn Trent Water	Severn Trent	UK
Southern Water	Greensands	UK
South West Water	Pennon Group	UK
Thames Water	Macquarie	Australia
United Utilities Water	United Utilities	UK
Welsh Water	Glas Cymru	UK
Wessex Water	YTL	Malaysia
Yorkshire Water	Saltaire Water	UK
Bournemouth and W. Hants Water	Sembcorp	Singapore
Bristol Water	Capstone (70%), Agbar/Suez (30%)	Canada, Spain/France
Cambridge Water	Alinda	USA
Cholderton Water	Cholderton Estate	UK
Dee Valley	-	UK
Folkestone and Dover	Rift	UK/USA
Portsmouth Water	South Downs Capital	UK
South East Water	UTA and HDF	Australia
South Staffordshire Water	Alinda	USA
Sutton and East Surrey Water	Aqueduct Capital	Canada/UK
Tendring Hundred	Rift	UK/USA
Three Valleys	Rift	UK/USA

Source: David Hall and Emanuele Lobina, *Water Companies and Trends in Europe*, (Brussels: ESPU), 2012.