

# Bringing water into public ownership: costs and benefits

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## 1. Water sector in England

The present system of provision of water and sewerage in England consists of nine large regional private water and sewerage companies, with a few smaller private water-only companies, which both own the entire assets of the system and are licensed monopolies of water and sewerage services in their areas. The water providers in Scotland and Northern Ireland remain in the public sector. In Wales, water is provided by a not-for-profit company. Three of the English companies are listed on the London Stock Exchange while six have been de-listed and are now owned privately.

The problems of the English system are:

- upward pressure on pricing due to payments of dividends and debt interest;
- narrow regulation by OFWAT, with a system of price controls that fails to deal with all of the methods of value extraction by shareholders;
- poor performance, for example, in terms of leakage and sewage-flooding, for which companies continue to be fined millions of pounds in 2016 and 2017;<sup>3</sup>

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<sup>3</sup> FT 03/11/2013 UK water companies struggle to plug leakage rates

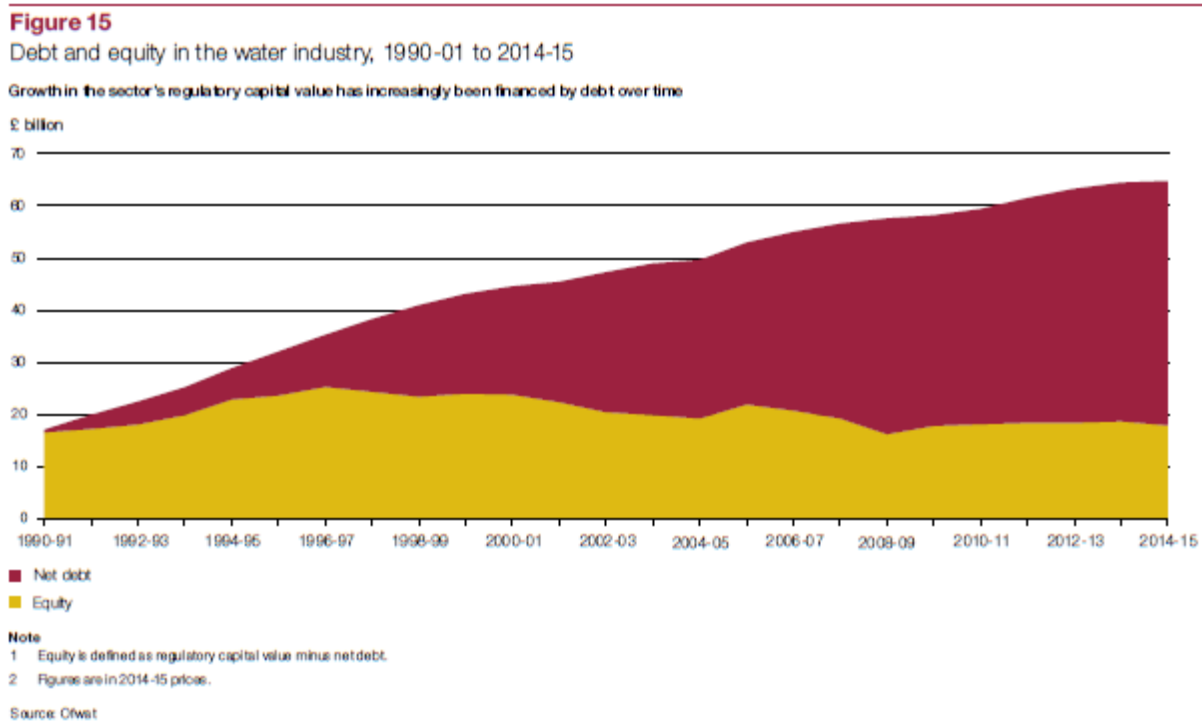
- lack of accountability or public control, with complex corporate structures, a dense web of intercompany loans and opaque offshore ownerships in some cases;
- rising inequality as many struggle to pay water bills which feed into dividend payments to some of the world's richest.<sup>4</sup>

## 2. Finances and Investment

The private sector paid very little for these companies at the time of privatisation in 1989. Investors paid £7.6bn for the shares, but the government took over all the debts of the sector (worth £4.9bn) and gave the new private corporations a 'green dowry' of £1.5bn, a combined injection of £6.4bn of public funds (Bayliss 2014). The companies were thus effectively debt-free at the time of privatisation.

A Report by the National Audit Office (2015) puts capital investment since privatisation at £126bn. However, this has largely been financed by debt as Chart A shows. The value of shareholder equity investment has hardly changed in the past twenty-five years, so the companies have financed investment by increasing borrowings rather than investing their own capital. Debts come at a cost.

Chart A: Debt and equity in water sector 1990-2015 (NAO)



Tables 1-3 review the finances of the nine regional English companies over the last 10 years. On average, the nine companies have paid nearly £1.5bn per year in net finance costs ((Table 2). The cost of this debt is much higher than it would be for public sector bodies: the yield on government gilts is about 1.2%, whereas OFWAT assumes the private companies pay more than double this rate, so the difference is equivalent to more than £500m. per year on the combined net debt of £42bn (Table 3).

<https://www.ft.com/content/c461a8ae-4495-11e3-8926-00144feabdc0> ; FT 04/05/2017 Thames Water: the murky structure of a utility company <https://www.ft.com/content/5413ebf8-24f1-11e7-8691-d5f7e0cd0a16>

<sup>4</sup> Hong Kong billionaire, Li Ka-shing who controls Northumbrian Water is ranked number 19 on Forbes list of the richest people in the world - <https://www.forbes.com/billionaires/list/#version:static>

While sector debt has been rising, shareholders have been extracting dividends. Table 1 provides summary data compiled from the water and sewerage companies' Annual Reports over the past ten years. The Table shows that almost all of the post-tax profit of £18.8bn has been paid out in dividends (£18.1bn). Arguably these are funds that could have been used to finance physical investment or to reduce company debt (and thereby lower debt interest payments).

Furthermore, three companies – Anglian, Severn Trent, and Yorkshire – have paid out more in dividends than their total pre-tax profits over the past ten years. This is not economically sustainable.

Table 1: Regional water and sewerage companies finances 2007-2016: totals

Company	Pre-tax profit (£m)	Tax (£m)	Post tax profit (£m)	Dividends (£m)	Retained earnings (£m)	Net finance costs
Anglian Water	3,018.80	-11.80	3,007.00	3,708.90	-701.90	-1,388.40
Northumbrian Water	2,173.40	-325.60	1,847.80	1,807.60	40.20	-1,132.70
Severn Trent Water	2,434.10	-177.40	2,205.60	2,441.60	-236.00	-2,125.40
South West Water	1,384.60	-194.90	1,189.70	1,013.90	175.80	-626.90
Southern Water	1,359.80	-171.00	1,060.30	666.80	393.50	-1,629.00
Thames Water	3,360.80	-195.30	3,165.50	2,531.30	634.20	-3,006.20
United Utilities Group Plc	4,244.10	-438.80	3,805.30	2,663.10	1,142.20	-2,052.70
Wessex Water	1,421.30	-231.80	1,189.50	1,117.50	72.00	-741.40
Yorkshire Water	1,310.30	80.90	1,391.20	2,178.50	-787.30	-1,947.10
<b>Total</b>	<b>20,707.20</b>	<b>-1,665.70</b>	<b>18,861.90</b>	<b>18,129.20</b>	<b>732.70</b>	<b>-14,649.80</b>

Source: compiled from company annual reports

Table 2: Regional water and sewerage companies finances 2007-2016: annual averages

Company	Pre-tax profit (£m)	Tax (£m)	Post tax profit (£m)	Dividends	Retained earnings (£m)	Net interest payable and similar charges
Anglian Water	301.88	-1.18	300.70	370.89	-70.19	-138.84
Northumbrian Water	217.34	-32.56	184.78	180.76	4.02	-113.27
Severn Trent Water	243.41	-17.74	220.56	244.16	-23.60	-212.54
South West Water	138.46	-19.49	118.97	101.39	17.58	-62.69
Southern Water	135.98	-17.10	106.03	66.68	39.35	-162.90
Thames Water	336.08	-19.53	316.55	253.13	63.42	-300.62
United Utilities Group Plc	424.41	-43.88	380.53	266.31	114.22	-205.27
Wessex Water	142.13	-23.18	118.95	111.75	7.20	-74.14
Yorkshire Water	131.03	8.09	139.12	217.85	-78.73	-194.71
<b>Annual total</b>	<b>2,070.72</b>	<b>-166.57</b>	<b>1,886.19</b>	<b>1,812.92</b>	<b>73.27</b>	<b>-1,464.98</b>

Source: compiled from company annual reports

Table 3: Regional water and sewerage companies' finances 2016

Company	Net debt	Equity	Gearing* (%)	Highest paid director (£m)
Anglian Water	6,539.2	3,014.1	79	1.20
Northumbrian Water	2,690.8	667.0	67	0.71

Severn Trent Water	4,823.4	1,018.5	61	2.40
South West Water	1,793.0	530.4	62	0.76
Southern Water	4,626.5	1,359.8	78	0.70
Thames Water	10,154.2	3,113.7	80	0.96
United Utilities Group Plc	6,260.5	2,705.5	63	2.80
Wessex Water	1,880.8	732.8	62	0.60
Yorkshire Water	3,551.7	1,148.0	77	1.20
<b>Total / annual total</b>	<b>42,320.1</b>	<b>14,289.8</b>		<b>11.33</b>

Source: compiled from company annual reports with additional material from Ofwat<sup>5</sup>

So, the cost of maintaining and improving the infrastructure for the last 28 years has not been financed by investors – it has been met by borrowing. With most of the profit, allocated to dividends, the companies have been borrowing ever-increasing amounts in order to pay for the actual physical investment. The companies which were debt-free at privatisation in 1989 have now accumulated over £40 billion in debt (Table 3), which now finances over three-quarters of the companies' assets.

Four companies have now been taken over by consortia of financial investors, three of which are registered in Jersey, and these have all undertaken a complex securitisation exercise via a subsidiary set up in the Cayman Islands which allows them to hike up debt levels still further. Table 3 shows that these are the companies with the highest gearing ratios (Anglian, Southern, Thames and Yorkshire). Thames Water in 2016 recorded net debt of over £10bn. In the securitised structures, the licensed water utility sits in a complex web of companies where dividend and interest payments flow to and from group companies so that the flow of funds is very difficult to track. Aside from the complexities of inter-company transfers, high debts have led to increased interest payments.

Despite the profitability of the sector, water companies pay little tax. In a ten-year review of company accounts, the combined tax charge in profit and loss accounts comes to £1.7bn on a pre-tax profit of £20.7bn – around 8%. Actual tax paid can be much lower: in 2013 for example, the shareholders extracted nearly £1bn in dividends, but paid only £1m in taxes.<sup>6</sup>

In 2016, water and sewerage companies paid out a total of £1.45bn in net interest payments and £1.482bn in dividends which is equivalent to over 28% of turnover. These costs are borne by consumers. Since privatisation in 1989, household bills have risen by 40% more than inflation (NAO 2015). On average, over the past ten years, water and sewerage companies have paid over £1.8bn per year in dividends, which equates to about £75 per household per year. This is an expensive way to finance infrastructure.

The regulator, OFWAT, has not proved a great obstacle to the companies, as noted by the House of Commons Public Accounts Committee, which stated in 2016 that: "Ofwat, like other economic regulators, has repeatedly overestimated the cost of finance in successive price reviews. ... As a result, water companies made windfall gains of at least £1.2 billion between 2010 and 2015 from bills being higher than necessary". Shareholders are likely to have made additional financial gains

<sup>5</sup> <http://www.ofwat.gov.uk/regulated-companies/company-obligations/performance/companies-performance-2014-15/>

<sup>6</sup> Corporate Watch 2014 Energy, rail and water privatisation costs UK households £250 a year <https://corporatewatch.org/news/2014/dec/08/energy-rail-and-water-privatisation-costs-uk-households-%C2%A3250-year>

outside the scope of the regulator, for example from shareholder loans at higher than market rates of interest, from the sale of land and property and from the sale of ownership stakes in the utility. However, the full amounts are difficult to determine, in part due to dense corporate structures, and to limited disclosure. Australian investors Macquarie, for example, sold their remaining 26% stake in Thames Water for an “undisclosed sum” earlier this year.<sup>7</sup>

### **3. International comparisons**

The English system is unique in the world. Despite much study and publicity, no other country has adopted this model in the last 28 years. Even where water is privatised, this typically takes the form of a fixed term concession rather than the complete transfer of ownership as has happened in the English model. The great majority of countries provide water and sewerage services through municipalities or regional public authorities (as was the case in the UK before privatisation in 1989). Even in the USA, 85% of water is public, carried out by municipalities. And there has been a strong trend in Europe and elsewhere in the last decade to re-municipalisation of private water services, including the cities of Paris and Berlin. Such systems are subject to scrutiny by local people, in a way the private companies of England simply are not.

There is considerable evidence to show that the efficiency of public systems is at least as high as that of private operators ( see e.g. <http://www.psir.org/reports/public-and-private-sector-efficiency.html> and Annex A), while the cost of financing the service is much lower, because governments can borrow money more cheaply.

### **4. Public ownership and operation of water and sewerage services**

England could follow these global trends and restructure the service as a local, democratic, publicly owned system. The primary benefit would be to stop the extraction of dividends to shareholders (£1.8bn per year) and to reduce interest payments on debt (£500 million per year). These combined savings of £2.3 billion per year equate to about £100 per year per household - equivalent to a cut in water bills of about 25%.

Under public ownership, these savings can be used in a number of ways, with the choices subject to open public debate: reducing charges, financing investment, reducing debt, cross-subsidising other public services, such as social care.

A new public system could be based on the following elements:

- New public bodies should be created for each of the water regions, to take over the system and operate water and sewerage services using the existing workforce.
- The ownership of these bodies, and responsibility for water and sewerage services, should be vested in the local authorities in the region. The boards of the new bodies should thus have a majority of representatives from municipalities in the region, but also include representatives from local communities and employees, plus national government appointees.
- Board meetings should be held monthly, in public, and all documents of the authorities should be open to public scrutiny.
- Public ownership and openness should become requirements for any future provider of water and sewerage services.

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<sup>7</sup> “Thames buyers stress their track records and long-term interest” The Water Report, 19 March 2017.

- The functions of OFWAT should be brought back under democratic political control by returning them to the ministry, or an agency directly accountable to the minister, thus ending the present system whereby the regulator acts autonomously, without political accountability. This national agency will be responsible for both price regulation and for the standards required of water authorities (currently derived from EU legislation). The national agency will be required to hold regular public consultation exercises in formulating its policies, and include representatives of the regional bodies, consumers, employees, and others.
- The new regional water authorities will be required to form an association to conduct annual public peer review of operations and efficiency, following the Netherlands model of 'sunshine regulation', a system which is at least as effective as, and much cheaper than, Ofwat (see Annex B).

Such a system would provide a huge gain in democratic control over a vital service. Decisions would be made in public, based on discussion of public interest, and subject to transparent availability of information. But it would also have substantial economic benefits for consumers and government.

The new public water utilities would acquire all the shareholder equity of the existing water companies. In the short term this means that the extraction of dividends from end users to shareholders would cease. In the longer term the existing private debt would be refinanced by public sector bonds at lower interest rates, thereby lowering the cost for the utilities.

## 5. Compensation

Legislation to make these changes requires bringing the water companies into public ownership, which in turn raises the question of compensation. UK law confirmed as recently as 2012 that the rules of compensation for such transfers to public ownership are not determined by stock market prices, but decided by parliament, based on the public interest, after taking into account various factors (see Annex C). Market value is only one factor in the valuation process.

Three companies are part of groups listed on the London stock exchange (Severn-Trent, United Utilities and Pennon), and so the market value of parent shares is known, and the proportion due to the water company can be estimated. On this basis, the total current market value of the shares in the water companies could be about £37bn (Annex D).

But Parliament will surely want to take into account other factors in negotiating compensation, including: the actual level of shareholder equity in the companies, or book value of the companies, which is only £14.3bn (Table 3)<sup>8</sup>; the substantial public subsidies given to the companies in 1989 (worth £12bn at today's prices); the failure of shareholders to invest new equity since 1989; the inflation of share prices by the extraction of dividends; the very low level of actual tax payments; and the use of subsidiaries in offshore tax havens like the Cayman Islands. Parliament may also want to address the remarkable feature of the companies' current licenses as providers of water and sanitation services, which states that they can only be terminated after giving the firms 25 years notice.

Thus, a wide range of figures is possible, depending on the outcome of these processes: for example, using book value, and adjusting for public subsidies, would point to a figure as low as £2.3bn; by

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<sup>8</sup> For the relevance of book value see e.g.

<http://www.investopedia.com/articles/investing/110613/market-value-versus-book-value.asp>

contrast the owners might hope for close to the market value of £37bn, without any account taken of the other factors.

The compensation should be considered in terms of an investment by the state, in return for which the public sector gains economically and socially valuable assets. In this case, there would be a clear and substantial return on such an investment, with annual savings of £2.3bn in interest and dividend payments. Even if the final figure was as high as £20bn, this would represent an investment with an annual return of over 11%.

Discussion of compensation usually raises concerns about the impact on pension funds. However, pension funds own only 3% of shares of UK quoted companies. The majority of shares in quoted companies (54%) are owned by foreign investors, with individuals, unit trusts, financial institutions (including banks and insurance companies), and other private companies holding 37%. The remainder are held by the public sector, trusts, and charities. The percentages of foreign companies or private equity funds held by UK pension funds is likely to be even lower. The concerns over the impact on pension funds could thus be dealt with by special provision for any impact on UK pension funds (ONS 2014).

## 6. Bibliography

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ONS Ownership of UK Quoted Shares: 2014 <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02>



## 7. Annexes

### A. Efficiency

PSIRU 2014 Public and private sector efficiency <http://www.psir.org/reports/public-and-private-sector-efficiency.html> : see p. 21

“It is often assumed that privatisation or PPPs will result in greater levels of technical efficiency. That is, the private sector can always deliver a given level of service with less input costs than the public sector. Politicians, media, academics and consultants frequently refer to ‘private sector efficiency’. This assumption is often shared even by critics of privatisation. But there is now extensive experience of all forms of privatisation, and researchers have published many studies of the empirical evidence on comparative technical efficiency. The results are remarkably consistent across all sectors and all forms of privatisation and outsourcing: there is no empirical evidence that the private sector is intrinsically more efficient. The same results emerge consistently from sectors and services which are subject to outsourcing, such as waste management, and in sectors privatised by sale, such as telecoms.....

In the water sector, a stream of empirical studies and reviews provide strong confirmation of the view that there is no significant difference in technical efficiency between private and public sector operators. These include both international and national studies.

A systematic review in 2008 of the global literature on all aspects of efficiency in water supply concluded simply that: “there is no hard evidence which points to a causal relation between management ownership and efficiency”.<sup>56</sup>

Another international review, published in 2010, which analysed 27 empirical studies on comparative efficiency in water (and waste management) in various countries, concluded that: “private production of local services is not systematically less costly than that of public production.”<sup>57</sup>

A comprehensive study of water supply services in France, where about three - quarters of the service is delivered by the private sector through concessions or lease contracts, found that in 2004, after making allowance for all other factors, the price of water provided by private companies is 16.6% higher than in places where municipalities provide the service.<sup>58</sup>

A series of studies in the UK has found that there has not been any significant improvement in productivity performance since privatisation; a 2007 report concluded that: “after privatization, productivity growth did not improve ... average efficiency levels were actually moderately lower in 2000 than they had been at privatization [in 1989].”

### B. Governance and current licensing system

<http://www.dutchwaterauthorities.com/wp-content/uploads/2015/05/Water-Governance-The-Dutch-Water-Authority-Model1.pdf>

Water Act 1973 <http://www.legislation.gov.uk/ukpga/Geo6/8-9/42/introduction>

- municipal control of water authorities: s.3 (1), p.6: “ the total number of members appointed by the Secretary of State and the Minister is less than the number of those appointed by local authorities.” Governance of the regional water authorities was by boards of governors. ... Over half of the members were nominated by local authorities” <http://extwprlegs1.fao.org/docs/pdf/gbr3563.pdf>

Companies hold licenses as appointed undertakers of water and sewerage services: license conditions include requirements that the undertakers must be limited companies and are entitled to 25 years notice of termination.

( Water Industry Act 1991 art 6.(5) <http://www.legislation.gov.uk/ukpga/1991/56/part/II>; OFWAT: Overview of water company licence conditions <http://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/licences/> ; Water firms win 25-year breather on licences <http://www.telegraph.co.uk/finance/2769449/Water-firms-win-25-year-breather-on-licences.html> ; example of Anglian Water [http://www.ofwat.gov.uk/wp-content/uploads/2015/10/lic\\_lic\\_ang.pdf](http://www.ofwat.gov.uk/wp-content/uploads/2015/10/lic_lic_ang.pdf) . Contain standard condition that “ For the purposes of paragraph (c) of Section 7(4) of the Water Industry Act 1991, the only circumstances in which an appointment or variation may be made, in relation to the area for which the Appointee holds the Appointment as water undertaker or, as the case may be, sewerage undertaker under this instrument, are where the Secretary of State has given the Appointee at least 25 years' notice to terminate the relevant Appointment in relation to the whole of its area and that period of notice has expired.” (Condition O: Circumstances in which a replacement appointment may be made, p.165)

### C. Legal rules on compensation –public interest is paramount

In the UK and the rest of the world, property owners always want as much compensation as possible when they lose their property as a result of a political decision. They have often been remarkably successful: when slavery was finally abolished in British colonies in 1833, UK slave-owners were paid £20million compensation – 40% of total government annual spending at that time – based on the actual value of slaves in different colonies.<sup>i</sup> More recently, company shareholders were compensated by UK governments when various sectors were brought into public ownership in the 20th century.

But there is no simple set formula in UK law for such compensation. In each case, the compensation paid has been the result of negotiations between the owners and the government of the day. Even the owners are not consistent in their preferred basis for compensation: for example, the shareholders of an aircraft company taken over by the government in World War II argued that the actual share price was the *wrong* basis for valuation. So, the actual practice has involved a range of different formulae.<sup>ii</sup>

The UK legal framework for compensation for the former private owners has no connection with the stock market rules. It allows parliament to set its own rules in each specific case, taking account of public interest considerations, as determined by the democratic process. This principle was confirmed in 2012 by the UK Court of Appeal and the European Court of Human Rights (ECHR), in relation to the rescue of Northern Rock in 2008, where the shareholders were awarded zero compensation. Some shareholders brought cases arguing that this was unfair, because the share price was £0.90, not zero. However, these cases were unsuccessful: the evaluation process used by the UK government was validated as entirely legitimate by the High Court, the Court of Appeal<sup>iii</sup>, and, for the same reasons, by the European Court of Human Rights.<sup>iv</sup>

The Court of Appeal stated:

“the court would only interfere if it were to conclude that the State's judgment as to what is in the public interest is manifestly without reasonable foundation..... if the assumptions indeed produce a nil value, that can only be because the business is shown to be worthless without the support put in by government”<sup>v</sup>

The ECHR re-stated the general principle that there was no right to full market value compensation if public interest objectives, including social justice and economic reform, lead to a different conclusion:

‘Legitimate objectives in the “public interest”, such as those pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value.’<sup>vi</sup>

This is not a new doctrine. The same principle was used by the English courts and the ECHR over 20 years previously, in rejecting claims for higher compensation by former shareholders of the shipbuilding and aerospace companies in 1977:

“A decision to enact nationalisation legislation will commonly involve consideration of various issues on which opinions within a democratic society may reasonably differ widely.... It would, in the Court's view, be artificial in this respect to divorce the decision as to the compensation terms from the actual decision to nationalise, since the factors influencing the latter will of necessity also influence the former.” (*Lithgow and Others v. the United Kingdom* (1986) 8 EHRR 329).<sup>vii</sup>

It was also used to reject a claim by the Duke of Westminster, the largest landowner in Britain, against a new law introduced by a Labour government in 1967 allowing leaseholders to buy freeholds at much less than the market value. The courts noted that:

“such legislation had been part of Labour Party policy for some years. It was regarded as a necessary social reform, required to right an injustice....”

and again, that, with ownership of property as well as with shares,

“Legitimate objectives of 'public interest', such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value”. (*James and Others v UK* [1986] 8 EHRR 123)<sup>viii</sup>

It is also worth noting that even in the USA, the principles for calculating compensation are not fixed, e.g. in Alaska: “Courts have accepted multiple valuation methods in eminent domain proceedings to determine just compensation, including fair market value, replacement value, and reproduction value.”<sup>ix</sup>

#### D. Market values

Market value estimates for water companies are based on actual LSE market values pro rata for proportion of water business by turnover or profit.

	RCV (m)	Mkt cap m.	RegWW turnover m.	Total turnover m.	Implied value of RegWW segment	Implied value as % of RCV
Severn Trent	7829	5184	1506	1787	4369	
United Utilities	10211	6143	1730	1730	6143	
Pennon	3150	3403	547	1352	1377	
Totals	21190				11889	56%
Industry (m)	66000					37029

Source: calculated from London Stock Exchange Dec 2016 data

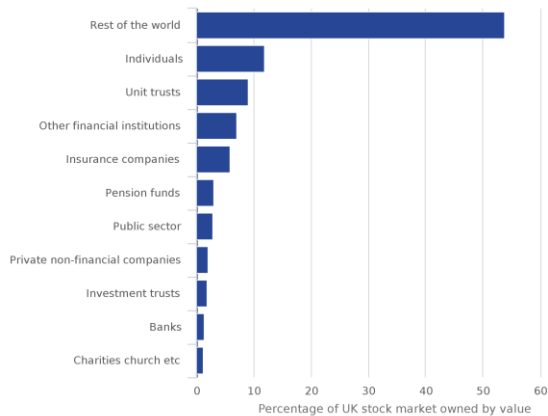
<http://www.londonstockexchange.com/statistics/historic/company-files/2016.zip>

#### E. Pension funds and investors

Pension funds own only 3% of shares of UK quoted companies. The majority of shares (54%) are owned by foreign investors, with individuals, unit trusts, financial institutions (including banks and insurance companies), and other private companies holding over one third (37%). The remainder are held by the public sector, trusts, and charities (ONS Ownership of UK Quoted Shares: 2014

<https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquoteds>

[hares/2015-09-02](#) ). The percentages of foreign companies or private equity funds held by UK pension funds is likely to be even lower. The concerns over the impact on pension funds could thus be dealt with by special provision for any impact on UK pension funds)



## F. Inflation since 1989

<https://www.ons.gov.uk/economy/inflationandpriceindices/datasets/consumerpriceindices>

CPI All Items Index: Estimated pre-97 2015=100: July 1989 52.3, July 2016 100.6: change = +92%.

<sup>i</sup> See Legacies of British Slave-ownership <https://www.ucl.ac.uk/lbs/project/context/>

<sup>ii</sup> Cairns, Mary Bell. 1951. 'Some Legal Aspects of Compensation for Nationalized Assets'. *Law and Contemporary Problems* 16 (4): 594–619. doi:10.2307/1189978

<http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2504&context=lcp>

<sup>iii</sup> Court of Appeal 28/07/2009 <http://www.bailii.org/ew/cases/EWCA/Civ/2009/788.html>

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