

Water company financing and financial performance



In 1989, the water companies in England and Wales were privatised with zero debt (with minor exceptions). The sale proceeds raised were £3.9 billion. The companies' regulatory capital value (RCV) has subsequently become accepted as an indication of their market value.

The current RCV of the privatised companies is approximately £44 billion. In order to calculate the equity value in these companies we need to subtract the current level of outstanding debt from the total RCV. We then need to add back the dividends that these companies have paid.

On this basis, the return that an investor who bought a share in each company and who reinvested all dividends would have earned is around 17.5% compound. This compares to the 8 - 9% return that was available to an investor who invested in a FTSE all share index-linked fund over the same period. Some of this high return can reasonably be ascribed to the novel nature of water privatisation, but it is instructive to note that companies' were much lower in the period after Ofwat's 2000 determination of prices than they have been more recently.

The principal explanation of the high levels of return on the equity investment in the companies has been the huge increase in the level of the companies' debt. The extent to which the companies have been able to increase their leverage has been underestimated, if not unforeseen, by regulators¹. It is arguable that the level of dividends paid by the companies has been excessive and is unsustainable if we return to more prudent lending principles.

The importance of the easy access to debt finance is evidenced by the recent transactions, which have valued companies substantially in excess of their RCV. This suggests that the RCV is perceived to be understating the true market value. Transactions in excess of RCV can be justified only if an investor believes that the expected return is higher than the true cost of capital for a company. This could be because the allowed for cost of capital is too high or that there is substantial (and ongoing) opportunity for outperformance of regulatory assumptions. Given that prices are determined every five years, it would be unwise to place too much value on outperformance of regulatory assumptions. This would suggest that the investors who are prepared to pay such premia to RCV consider the return allowed for by the regulator overstates the actual cost of capital (real or perceived) at least for these investors. In large part this is a function of the low cost of debt that was available in the market. If a premium of 10% to the RCV is justified, the return to the equity holder increases to almost 19%. Customers will lose out if the regulator allows the companies to earn too high a return on their RCV because their bills will be higher than they need to be.

¹ Ofwat, even in its early days, recognized the potential for the companies to increase their leverage.

How do we know that it is the increase in leverage that has been, at least in part, responsible for the high returns earned by investors? Contrary to the popular view, the companies have only been relatively marginally cash negative since their privatisation.

Debt at March 2008: £29.2 billion

Dividends distributed (1989-2008): £24.1 billion

It is certainly true that companies have been able to improve their performance and to reduce their costs. But it is equally true that if allowed for returns were not decreased at a time when increasing leverage allowed for higher dividends, the return that the companies should be allowed to earn on their RCV should not now be revised upwards to reflect the higher cost of debt. This is a risk that it is appropriate for the shareholder, and not the customer, to bear.

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