

# Water Industry Finance and Investment

## Customers and shareholders investing in improvement

### Summary

As a result of high investment the water and sewerage service in England and Wales has improved a lot in a comparatively short time. Water bills have risen to pay for the investment – without it bills would have fallen as the cost of providing the service has been reduced by gains in efficiency.

Price regulation allows companies (if they are efficient) enough revenue from sales to provide the service, to fund a proportion of the investment they are required to carry out, and to make a profit to cover returns to investors in interest on loans and share dividends. They obtain the extra finance they need by supplementing sales revenue with long-term investment finance from the capital markets.

Today's customers see the benefits as soon as the projects are complete, but future customers share the cost because they will also benefit from long-lasting improvements. This 'mortgage' system makes sense for society, for the environment, and for investors who manage the savings of millions of people.

### Investment on a surprising scale

In recent years the water industry has invested, on average, half its turnover in new assets.

Between 1990 and 2010 water companies in England and Wales will together have invested more than £80 billion in bringing vital infrastructure up to standard and improving the quality of their services. This represents around half their sales revenue.

The scale of investment is surprising to many people for three reasons:

- i) In other sectors capital expenditure is much smaller in relation to sales revenue. Water companies are said in the jargon to be "capital intensive" (Table 1).
- ii) Even the biggest water investment projects are invisible to most people, either underground or on remote river banks. This is particularly true of wastewater treatment, which many of us choose not to think about.

#### Turnover and capital expenditure

| 2007                                       | Turnover (billions) | Capital expenditure (billions) | Capital expenditure as % of turnover |
|--|---------------------|--------------------------------|--------------------------------------|
| BP   | US\$284             | US\$20.6                       | 7.3                                  |
| GlaxoSmithKline                            | £22.7               | £2.1                           | 9.4                                  |
| Tesco                                      | £46.6               | £3.0                           | 6.4                                  |
| National Grid Transco                      | £8.7                | £2.3                           | 27                                   |
| <b>Water industry in England and Wales</b> | <b>£8.7</b>         | <b>£4.4</b>                    | <b>50</b>                            |

Examples are the upgrading of a large sewage treatment works to meet standards set by environmental regulators; and the construction and commissioning of a sewage sludge treatment plant.

iii) Our fast-moving society takes water services for granted. We want them to work well now but are not very interested in the details or costs of building for the future.

## Investment for now and the long term

Without the investment programmes prices would have fallen substantially due to efficiency gains.

As well as improvements, water customers and the public want value for money. New investments, whether they are mains, sewers, treatment works or monitoring systems, must provide years (or generations!) of trouble-free service. So long-term investment finance is essential. Companies regularly obtain loans that are repaid like a mortgage over 30 or 40 years.

In many countries water service providers are owned by the government and financed by the tax-payer. In England and Wales water companies are privately owned and have access to capital market finance. The tax-payer pays nothing.

What matters more than ownership is regulation that ensures finance is a) available when needed; and b) matches the life of the assets it funds. If a big capital investment programme is needed, both these conditions must be met. Otherwise water bills will be higher than necessary and poor value for money.

Water bills have risen due to the scale of the work needed and the short delivery time. Without the investment programmes prices would have fallen substantially due to the efficiency gains made by companies. As it is, price rises have been much less than they would have been without the efficiencies. This is worth some £100 a year to the average customer in 2008 (Ofwat).

## An investment partnership

Companies present operating and capital budgets which are tested for Ofwat by independent consultants.

Water industry finance works through a partnership between the companies, their customers and investors in a framework of price regulation led by Ofwat.

Each company consults widely on its plans for the 5-year period. When the requirements are settled it presents management plans to Ofwat. The plans contain operating and capital expenditure budgets which are challenged for the regulator by independent consultants.

Ofwat then assesses the sales revenue the companies will need to cover:

- operating expenditure (for providing the service);
- a proportion of capital expenditure (for investing in plant and pipe networks and improving the service); and
- profit (for making a return to investors as dividends and interest on loans to pay for remaining investment).

Having done this Ofwat sets price limits for each of the 5 years. The limits build in estimates of a) the cost of the returns the companies will need to pay to investors; and b) the efficiencies Ofwat expects them to make to keep bills as low as possible.

Companies then prepare to implement their plans. This means planning for engineering and scientific projects and for obtaining the capital finance they will need.

## Investors, markets and customers

Each year to meet its investment obligations the industry has had to obtain significant extra finance over and above its revenue.

Ofwat allows a certain amount of finance

for investment in the bills paid by today's customers but assumes that companies will be able to obtain any extra finance they need from the capital markets. In fact every year since 1990 there has been a significant gap – often as much as £1 billion – which has been filled by market investors. This is why water companies are described with some understatement as “cash negative”.

In effect, judgments have been made:

- that the investment was necessary and must go ahead as quickly as possible to meet government deadlines;
- that it is not fair for today's customers to pay the whole cost as future customers will share the benefit from long-life assets; and
- that well-run water companies will be able to obtain the necessary finance and pay for it over the long-term (this has been borne out in practice).

Companies obtain most of the new capital they need in loans from institutions like pension funds arranged through the capital markets. The institutions are happy to lend as long as they receive a fair rate of interest. Companies' debt has risen substantially – in 1990 they had practically none, but by March 2007 the total stood at over £27 billion, more than £1,000 for every household.

## Profits and bills

Companies that win investors' confidence can obtain funds at competitive rates of interest.

A strong financial performance, including making steady profits, helps keep water bills down. This is because the large amount of

capital invested in the companies over the years means that returns to investors account for a substantial share of company revenue.

But companies that meet their obligations within price limits and make satisfactory profits win investors' confidence and can obtain funds at competitive rates of interest. The result is lower costs – and lower bills.

Price regulation also provides an incentive to be efficient because companies are allowed to keep the amounts they save on the costs agreed with Ofwat as extra profit, but only until the next price review. At that point this reward for 'out-performance' is returned to customers in price limits set for the following 5 years which are lower than they would have been. In this way both customers and companies benefit from companies' greater efficiency.

## Investment, profits and return on capital

The most important single fact about water company finance in recent years has been the scale of capital investment.

The main advantage of this kind of regulated investment is that benefits come more quickly and costs are lower than if companies used a pay-as-you-go system. The costs can be spread over a longer term like a mortgage. It would be unrealistic and unfair to ask today's customers to foot the whole bill.

The investors who make this possible do so by buying water company bonds or shares through the debt or equity (share) markets. For the most part they are fund managers whose

**Table 2 – Comparing rates of return**

| Sector                                     | Period          | Net rate of return % |
|--|-----------------|----------------------|
| Manufacturing companies                    | 2006-07 average | 7.7                  |
| Service companies                          | 2006-07 average | 20.0                 |
| <b>Water industry in England and Wales</b> | <b>2006-07</b>  | <b>6.4</b>           |

Source: National Statistics and Ofwat

duty is to maximise returns on the savings and pensions of millions. Water companies are attractive because as long as they are efficient and successful they make steady profits and fill an important place in investment portfolios.

The most important single fact about water company finance in recent years is the scale of capital investment. It is large by comparison with most companies of a similar size and has brought a big increase in the accumulated value of the assets companies own and manage on behalf of the public.

Companies must reward this investment by paying dividends from their profits. Because the investment is unusually large the profits

needed are correspondingly large, but the actual return paid to investors is modest in percentage terms.

In 2006-07 the replacement value of the industry's tangible assets was £239 billion – a very large sum but not so surprising when you think it meets the daily water and sewerage needs of 52 million human beings and hundreds of thousands of businesses. Ofwat uses a more market-related base to measure return on capital employed – the Regulatory Capital Value. In 2006-07 this was £42 billion and the overall pre-tax return on capital was 6.4%. We can put these figures into context by comparing the return on capital made in other sectors (Table 2, page 3).

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