Water UK

Finance and investment

Briefing note 3
Customers and shareholders investing in improvement

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www.water.org.uk

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 bear 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.

Ivestment on a surprising scale

In recent years the water industry has invested, on average over 40% of its turnover in new assets.

Between 1990 and 2018 water companies in England and Wales together have invested more than £150 billion in brining vital infrastructure up to standard and improving the quality of their services.

This represents over 40% of their sales revenue.

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

- 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).
- 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. 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.
- 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.

About Water UK

Water UK represents and works with the major water and wastewater service providers from both the private and public sectors in England, Scotland, Wales and Northern Ireland. Our vision is of a water sector that provides customers and communities with world-class services and enhances the UK's quality of life.

2018	Turnover (billions)	Capital expenditure (billions) (*R&D expenditure for GSK)	Capital expenditure as % of turnover
BP	US $245	**US $17.8**	**7**
Glaxo Smith Kline	£30.2	**£3.9***	**13**
Tesco	£57.5	**£1.1**	**2**
National Grid	£15.2	**£4.3**	**28**
England & Wales Water industry	£11.7	**£4.9**	**42**

Table 1: Relative scale of capital expenditure in different sectors

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 even 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, rather than relying on tax-payers to fund investment.

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 rose after privatisation due to the scale of the work needed to make up for lack of investment when water companies were in public ownership. Without the investment programmes prices would have fallen substantially due to the efficiency gains made by companies – companies have improved their productivity by 64% since privatisation.

As it is, price rises were much less than they would have been without these improvements. This is worth some £120 a year to the average customer.

An investment partnership

Companies present business plans which are tested for Ofwat and 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 to understand customer and stakeholder priorities for the next 5 years and beyond. Companies base their business plans on these priorities and present them to Ofwat. The plans contain operating and capital expenditure budgets and promises to improve service levels, which are challenged by regulator and 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 controls for each of the 5 years. The controls 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.

Investment, 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 will need from the capital markets. This gap – which may run into billions – has to be filled by financial market investors. This is why water companies are described with some understatement as 'cash negative'.

In effect, judgements are made:

- That investment is necessary and must go ahead as quickly as possible to meet government deadlines and customers' priorities;
- 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;
- That well-run water companies will be able to obtain long-term finance (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, as this is normally the cheapest way to raise the finance they need and keeps customers' bills down. 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 2015 the total stood at over £40 billion

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 their price controls 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 over the last 25 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 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 over the last 25 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.

The replacement value of the industry's tangible assets is well over £250 billion – a very large sum but not so surprising when you think it meets the daily water and sewerage needs of over 55 million people and hundreds of thousands of businesses.

Ofwat uses a more market-related base to measure return on capital employed – the Regulatory Capital Value. In March 2018 this was £72.5 billion and for the period from 2015-20, Ofwat set an overall return on capital of 3.74%, the lowest ever return to investors.

In 2019, Ofwat will make decisions for 2020-25, and have already said they expect to set and even lower return to investors, less than 3%, to help keep bills down for customers.

Find out more

More information on the water industry is available at www.working4water.org.uk.

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