Private Island - James Meek – Verso Publishing – 2015

The privatisation of Britain’s water companies in 1989 had nothing in common with the romantic notion of shareholder capitalism, where inventors and entrepreneurs have ideas, start businesses and sell shares to bold investors in order to raise money to help those businesses expand. Far from being exciting new entrepreneurial ventures, the companies involved were settled operations that had been around in one form or another for almost 200 years, and had benefited, for more than half that time, from steady infusions of ratepayers’ and taxpayers’ money.

The most striking contradiction between water privatisation and Thatcherite free~market romanticism was the monopoly nature of the water companies: millions of customers who have no choice of supplier, no choice but to take the water, and no choice but to pay for it. Millions of captive monthly payments in perpetuity: an investors dream. Yes, there was a regulator, Ofwat, to limit prices, and to make sure the companies invested in rebuilding the ageing water and sewage systems, but there seemed little danger that the government of Margaret Thatcher would prevent shareholders making fat returns. And so it proved, even unto her successors.

The simplest way to understand the way the water set-up works in England is to think of it as a form of buy-to-let scheme, with us, the customers, as the tenants, paying water bills, like rent; the shareholders as landlords, owning the water companies; and the company staff, like a property management agency, collecting the rent and maintaining the property. Every so often a government inspector - Ofwat - comes round, sets a limit on how much rent the property managers can charge, and tells them they should get a move on with the renovation. But if we don’t like the property, the management agency or the landlords, or if we think the rent is too high, we don’t have any choice. We can’t move to a cheaper property, or a better-run one; were stuck.

Ofwat argues that English water companies are more efficient than they were before privatisation, pollute less, provide cleaner drinking water and have spent tens of billions of pounds renovating the country’s water system. All but the first proposition are true; the first may be too. But that’s to compare the privatised water companies with the investment-starved, bureaucratic, centrally funded leviathans of the 1970s and 1980s, not with what they might, or should, have been. In January 2008, the Oxford economist Dieter Helm published a hair-raising analysis of the regulation of Britain’s privatised utilities that might have shocked the nation, had its dense technical vocabulary been more comprehensible to MI-‘s and non-economists. Helm argued persuasively that Ofwat had permitted the growth of a system which efficiently ripped customers off, while exposing utility companies to a risk of bankruptcy that has never been higher.

It works like this. When Ofwat decides how much the water companies should be allowed to charge customers, one of the key numbers is how much the regulator thinks it’s fair for an investor who puts money into the water industry to get back: the ‘return on capital. But a water company can get investment

in two ways. It can get money by selling shares to shareholders - ‘equity’ - or it can borrow money directly; that is, take on debt. Crucially, equity commands a

higher expected rate of return for investors than debt, because shareholders are expected to be more tolerant of risk. The problem Helm identified was that England's water privatisation lumped together two entirely different sides of the business: on the one hand, the existing assets (waterworks, pipeline networks, reservoirs, pumps and so on); and, on the other, operations plus investments in new equipment. The first side was low-risk, and could easily be financed with debt. The second was riskier, and more suitable for finance with a mixture of debt and equity. But Ofwat only has one figure for what it considers a reasonable return on capital: an average of debt and equity.

In other words, Ofwat bases the amount customers pay for water on the assumption that water companies will take on a certain mix of expensive equity financing and cheaper debt financing. But what if water companies simply take on more debt than Ofwat expects? Then the customers will still pay for water according to Ofwat's assumptions, but shareholders will pocket the difference between the two, and that, Helm says, is exactly what happened. 'Investors,' he wrote, 'now contemplate an extraordinary open goal The scale of this transfer (from customers to shareholders) is enormous.' In an article in the Financial Times inspired by Helms analysis, Martin Wolf wrote: 'Investors have been able to buy the companies (BAA and the water companies, for example), replace the equity with debt and enjoy a licence to print money. Professor Helm estimates that this financial arbitrage has been worth up to £1 billion a year, at the expense of the customers, predominantly in water. This is, quite simply, a scandal.' As if this wasn't bad enough, Helm pointed out that the huge recent increase in utilities' debt threatened the stability of the riskier side of their business, the day-to-day operations. 'The utilities may not be robust against adverse external shocks,' he said bluntly. 'They might go bankrupt'.

Emma Cochrane, the head of corporate finance at Ofwat, wrote to me in an email that the regulator was familiar with Helm's ideas, had considered them 'very carefully', and rejected them. Helm believes the role of Ofwat itself makes investors in water companies effectively invulnerable to risks where their fixed assets are concerned, passing the risk on to customers; Ofwat disagrees. Cochrane also questioned how easy it would be, as Helm suggests, to split the safe pipes-and-reservoirs side of the water business off from the riskier operate-and-build side. 'You argue that Ofwat has permitted a system that both rips off customers and exposes utility companies to bankruptcy risk. I'm not sure you can argue both,' she wrote.

The Mythe debacle seems to give ammunition for both sides: on the one hand, Ofwat was sufficiently protective of Severn Trent's shareholders to allow the company not to compensate customers for losing their water supply. On the other, Severn Trent lost £14 million as a result of the Mythe failure. Yet on balance, the shareholders seem to win, whatever happens. After the flood, profits were down, but dividends were up, and Severn Trent hadn't lost a single customer, because the customers have nowhere else to go.

On the face of it, Cochrane might seem to be fair in questioning whether a company can be both rapacious and vulnerable. Yet as we saw in the previous chapter, in the five years of Railtrack's sorry existence, the privatised railway infrastructure company sucked in vast amounts of money from

government and rail users, blew out almost £4 billion in debt repayments and dividends, and then collapsed.

It's not as if there aren't other models for water companies. There's the municipal socialism of late nineteenth-century Britain, when business minded councillors ran networks of utilities as successful commercial concerns, profitable and efficient but publicly owned. Closer to hand, there's Scottish Water - resembling the old water boards in England, but run as a commercial firm, that is to say not subsidised out of general taxation, and with income and expenditure accounted for like a private company. Wales is served, under Ofwat's supervision, by the Welsh water company Glas Cymru, which has no shareholders, but is financed entirely from bonds, borrowings and income from customers. As in France, Glas Cymru puts the actual operation of its water services out to tender to private companies.

A comparison of Scottish Water, Glas Cymru and Severn Trent is instructive. Between 2009 and 2013, Severn Trent gave out almost £1 billion in dividends to shareholders. Had Severn Trent been run as a non-profit, commercial venture, a proportion of those dividend payments would have had to go towards paying interest on debt, but the cash leaked would have been less, and the surplus would have been ploughed back into the business of pipes, sewers and clean water. In the same period Scottish Water, a state-owned, unsubsidised, not for profit organisation, gave away no dividends. Its prices are about the same as Severn Trent - which boasts that it is the cheapest of all English water companies - and yet, over that same five year period, Scottish Water invested more than £800 per customer, against £475 for Severn Trent. For better or for worse Glas Cymru, meanwhile, actually handed money back to its customers as a form of 'dividend'.

Water privatisation has thrust international generosity on the English public. Popular discontent with the supposed impositions of the European Union is mainstream, yet this discontent finds its strange opposite in the calmness with which English water customers hand billions of pounds over to their monopoly water providers each year, only to see them transmit chunks of it overseas. Anglian Water, for instance, is owned, through a chain of companies registered in Jersey and the Cayman Islands, by a mainly overseas consortium. One consortium partner is the Canada Pension Plan Investment Board. Whenever the captive customers of Anglian turn on the tap they are, in a small way, helping to 'sustain the future pensions of 18 million Canadians', as the CPPIB puts it.

Northumbrian Water, which serves the northeast of England, belongs to China's Li Ka-shing's Cheung Kong Infrastructure, the same outfit mentioned in the next chapter as having the monopoly on London's underground electricity cables. *(China's Li Ka-shing's companies also own NZ's Wellington Electricity and Envirowaste [NZ's second largest rubbish disposal company] As at February 2021 Li is estimated to be worth US$32.9 Billion)* Southern Water (Sussex and Hampshire) is owned by a Jersey registered consortium called Greensand Holdings, bringing together various Australian pension funds and the Swiss bank CBS. Ownership of Yorkshire Water is split between various institutional rentiers, including Citibank and the government of Singapore. When the US energy company Enron drowned in its own hype

in 2002, it owned Wessex Water, which serves Dorset, Somerset and Wiltshire. Wessex was bought by YTL Power of Kuala Lumpur - its slogan at the time ‘World Class Products at third World Prices’. (Since changed to ‘World Class Products and Services at Very Competitive Prices’).

One of the ideals of water privatisation that was most important to its political sponsors - expansion of the number of small shareholders in Britain, the acquisition by ordinary citizens of a direct stake in the financial success of the companies providing them with essential services - hasn’t been met. Originally the firms that were privatised became, in the terminology of the markets, ‘public’ companies, in the sense that they were floated on the stock market, and anyone with money could buy shares in them. Now most of the formerly ‘public’ privatised firms are only accessible to those who can deal in billions. In market terminology Anglian, Northumbrian, Southern, Thames, Wessex and Yorkshire are ‘private companies’, no longer traded on the stock market; small shareholders have been bought out by big institutional owners, who occasionally sell great chunks to each other, out of their customer’s ken. The only big water companies still listed on the London Stock Exchange are United Utilities, South West (as Pennon Group) and Severn Trent, which fought off a takeover bid in 2013 from a consortium uniting the Kuwait government, a Canadian pension fund and (a rare one, this) the pension fund for British academics.

Thames Water, which holds a monopoly on London’s water supply, was ‘taken private’ - that is, the moment where a privatised but publicly listed company becomes absolutely private property - in 2000 by the German energy company RWE. In 2006 RWE sold it on to a consortium led by an Australian investment bank, Macquarie. At the time of writing Macquarie is the dominant partner - it owns just over a quarter of Thames - with a dozen other institutional owners, only one of which, the British Telecom pension scheme with 13 per cent of Thames, is based in the UK. If you were a resident of London, unhappy with Thames’ service, and wanted to stage a protest against its owners, or if you were a British journalist, politician or regulator who wanted to meet them on their home turfs, you’d face a long, expensive trip. The BT pension scheme is based in Chesterfield, England. Macquarie is based in Sydney, Australia, as is the investment house AMP Capital, which has 5.5 per cent of Thames. While you were in Australia, you’d have to visit Brisbane, home of the Queensland Investment Corporation, (8.7 per cent of Thames) and Wollongong in New South Wales, headquarters of the pension fund State Super (2.4 per cent). Your journey would barely have begun. You’d also have to go to Abu Dhabi, base of that sheikhdom’s oil investment fund (9.9 per cent of Thames) and Beijing, home to the Chinese government's Chinese Investment Corporation (8.7 per cent). You’d fly trans-Pacific to Canada, where you’d stop off in Victoria, BC (British Columbia Investment Management Corporation, 8,7 per cent); Edmonton (Alberta Investment Management, 3.2 per cent) and Toronto (Aquila Infrastructure, 2.6 per cent, and Optrust, 4.3 per cent). Your last leg would take you across the Atlantic to Holland, home of ABP, based in Heerlen (4.3 per cent) and Stichting Pensioenfonds Zorg en Welzijn of Zeist (2.1 per cent). Truly, the empire of Thames Water investors is one on which the sun never sets.

Macquarie and the rest of the "Thames Thirteen are a good example of an attempt to take advantage of weak water industry regulation to suck money out of the taps. In the most recent year for which accounts are available, Thames received £1.23 billion from its customers. The proportion of this which reached the Thames Thirteen was relatively small - only £75 million, which represents, based on some Ofwat data from 2007 about how much of their own money the original members of the Macquarie consortium put into the purchase, a return of just over 3 per cent - pretty meagre. But look at the accounts. The headline figure recorded for dividends to shareholders is much higher - £231 million, or 12.9 per cent of turnover. How to explain the difference? The secret lies in the chain of companies through which the Thames Thirteen owns the actual utility. As that £231 million moves away from the pipes and sewers on its journey to Canada and the Arabian peninsula, it stops of at other entities, like Thames Water Utilities Cayman Finance Limited. Somewhere in the chain it sheds £156 million. This is 'inter-company interest' and relates to the money the Thames Thirteen borrowed in order to buy Thames in the first place. To put it simply, the buyers of Thames Water took out a mortgage to get it, and the money they earn from direct dividends is trivial compared to the amount they think they'll gain when, as they eventually will, they sell the company on.

Think back to the buy-to-let analogy I used earlier. Suppose you received a big inheritance, bought a flat in London as an investment and rented it out. If you paid for the whole flat up front in cash, you'd not be doing too well by capitalist standards. You might earn a few per cent a year on the money you spent which you would then be taxed on. But what if the flat increased in value? What if you bought the house for half a million and sold it five years later for £600,000? Well, that's a gain of Z0 per cent - not bad. However, there's another way. What if you could get a loan for 95 per cent of the flat's value? Then you'd only pay £25,000 up front, use the rent to make the interest payments, and five years later get back £125,000 - a 400 per cent return on your investment. And if you could set the interest payments on the loan off against tax, even better.

That's what private equity consortia like the Macquarie-led Thames Thirteen are doing: borrowing money to buy privatised infrastructure using a small down payment, taking a relatively small dividend directly, and using the rest of the dividend to pay off the loan in the hope that when, after a few years, they sell the water firms/ports/airports/motorways, they'll make an enormous profit. In 2006, when the Macquarie-led consortium beat off rivals to buy Thames (the consortium had a slightly different make-up then) it paid $7.9 billion, at a time when Ofwat, the regulator, reckoned the company's underlying assets were worth £5.9 billion. Based on early Ofwat estimates, most of the loans the consortium borrowed to complete the deal, £4.4 billions worth, would have gone on the company's books - not an unreasonable amount of debt for a company with a big programme of works to carry out. But a significant additional amount, £l.2 billion, would have been piled onto the accounts of that chain of holding companies, to be paid back through dividends. To buy Thames, then, Macquarie would have borrowed 95 per cent of what Ofwat said the company was worth, and paid, in all, 134 per cent.

The Thames Thirteen, in other words, believe the company is worth much more than Ofwat does. Where did the consortium hope the extra money was going to come from - the extra money to meet its high mortgage payments, and to increase the company's price so it could make a profit when it sold it on? Macquarie may be a super-efficient manager, but a generation after privatisation, it was never going to be able to sack enough people, sell enough land or transform working practices radically enough to make up the difference. There would be limits, too, on how far Thames might be able to drag its feet on the vast programme of pipe and sewer replacement Ofwat demanded. The only give in the programme was the possibility that Thames customers were paying much more for the water system and its renewal than Macquarie's cost of capital - its mortgage rate - required. This is clearly what Macquarie believed, or at least persuaded its fellow investors it believed; and Ofwat didn't seem to mind. Ofwat's attitude is that it doesn't care how much punters pay for a water company, as long as they don't put the company's operations in jeopardy, But this ignores the fact that the overwhelming factor determining a water company's price is Ofwat's own rulings about how much the company can charge customers, and how much it must invest. The Macquarie consortium's bid was a group of sophisticated investors telling the body supposed to protect British citizens' interests that it had screwed up, and it was going to rip them off.

Where does this leave Thames Waters fourteen million customers? Paying more for their water than they should, with a large share of that payment going to remote, unaccountable bodies over whom they have no control, and whom they have no choice but to accept. And regardless of whether it is set at a fair level or not, the obligation to pay, and the lack of choice about whom to pay it too, makes the English water bill, effectively, a tax. I'm all for trade, mutual investment and the exchange of people and ideas between Britain and China. I've nothing against the Chinese. I sympathise with residual anger that Britain waged war against China in the nineteenth century in support of British opium dealers, yet has no popular memory of the fact. But nobody could describe China today as a democracy It is an authoritarian state that censors free expression and represses campaigners for social justice with a degree of harshness greatly in excess of that currently accepted in Britain. The ruling elite identify themselves as communists, yet have grown personally wealthy by endorsing a version of capitalism. When we Londoners turn on our taps and fill our kettles, it is as if we are taking part in an enactment of die last scene from George Orwell's Animal Farm, where the post-revolutionary pigs and the cynical farmers sit down to feast together. A British political party that has traded since I was a child on its claim to patriotism, its belief in freedom and democracy, and in its contempt for communism, has enabled a system in which I am obliged to pay an annual tax to the worlds biggest communist country in order to exist.

From the perspective of the Thames Thirteen there's a possible flaw, of course, in the scheme I've described above. It's the same as the flaw in buy-to-let. What if the value of the asset you buy, the house or the water company, doesn't go up? What if it falls? What if interest rates go up, you can't make the loan payments, and you have to sell, just when everybody else is trying to sell

for the same reason, driving prices down further? Well, that's bad news for the ultimate owners ~ but not for everyone.

Look again at the identities of the Thames Thirteen. Apart from Macquarie, which is acting as the agent for another group of smaller institutional investors, and the two sovereign wealth funds, most have something in common: they're investing on behalf of present and future pensioners, and are, or grew out of, pension funds set up for state workforces. "The Queensland Investment Corporation began as the pension fund for Queensland state employees; State Super caters for New South Wales civil servants. ABP and Stichting Pensioenfonds Zorg en Welzijn are pension funds for Dutch civil servants, teachers, social workers, doctors and nurses. 'The Alberta, British Columbia and Optrust funds in Ontario invest on behalf of the public servants of those provinces. BT was once a government firm. Even AMP Capital, never a public outfit, had communitarian origins - a big demutualisation of a non-profit Sydney life insurance firm in 1998.

When you look more closely at what happened to Thames Water, it is not a simple, and potentially chauvinist, tale of exploitation of captive Londoners by cunning foreign capitalists. It is a tale of clever middlemen. On one side, millions of Thames Water customers, paying an inflated private water tax; on the other, millions of Dutch, Canadian, Australian and British pensioners, dependent on their pension funds in their old age, and millions of Chinese and Emiratis, powerless to influence their government's disposition of national wealth. In the middle, an international fraternity of fund managers, telling the Thames customers what a brilliant deal they have with the Thames Thirteen as their tax collectors, and telling the world's pensioners what an extraordinary return they're getting on their stake in Thames Water, so extraordinary that they, the private planners of the fund manager class, need to be rewarded with fat fees, options, salaries and bonuses. It's not possible for both messages to be true. And if the Thames Thirteen lose their shirt on their punt - if Ofwat gets tough, for instance, and they end up selling Thames to the next buyer for less than they paid for it - there'll be no clawing back of the extras, the top 1 per cent remuneration, the beachfront homes, the trophy cars and the vintage wine cellars that the fund managers have gained over the years.

In 2012 the new head of the Ontario civil servants' pension fund Optrust, Stephen Griggs, demanded to know why members of the fund's Private Markets Group - the team responsible for buying a stake in Thames Water - were not paid according to what other Canadian pension fund managers were paid, but according to salaries paid by the likes of Goldman Sachs on Wall Street. Soon afterwards, he was sacked.

The privatisation of New Zealand's electricity assets and railways had much in the way of similarities.