Who owns the water companies?

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Who owns the water companies? Are publicly quoted companies better than private equity and infrastructure owned companies? Does it really matter?

All sorts of claims are being made, and the merit of the discussion is that it asks very good questions. The demerit is that it does not give very good answers. For at the heart of the debate is a very simplistic view that the ownership of publicly quoted companies is sharply different from that of privately owned ones. But it isn't. And the reason for this mistake is that little attention has been paid to who ultimately owns the publicly quoted companies.

It turns out that the owners of the publicly listed companies comprise mainly of the same sorts of investors that comprise the funders of the private equity and infrastructure funds owned companies. What's more, the largest owners of each of the publicly listed companies own shares in *all* the listed companies. Two Lazard investment vehicles – Lazard Asset Management LLC and Lazard Asset Management Pacific Co. – own between them roughly 10% each of Severn Trent *and* United Utilities *and* Pennon. Vanguard Group Inc., Blackrock Investment Management (UK) Ltd. and Legal and General Investment Management Ltd. also own stakes in *all* of them. No such cross-ownership characterises the privately owned companies, though even here a detailed examination might reveal more subtle overlaps too.

Institutions in total own around 35% of United Utilities *and* Severn Trent *and* over 55% of Pennon. The tables below provide a recent snapshot and hence only a general picture – subject of course to change.

TABLE: Ordinary share ownership of the quoted water companies

SVT

Rank	Type	%OS
-		
-	Institutions	35.21
1	Lazard Asset Management LLC	5.08
2	BlackRock Investment Management (UK) Ltd.	4.14
3	Legal & General Investment Management Ltd.	3.60
4	Maple-Brown Abbott Ltd.	3.40
5	Lazard Asset Management Pacific Co.	3.07
6	The Vanguard Group, Inc.	2.98
7	Standard Life Investments Ltd.	2.68
8	Norges Bank Investment Management	1.79
9	Nomura Asset Management U.K. Ltd.	1.68
10	BlackRock Advisors (UK) Ltd.	1.46
11	Royal London Asset Management Ltd.	1.24
12	Invesco Asset Management Ltd.	1.04
13	Deutsche Asset Management Investment GmbH	1.01
14	Hargreaves Lansdown Stockbrokers Ltd.	1.00
15	BlackRock Fund Advisors	1.00

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Rank	Type	%OS
-		
-	Institutions	34.06
1	Lazard Asset Management Pacific Co.	8.03
2	The Vanguard Group, Inc.	3.10
3	Norges Bank Investment Management	3.03
4	Legal & General Investment Management Ltd.	2.98
5	M&G Investment Management Ltd.	2.01
6	Lazard Asset Management LLC	1.99
7	BlackRock Fund Advisors	1.80
8	Nomura Asset Management U.K. Ltd.	1.69
9	RARE Infrastructure Ltd. (Investment Management)	1.61
10	Hargreaves Lansdown Stockbrokers Ltd.	1.56
11	Magellan Asset Management Ltd.	1.44
12	Royal London Asset Management Ltd.	1.32
13	Deutsche Asset Management Investment GmbH	1.19
14	Threadneedle Asset Management Ltd.	1.17
15	SSgA Funds Management, Inc.	1.15

PNN

Rank	Type	%OS
-		
-	Institutions	56.50
1	Lazard Asset Management LLC	9.90
2	Pictet Asset Management SA	6.10
3	Threadneedle Asset Management Ltd.	4.84
4	Capital Research & Management Co. (Global Investors)	4.79
5	RARE Infrastructure Ltd. (Investment Management)	4.61
6	AXA Investment Managers UK Ltd.	4.31
7	Invesco Asset Management Ltd.	4.10
8	UBS Ltd. (Market Maker)	3.96
9	Royal London Asset Management Ltd.	2.58
10	The Vanguard Group, Inc.	2.33
11	Aviva Investors Global Services Ltd.	1.95
12	BlackRock Investment Management (UK) Ltd.	1.91
13	Legal & General Investment Management Ltd.	1.86
14	Lazard Asset Management Pacific Co.	1.73
15	Hargreaves Lansdown Stockbrokers Ltd.	1.53

Source: Factset, 19th July 2018

Concentrated ownership brings with it influence and power over the directors of the company. A recent concern raised in a rapidly growing number of academic studies is over whether owning stakes in several companies in the same industry raises competition issues. Attention has in particular has focused on whether the stakes held by Blackrock and Fidelity and others in several of the main US financial institutions should raise alarm bells with competition authorities. In the case of water, the question is about both common ownership of monopolies and common ownership of competitive elements – and whether the monopolies can be opened up to auctions and competitive bidding.

Being the biggest shareholders gives these investors privileged access to the company directors; something the private ownership model makes a virtue of. When the biggest shareholder rings up, chief executives and finance directors tend to sit up and take note. When they say, for example, they are worried about Labour's renationalisation plans, and they say this to all the companies, you can expect a concerted lobbying to follow. It might happen anyway of course, but the point is that the influence of owners is subtle and not that transparent.

It matters even more if the companies can potentially or do now compete with each other. In water, there is already comparative efficiency competition, and now markets are opening up, there is already some competition for some sorts of customers. The really interesting question is however whether they can in future be opened up to bid against each other for core elements of the network services, notably in the system operator model, to which we turn later below.

How does this concentration of owners of the publicly quoted companies around institutions compare with the private ownership model? Take Thames, and its much attacked ownership structure. The accusation is that private owners like those of Thames are only interested in short term profits, engage in financial engineering, pay excessive executive salaries, and put pressure on the boards to pay out excessive dividends.

But who were the ultimate owners of Thames? Private equity and infrastructure funds do not put much of their *own* money into these companies: they get institutions to put money into their funds, and then the fund buys the companies, and the fund manages the companies on behalf of the investing institutions. Take a look at the investors in these funds and they do not look that different in kind from those in the publicly quoted companies. Indeed Lazards, Blackrock and Vanguard are arguably fishing in roughly the same ponds.

The key difference between the private companies and infrastructure model and publicly quoted companies model is the degree of control the private equity and fund manager has relative to the direct investors in the public companies. The fund directly intervenes, with placements on the board and oversight of the management. It does this presumably to better align the interests of its investors and the management of the company. This has played out in the decisions. Infrastructure and private equity ownership has resulted into some radical corporate surgery, getting rid of the diversifications, and concentrating on the core assets. It has been about focus and financial management. It was the publicly owned companies, not the private ones, that went on the diversification buying sprees, wasting in some cases staggering amounts of money.

The infrastructure and private equity model has tended to be aggressive on financial engineering, exploiting the flaws in the regulatory controls, and especially in arbitraging between the cost of equity and the cost of debt, when given a weighted average cost of capital (WACC) regulatory approach. They could securitise the debts. The publicly quoted companies have not however been far behind. Look at the dividend policies and the share buybacks of the quoted companies. It is a matter of degree and not kind.

Arguably the quoted companies have a greater degree of manoeuvre when it comes to their owners. The executives can't be so easily sacked, and even when shareholders have a go at salaries, the boards tend to carry the day. It is Severn Trent that reportedly pays £2.4 million to its chief executive, and has a progressive dividend policy of increasing the pay outs by *at least* RPI + 4 until 2020. That leaves little room for reinvestment in the business. There is no clear evidence that the investment record has been any better for the publicly owned companies. They have been roughly equal players in the game of paying out almost all profits as dividends.

This suggests that there is less to distinguish the two models of ownership than some commentators have suggested. So, does ownership – and the different types of ownership – really matter at all? If the infrastructure and private equity model is designed to close the gap between owners and managers, and solve the well known corporate principal-agent problems, why would this not be good news? Why wouldn't the argument be turned exactly the other way around, that this model is superior in efficiency terms to the publicly quoted one?

The answer to this question goes to the heart of what is going on in OFWAT's general approach to regulation and in the broader debate about private versus public ownership and nationalisation. What Jonson Cox is up to, in trying to do "deals" with some of the companies, and trying to influence the gearing and dividend policies, is to *attenuate* the control of the owners. He is both trying to drive a wedge between owners and managers, and get managers to pursue the public interest rather than that of their private owners. In this endeavour, he is in the same game as Jeremy Corbyn. It is a game of regulatory corporatism, with the aim to make the water companies "public-interest orientated companies". The difference is one of degree: Corbyn wants to get rid of private ownership control altogether; Cox wants to weaken it substantially.

None of this is going to end well if persisted with. Corbyn's renationalisation is much easier to effect than the companies (and their paid consultants and think tanks) claim. But if Labour gets ownership, what is it going to do with it? It is just another set of owners. Cox's regulatory corporatism might actually trigger Corbyn's preferred outcome: meddling in the boards is not going well so far. None of the quoted companies seems to have taken much notice. The salaries have not been cut, and the dividends remain aggressively set.

The gearing might come down, but then the whole industry is gradually sliding towards pay-as-you-go, rather than pay-when-delivered. The irony is that the holy grail of lower gearing is now just going to put up the water bills. If the regulator tells the company boards what to do (in the business of regulatory corporatism), and they do it, the regulator has then to ensure they can finance their functions at that new lower gearing levels. The WACC leads to a higher return for a higher ratio of equity to debt. (A more subtle approach would at least distinguish between gearing of the RAB, and gearing of the rest of the business).

After all the bluster and noise, and all the speeches – all of which have raised the political and public temperature and the expectations - the voters may agree all the more so with Corbyn's renationalisation policy, since the Cox strategy is likely to fail. So far, as the latest round of announcements on dividends and salaries has indicated, the companies are not taking much notice. Indeed the more Cox threatens the companies, the more their directors' fiduciary duty to investors kicks in. Why reinvest rather than pay out profits if the threat is that they are going to get confiscated? That after all is what led Railtrack to up its dividends as its ship was sinking.

Making scapegoats of the privately owned companies does not disguise what is also going on in the publicly quoted ones. The salaries are not being cut, and the problem of past financial engineering is that it has happened and been allowed to happen – by the regulatory bodies that now have finally woken up to the consequences. The horse has bolted, and still the dividend pay outs are maintained.

Is there a way out of this terrible mess? The answer is yes. It is to crank up competition substantially, and focus on competition not ownership as the way to discipline the managers of the companies. Ownership is not, contrary to the claims of all the protagonists, the most important issue. It does not much matter whether they are quoted or unquoted companies. It is the same sorts of investors in both cases. State ownership would not be a disaster – it isn't in Europe. None of these models "solves" the basic problems. There are things the state should do. These are policies and plans and regulations. The state has to decide what outputs the industry should deliver. It does not actually have to deliver them. Labour needs to realise that it is often better not to own things it might wish to control.

The better model focuses on competition, but not the switching sort that has been and probably will continue to be a very limited exercise with marginal impacts and lots of costs. The sort of competition that really could make a difference is created by opening up the business plans to auctions and competitive bidding. This is what the catchment system operator model does [Catchment management, abstraction and flooding: the case for a catchment system operator and coordinated competition. Helm 2015], alongside opening up flood defence, land management and much else within the catchments. Instead of the periodic review and the WACCs and all the interference that the Cox approach entails in the internal working of the companies, the answer is for the state to decide the outputs and then for the system operators to offer up the business plans to competitive tendering. (It is a model that can also be applied in electricity, rail networks and to the splitting out of these functions in Openreach too – indeed in electricity and rail it already effectively is).

As with the proposals I set out for the regional system operators in the electricity industry in the *Cost of Energy Review [Helm 2017]*, the way to move to the system operator model is in careful evolutionary steps. There will still be some core monopoly elements for quite some time to come, though in principle the whole operation could be taken over by another company in a bidding process. What matters is the direction of travel: making sure the managers and the investors know that they are going to see more and more of the businesses made contestable.

In this system operator model, it does not much matter who owns the companies, and whether they are publicly quoted or private – or even state owned. Even if it did the market bidding processes will tease out whether one model is really better than another. OFWAT's obsession with dividends, salaries and gearing is replaced by a market test. There will of course need to be a "fit and proper" test in the auctioning processes. We don't want any more Carillions. But this aside, almost all of Cox's highly interventionist proposals can be safely ignored in the catchment system operator model.

There would, in this system operator model, be one remaining ownership issue that would still matter. This is the ownership by investors of stakes in each of the competitors. This cross ownership would be a serious concern, and as more generally in other concentrated oligopolies like banking, it would need to be limited and even perhaps banned. The obvious proposal is that stakes above a certain level cannot be held in more than one firm in an industry, and the CMA would need to take this cross ownership into account, both between the publicly quoted companies and between them and the infrastructure and private equity models too.

Owners should control companies. Corbyn agrees with this: he thinks owners (in his case, the state) should control the companies. So do the investors in public and private water companies. The question is whether that ownership is used to exploit customers or to maximise efficiency in competitive markets. In a competitive market, ownership can be largely ignored. It does not matter, because the companies are prevented from exploiting their customers for fear of losing their businesses.

If the incumbents really want to head off the Corbyn attack, and to end the slide towards it that Cox's approach may exacerbate, they need to get serious about competition. The system operator model can do this, and it is superior in all the utilities to RPI-X and periodic reviews, and to rate of return regulation, the other regulatory model. The regulatory job in the system operator model is to make sure the competition is open and fair, and to do this, the competition regulators need to take a close look at the cross-ownership that has emerged.

We should stop wasting time trying to define a preferred ownership model, and instead realise that the various public equity, infrastructure fund and private equity models have much in common. The same sorts of investors own them. Instead we should get serious about a new and better way of regulating. RPI-X is very twentieth century, before the new technologies that facilitate auctions and competition and disaggregation, which are the twenty first century context. It is time for regulation to move on, modernise with the technological possibilities and get attuned to the new world. System operators keep public the decisions that are for society to make about systems, and leave the private sector in whatever ownership models it chooses to compete to deliver these public goods. We just need to make sure that cross-ownership is limited so that monopoly does not reappear in a new guise.