*BRITISH BROADCASTING CORPORATION* *RADIO 4*

*TRANSCRIPT OF "FILE ON 4" – "LIQUID ASSETS"*

*CURRENT AFFAIRS GROUP*

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| *TRANSMISSION:* | *Tuesday 14th January 2014* | *2000 - 2040* |
| *REPEAT:* | *Sunday 19th January 2014* | *1700 – 1740* |

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| *REPORTER:* | *Lesley Curwen* |
| *PRODUCER:* | *Ian Muir-Cochrane* |
| *EDITOR:* | *David Ross* |

*PROGRAMME NUMBER:* *14VQ5356LH0*

"FILE ON 4"

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Producer: Ian Muir-Cochrane
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MAN: When the sewage started coming in, faeces, toilet paper, it was just everywhere. And when you're trying to drop a bucket in, it was splashing up onto you – onto your face, onto your lips. But we're just trying to bucket it out, just to save it going into the house.

CURWEN: The current widespread flooding may be the fault of nature, but this man says it's his water company's fault that his property was flooded with sewage.

MAN: They have no responsibility to the little people – us. They want to extract as much money while we all suffer the consequences. We are just the little people.

CURWEN: So are some privately owned water companies like his putting the focus on finances rather than the customer? Tonight on File on 4, we examine the record of two of Britain's major water suppliers to try to find out just how the money from our bills is spent. It's an eye-opening tale of big debts, high dividends and City firms who take a cut along the way.

PRYKE: You've got financial advisors of course, you've got legal specialists, you've got credit facility providers, you've got finance lessors, you've got hedge counterparties to deal with the different types of risks that are going to be encountered. All of them are paid out of household bills, a good source of income for a whole host of intermediaries in and around the City of London.

CURWEN: As regulators decide how much water companies can charge over the next five years, are customers being short-changed in pursuit of the bottom line?

SIGNATURE TUNE

ACTUALITY WASHING UP

CURWEN: This is what I take for granted, being able to turn on taps and do the washing up or run a bath or flush the loo - all courtesy of my local water company. If you live in England and Wales, there are ten or more major companies providing those services – I get my bill from Thames Water.

ACTUALITY ON STREET

CURWEN: I'm interested to find out where the money I pay in my bill goes. Thames Water is certainly doing well – with the last half-year profits up by nearly a fifth, at £134 million. So what kind of company is it? It's changed - well, all the English and Welsh water companies have, in the 25 years since privatisation, when the Conservative Government decided to sell them to attract private money for massive investment. In Scotland and Northern Ireland, though, water is still in public hands, and Welsh Water is now a not-for-profit company. Between 1989 and 2000, water bills actually fell, but in recent years they've been going up faster than inflation. And here on the Dickens Estate in Bermondsey in South London, I've met Thames Water customers like Anne Downs who find it hard to pay the water bill.

DOWNS: Gone up drastically, gone up.

CURWEN: Why do you think that is?

DOWNS: I don't know, because I'm not using any more water.

CURWEN: How hard is it for you to pay?

DOWNS: Very very hard. I'm even telling the children, please turn the tap off, don't have a bath, have a shower, stop flushing – which I shouldn't have to, because that's a human thing, to flush the chain, but it's on my mind that we're using too much water. And if they go up, well I don't know what'll happen if it'll go up again.

CURWEN: Do you have a water meter?

DOWNS: Yes, I do. There'll come a point where I don't know, we'll go up my mum's to have a bath. Water is a basic thing, I think. You can put more clothes on to keep warm, but you can't wash with no water.

ELSON: It may surprise people to know that at National Debtline we took a record number of calls for help with water debts last year and these water bill related calls were actually higher in volume than those relating to rent or mortgage arrears.

CURWEN: Joanna Elson is Chief Executive of the Money Advice Trust, which advises people in financial difficulties.

ELSON: We've seen a very significant increase in the proportion of calls that we take about water debts. So back in 2007 it was about 3% and in 2012 it was about 14% so really quite a significant rise.

CURWEN: Why?

ELSON: A range of things. Of course, there have been over-inflation increases for several years now for water, and I think that, added with the other cost of living pressures that people face, it not only costs more to fill up your kettle, it costs more to turn it on and to put food on your table and to get to work and so on, just means that something has had to give.

CURWEN: Last month we learned that most water companies are asking the regulator for smaller price increases from 2015, which will be at, or below the rate of inflation. Some customers may still find it hard to pay water bills, because in tough economic times, people's earnings haven't gone up as fast as inflation. My supplier, Thames Water, wants bills to go up 11% above inflation. When people's incomes are being squeezed, it seems important to know where the money from water bills goes.

ACTUALITY ON TRAIN

VOICE OVER LOUDSPEAKER: Ladies and gentlemen, the train will shortly be arriving into Milton Keynes Central …

CURWEN: Here I am in Milton Keynes. I've come here because this is the home of the Open University, and I'm going to meet an Open University academic who's been investigating the financial structures of the companies behind Thames Water.

ACTUALITY AT OPEN UNIVERSITY

CURWEN: Hi, Lesley Curwen, File on 4. How are you?

PRYKE: Pleased to meet you.

CURWEN: I'm meeting Michael Pryke, from the Social Science faculty of the Open University. He's studied the structure of the company, which is the UK's biggest water and sewerage provider, serving 14 million customers. Like other water companies, it's a monopoly. You can't shop around.

PRYKE: The financial world would describe the structure as a wedding cake and I think that's a useful image to hold in mind, because there's more than one company and there are a whole series of linkages between them.

CURWEN: You've got a diagram that shows us that?

PRYKE: Indeed, there is a very helpful or a very confusing diagram, it depends which way you want to look at it. That shows at the top of the wedding cake a little box entitled Shareholders and underneath that, Kemble Consortium, and then right down at the bottom you get two boxes, one labelled Thames Water Utilities Finance and the other Thames Water Utilities Cayman Finance Ltd, and in between there are a whole series of companies with inter-linkages between them, all very similar sounding. For example, you've got Kemble Holding Companies, Kemble Water Holdings Ltd. Down towards the bottom you will see Thames Water Utilities Ltd, which is the company that you would pay your bill to.

CURWEN: There's eight levels. Is that right?

PRYKE: There are eight tiers to the cake, yes.

CURWEN: Michael Pryke explained that Thames Water borrows money to invest it in the water and sewerage system – well, that's what privatisation was all about. It raises the money by selling bonds or securities to international investors. These are effectively IOUs, a promise to pay back the money, with interest, to the investor at a future date. This process is called securitisation. Surprisingly, the bond-holders are not investing in the underground pipes and sewers.

PRYKE: So what's been securitised is in effect your ability to pay your bill on a regular basis and for that process to be projected into the future. It's turning your promise to pay into something that can be seen as a secure stream of revenue, which is then turned into various forms of bonds and sold to investors globally.

CURWEN: So the bonds that they're selling to investors globally are really based on the premise that people like me will carry on paying their bills to Thames Water for, what, the next twenty, thirty, even forty years?

PRYKE: If you look at the financing structure of Thames, you'll see that they've issued bonds based on the ability of Thames Water's customers to pay their bills right through to 2062. This whole process is, in effect, turning you into a walking talking financial asset, into a human revenue stream. It's your ability to pay that is what is being securitised not the pipes under the ground.

CURWEN: That was quite a surprise. What was still puzzling me was who is behind the consortium that's borrowing money on the back of people's water bills.

PRYKE: The Kemble Consortium is led by the European arm of the Australian bank, Macquarie, and the Macquarie Group manages a range of investors from around the world. What's surprising to a Thames Water bill payer is the fact that you would have the likes of the Abu Dhabi and Chinese investment corporations' sovereign wealth funds who are benefiting from your water bills in the forms of dividends and interest on bonds.

CURWEN: So let's get this right. Some of my bill payment is ending up in China or Abu Dhabi?

PRYKE: China, Abu Dhabi, Canada, Australia, Spain. But what's more interesting, in order to turn your household bill into a global financial asset, it has to pass through a series of processes. At each of those turns, it has to pass through the hands of particular sets of intermediaries, each of whom will skim off a little.

CURWEN: You mean they'll charge fees?

PRYKE: They will gain by the fees they charge. You've got financial advisors of course, you've got legal specialists, you've got credit facility providers, you've got finance lessors, you've got hedge counterparties to deal with the different types of risks that are going to be encountered. All of them are paid out of household bills, a good source of income for a whole host of intermediaries in and around the City of London.

CURWEN: It's not just Thames Water which employs this sort of securitisation. Other water companies owned by private investor groups, such as Yorkshire Water, Southern Water and Anglian, follow a similar model. Often these are run by foreign investment banks which part-own the water company and are focused on getting high financial returns. For this reason they're sometimes compared to private equity groups. Only about 40% of the water companies in England and Wales now keep the old-fashioned model from the first days of privatisation, where the company's shares are publicly traded on the stock exchange – the foremost are United Utilities and Severn Trent.

ACTUALITY OF BELL AT PORTCULLIS HOUSE

CURWEN: That's the division bell for a vote in the House of Commons. My interviewee here in Westminster has just had to rush off to vote. He is Charlie Elphicke, a Conservative MP who used to be a tax lawyer.

ELPHICKE: Well, what we're looking at is my report setting out the problems in the water industry. What I found …

CURWEN: He has assembled an unpublished report about four of the privately owned water companies, including Thames Water. He looked at levels of profits and dividends and the amount of borrowing on the company's books compared to its capital – it's known as gearing, and there are different ways to calculate it. First, dividends.

ELPHICKE: What I found was that some companies are paying out more in dividends then they make in profits, particularly Thames have been doing this. Now this is a concern, because it's an unhealthy sign for any company to be paying out more to its shareholders than it actually makes in profitability.

CURWEN: So where is the rest of the money for the dividends coming from, if it doesn't come from profits?

ELPHICKE: Increased indebtedness, so these companies are getting deeper into debt in order to finance their dividends. What they're doing is taking out the cash reserves, that buffer that every company needs to have, they're paying that out to shareholders and then they're going down the bank to borrow more money. And the situation then is that they're going to get more and more debt and have less and less risk capital for investment. It's something that's happened over the last decade or so. Back in 2005, Thames had a gearing or mortgage rate of 56% and today it stands at over 93% so that's …

CURWEN: That's according to your figures?

ELPHICKE: Whichever way one presents the figures, whichever calculation you take, there has been a staggering increase in debt. And the reason for the staggering increase in debt is overseas investors could see an opportunity to squeeze a higher return.

CURWEN: Thames Water dispute Charlie Elphicke's figure of 93% - they say his calculation is based on an 'inappropriate' measure of their debt and their figure for the gearing is much lower, 76.8%. Another issue the MP's been looking at is tax, corporation tax. Companies can make use of different methods to delay paying it. If they make big investments in equipment or infrastructure, they get tax breaks called capital allowances. But there's another way too - if you're paying interest on your debts, you can also defer corporation tax until a later date. And if you've got very big debts, that's potentially quite a lot of tax saved. Charlie Elphicke again.

ELPHICKE: Thames Water haven't been paying any corporation tax for the last three years. Yorkshire Water haven't been paying any corporation tax for the last three years either. Anglian Water has paid an incredibly low amount of corporation tax and Southern Water paid barely any corporation tax at all in the last year, and their shareholders are doing very very well, but my concern is that bill payers are getting a bad deal.

CURWEN: By now I really wanted to speak to Thames Water to ask them more about the dividends, the debt levels and so on. Thames turned down our request for an interview. In response to our questions about high gearing, Thames Water said:

READER IN STUDIO: The primary reason for debt levels increasing is the use of debt to fund our record £1 billion a year programme of essential investment to improve our pipes, sewers and other facilities.

CURWEN: On dividends, the company said its shareholders did not receive a dividend in the second half of 2012/13. While Thames Water did not produce specific figures for the last three years, it said it was incorrect to say it had paid out more in dividends than it earned in profits.

READER IN STUDIO: Thames Water Utilities has paid out 82% of post-tax profits as dividends over the period since 2006.

CURWEN: Thames did not dispute the fact that they'd paid no corporation tax. In fact they've said publicly they do not expect to pay any for up to ten years because they're making such big investments. The body which represents the whole water industry, WaterUK, did agree to an interview. I met Rob Wesley, its head of policy.
Some companies are paying out more in dividends than they actually make in profits. That seems outrageous in some ways. How can you justify that?

WESLEY: The reason for this is the very large amount of investment that's required to ensure that customers receive reliable, high quality water services and their sewerage is taken away. In other sectors, companies would keep some of the profits to reinvest in future services. Because the investment in water and sewerage services is so large, the companies need to raise additional finance over and above their profits from external investors, from financial investors. Those investors need to be paid a return …

CURWEN: Need to be paid a return, but do they need to be paid a return which requires more borrowing?

WESLEY: Investors need to be paid a return that will encourage them to provide finance, because investors have a choice. If companies don't provide a sufficiently high return then investors won't put their money into water companies.

CURWEN: But not all companies are paying out more than their profits in dividends, are they? I mean, there is a choice. Doesn't it seem extreme that they're going to those lengths?

WESLEY: Different water companies have different investment profiles. At an industry level, £5 billion of investment every year has to go into the ground otherwise we couldn't rely on our water supplies going forward. That means the companies have to raise a large amount of money from financial investors, which does mean that those investors have to be paid a return.

CURWEN: Investment then is seen as the justification for high gearing and high dividends. Since I was trying to find out what had happened to the money from my bill, I wondered about Thames Water's record on investment. MP Charlie Elphicke claims his figures show their spending on investment has actually gone down.

ELPHICKE: Investment has been falling in real terms, so in 2007/8 Thames had a gross capital expenditure of some £1.2 billion in today's prices, and that has now fallen to just over a £1 billion a year and that picture is across the board. So we've seen falling real investment - that's your leaking pipes, your sewage works, your upgrading of the quality of the water system.

CURWEN: Now you say Thames' investment fell 20% over the past five years. Thames says it's gone up by 25% over the past five years. You can't both be right.

ELPHICKE: Well Thames put out figures on different bases and different timelines. What I've done is use the numbers from OFWAT and from Thames' own statutory accounts and then calculated it by reference to RPI inflation, so it seems to me the OFWAT figures and the figures in Thames' statutory accounts are likely to be more accurate than what Thames have been saying.

CURWEN: Once again, Thames Water said the basis of Charlie Elphicke's figures was incorrect and their capital investment had been steadily increasing in real terms. One thing's for sure – Thames Water would like me to pay a substantial rise in my water bills, to be spent on their biggest ever investment project.

ACTUALITY ON RIVER

CURWEN: I'm on a commuter ferry on the River Thames. Now the main reason why Thames Water wants to raise bills by 11% above inflation for me and 14 million other customers is to cure a problem which affects the quality, the smell and the safety of the river water that I'm looking out at now. It's all about raw sewage which gets swept into the river after heavy rain from something called Combined Sewer Outflows, which were built in Victorian times.

ANNOUNCEMENT VIA LOUDSPEAKER: Passengers for the next ….

CURWEN: The solution, according to Thames Water, is a super-sewer, known as the Thames Tideway tunnel, which is expected to cost more than £4 billion. The Government has agreed to effectively insure some of the risks of such a large project - that's called contingent financial support - though it's not actually putting any money up front. Thames Water has asked the regulator, OFWAT, for permission to charge bill payers like me extra money to help pay for the project. OFWAT last year refused a previous Thames request to put up bills by 8% to fund the tunnel. Martin Blaiklock is a consultant in the financing of infrastructure projects and a former director at the European Bank for Reconstruction and Development.

BLAIKLOCK: I went back and looked at the accounts and said to myself, well, what would have happened supposing since the year 2000 they hadn't paid any dividends at all and they'd just put that extra money aside, put it in the bank for when they needed to actually implement the Tideway Tunnel project? They would have enough money, I reckon, in the bank today to be able to fund that project.

CURWEN: But it is unrealistic?

BLAIKLOCK: It would be unfair. Let's suppose then 50% of their profits they paid out as dividends. Now they would still have made 8% or 9% return on investment, which is reasonable for a private sector public service monopoly, and they would have had 50% of the money left back, which could have used to pay for the tunnel. The amount of leverage or debt in their balance sheet would be more reasonable. They wouldn't have all the money they needed to pay for the tunnel, they'd probably have around half. Well, if their financial strength was better, they could probably raise the other half.

CURWEN: Former water regulator Sir Ian Byatt, who oversaw the industry from privatisation until the year 2000, is opposed to the building of the Tideway Tunnel. He thinks there are cheaper options. But he too is outspoken in his view of Thames and its dividends policy.

BYATT: I'm very worried about the scale of dividends. Right from the beginning there was an issue about dividends, but it's become very much more serious. The scale of that has got very much greater in the last ten years and the private equity companies are paying huge dividends. I believe that Thames in the last six years have paid out extremely large dividends, and those dividends, I believe, should have been available for future investment, because they've disappeared and because the structure is opaque and the authorities opaque, how do you get them back again? Well, of course there is one way of getting them back again, which is to insist the company does carry out its obligations and if it says it feels it can't, well then it can be put into special administration, as Railtrack was.

CURWEN: Isn't that going a bit far, to threaten them with effectively losing their licence?

BYATT: Well, but they have obligations. The licence is not there … it's not a licence to print money, though it's a licence to carry out certain obligations on behalf of the public, and if you're failing to follow the terms of your licence, of course you can't be allowed to continue. It may be tough but then, you know, it's a pretty tough world.

CURWEN: Again, we would have liked to talk to Thames Water about this, but we were not given an interview. This was their response to Sir Ian Byatt's remarks.

READER IN STUDIO: The need for government contingent financial support does not arise because of any deficit or shortcoming in Thames Water's financial arrangements. Any company would require this sort of support for a project of this size and complexity in order to keep costs down.

CURWEN: There are several crucial factors in Thames Water's financing. The regulator will decide this year how much return water companies will be allowed to make over the next five years. In fact, companies made very big profits in the last five years because OFWAT's assumptions about inflation and interest rates proved to be too generous. And when Thames Water want to borrow more money for the super-sewer, the key factor is their credit rating. It's the same for any water company. Investors looking to buy their bonds need to know that the company is in good shape. The credit ratings agencies assess how

CURWEN cont: much risk is being taken in a business and give it a score which could vary from investment grade, right down to junk bond status.

ACTUALITY AT CANARY WHARF

CURWEN: I'm on my way up in a lift up to the tower of Number 1 Canada Square, which is the highest tower in Canary Wharf. I'm here to see the credit rating agency, Moodys, to find out what they think about some of the water companies.
I'm meeting Neil Griffiths-Lambeth from the Infrastructure and Utilities Group at Moodys to talk about the gearing, the amount of debt in the water companies, including Thames.

GRIFFITHS-LAMBETH: When the sector was privatised in the late eighties, companies had no debt and ratings at that time were as high as AA. Today, the average gearing in the sector is probably 60% up to as high as 70% and the average rating is BAA1, so very much lower than it was at privatisation. The lowest investment grade rating is BAA3, so companies are two notches above that at the moment.

CURWEN: And if they were to lose the investment grade rating, what happens then?

GRIFFITHS-LAMBETH: If you lose your investment grade rating, then you would expect typically to pay more for your debt and your ability to access the market may become uncertain.

CURWEN: And all kinds of regulatory events are triggered if you lose it?

GRIFFITHS-LAMBETH: I think certainly OFWAT would be very concerned if companies were to lose their investment grade rating, yes.

CURWEN: In fact OFWAT requires that these companies keep an investment grade rating. If they lost it, they would be in breach of their licence and forced to stop paying dividends. And if things got really bad and a company became insolvent, it could be sold or put into what's called Special Administration. That's never happened in the water industry. I was hoping to talk to the regulator, the relatively new head of OFWAT, Jonson Cox, CURWEN cont: about high levels of debt, but he was not available for interview. OFWAT sent a statement saying, while there's no evidence to date that companies have taken excessive risks by increasing levels of gearing:

READER IN STUDIO: Highly geared, securitised structures are comparatively untested against a full range of potential risks. New risks may emerge that challenge these structures and compromise companies' ability to deliver good outcomes for customers over the longer term.

CURWEN: One major concern is that living with very high levels of debt might skew the priorities of management. Robert Miller Bakewell is an independent analyst who covered the water sector for two decades.

BAKEWELL: There is absolutely no doubt that companies with higher gearing are managed in a different manner, because the whole focus is on cash and that may move attention away from other important criteria for regulated utilities in terms of customer service and capital investment. Some decisions may be influenced by the need to conserve cash in the short term.

CURWEN: Why does cash matter so much?

BAKEWELL: Well, cash matters because you have got bills to pay, but also because of the financial ratios and not breaching the banking covenants, so the cash flow from these companies is very important to keep the corporate wheels turning.

CURWEN: The impact of high debt levels on risk aversion – why would that be an issue?

BAKEWELL: If you're running a highly leveraged company, you're not going to perhaps take the risks associated with innovation, in terms of finding new solutions to solving your operational issues, rather than innovating, bringing in new technology and ultimately perhaps producing a more efficient, lower cost service.

ACTUALITY IN OFFICE

CURWEN: So do high debt levels affect customer service? I've been looking at the Consumer Council for Water website, at the chart showing customer complaints – and what leaps out at me is the name of one of the most highly geared companies, Southern Water. Southern saw the biggest surge in written complaints – a 77% increase compared to the previous year – making them the worst performing company by this measure.

DOUGHTY: When the sewerage started coming in, faeces, toilet paper, it was just everywhere. It was on our clothes, it was on our shoes. After a little while you got used to the smell of it, but it was on your hands, and when you're trying to drop a bucket in and it's splashing up on to you, on to your face, on to your lips, but we were trying to bucket it out, just to save it going into the house, but unfortunately we didn't succeed and eventually it overwhelmed us.

CURWEN: It's very distressing.

DOUGHTY: It was not only distressing for me, but I've got a grandchild who lives in the house who's got a hole in the heart.

CURWEN: Paul Doughty is a landlord in Margate in Kent, a customer of Southern Water.

DOUGHTY: It started in about April of 2013. The drain kept blocking. The contractor, after several attempts, said that it wasn't my drain, it was the main sewer which was blocked. I contacted Southern Water and Southern Water kept pooh-poohing the idea. It was my responsibility. Eventually they decided to do further investigations. They surveyed the drains. After excavation they found that it was a storm drain which had broken off of one of the pipes and was blocking the sewerage.

CURWEN: In their pipes, in Southern Water's pipes?

DOUGHTY: In Southern Water's pipes. They'd never acknowledged the fact that it was their responsibility. They never acknowledged the fact it was their problem. It was always down to me. They have no responsibility to the little people – us. They want to extract as much money for pension funds and everybody else while we all suffer the consequences. We are just the little people.

CURWEN: Southern Water have now acknowledged the sewage flooding was their fault and they told us it was unacceptable that Paul Doughty's concerns had not been taken into account. Sewage pollution in Margate happened on a much bigger scale too. In 2012, on the Queens' Diamond Jubilee weekend, 25 miles of beach were closed after the Foreness pumping station flooded and raw sewage spilled into the sea. A previous spill in the same place a year earlier led to Southern Water being fined £200,000. The local council's scrutiny committee argued there had been a lack of investment and routine maintenance. In fact, OFWAT figures show Southern Water have the worst record for serious sewage pollution incidents. Does the company's Communications Director, Geoff Loader, admit there had been insufficient investment at Foreness?

LOADER: I think ultimately the answer to that is yes, because subsequent to those incidents we have invested several millions of pounds to improve the operation of that plant. I think what we need to understand is that the incidents were caused during exceptional weather and the pumping station didn't do what it should do and that was down to a combination of complex engineering factors. We've since responded to the concerns about the pumping station.

CURWEN: According to OFWAT, you've got the worst record on serious sewage pollution. Why is that?

LOADER: We've had issues with pollution incidents over a number of years. We've got a very large infrastructure of sewers in the south. We've got some 40,000 kilometres and from time to time there will be issues with that, with sewers blocking or with pipes bursting. What I can say is that we've recognised that as an issue and we've been specifically addressing it, and the number of pollution incidents has come down by something like half in the last two years, so we are making progress.

CURWEN: So has this highly geared company been distracted by the need to focus on and conserve cash? Southern Water are owned by a consortium of pension funds and investors, led by the US bank J P Morgan, and they borrow money using a similar securitisation model to Thames Water. According to Moodys, the proportion of debt in the company, the gearing, is 81%. Like some other water companies, they've used a certain kind of financial derivative or swap to protect against lower inflation, which would translate into lower water bills and less money coming in. The ratings agency, Moodys, has expressed

CURWEN cont: concern that these derivatives, called synthetic index-linked swaps, can be risky. I asked Neil Lambeth Griffiths [sic] from Moodys about Southern Water's credit rating.
Looking at the rating for Southern, why is it the lowest?

GRIFFITHS-LAMBETH: We rate Southern Water one notch below the comparable companies and this largely reflects the additional risk embedded in its derivative portfolio. It has around £1.3 billion worth of index-linked swaps.

CURWEN: What is it in particular that made you reduce Southern's credit rating?

GRIFFITHS-LAMBETH: It was a combination of two factors. Firstly, weak cash flow generation, but secondly it's about the precise form of the index-linked swaps that they have entered into.

CURWEN: The rating for Southern is BAA2 and how far above falling out of investment grade is that?

GRIFFITHS-LAMBETH: So the lowest investment grade rating is BAA3, so it's one notch still above that.

CURWEN: If the regulator were to bring in a regime which brought lower prices for all the companies, do you think Southern's credit rating might go down further?

GRIFFITHS-LAMBETH: A material reduction in the allowed cost of capital could result in pressure on ratings across the sector, particularly for highly leveraged companies, including Southern Water. But, of course, management and shareholders do have some options available to them, include balance sheet strengthening.

CURWEN: That kind of strengthening might mean shareholders have to inject some fresh money. Southern Water's shareholders haven't taken any dividends for several years. Later this month, OFWAT will publish guidance on the next pricing regime,

CURWEN cont: which starts in 2015. It's widely expected to put a squeeze on companies' profits and on credit ratings too. Geoff Loader, director at Southern Water.
According to Moodys, yours is the lowest credit rating of all the water companies. How much of a concern is that?

LOADER: It is a concern. Obviously you want the ratings agencies to be supportive of what we're doing and we've done a lot of work with Moodys over the last two years to explain the way the business is structured and the debt we have. Obviously when you take out loans, you're very much dependent on what market is available at the time you're taking out the loan and you need the money, but fundamentally we believe we've got a good debt structure, but we also have to look at the performance of the company and the service we're providing, and as those elements improve as well, I think the position vis-a-vis Moodys' view of us will improve.

CURWEN: You say it's a concern. Are you concerned you might actually lose your investment grade rating? That would breach your licence, wouldn't it?

LOADER: Well, I think there's always that big spectre at the back of any, any monopoly industry, there is the licence that you have, but the biggest concern for us would be if our customer service reached such a level that OFWAT was to say, well, we're going to fine you for that, we're going to impose a financial penalty. But even worse than that, they could go down the route of taking away your licence.

CURWEN: If you did lose your investment grade rating, is that the end of the line for Southern Water?

LOADER: I think that would be me speculating and I really don't know what that situation would be. I think what we have to do is demonstrate to the likes of Moodys that we have got sound financial management, we have got a sound financial basis on which to deliver for customers, and if we're delivering for customers then we're fulfilling our regulatory contract, so we're acknowledging the fact that we're a monopoly company but we're acknowledging the fact that we have to deliver for customers as part of that regime.

CURWEN: The regulator, OFWAT, says it's challenged companies to become more transparent and to focus more on customers and if necessary, it says, it will step in to make sure they get a fair deal. In my efforts to see where my payments go, I've struggled to understand the complexities of securitisation and the spidery corporate structures of some of our water companies. Former water regulator, Sir Ian Byatt, says it shouldn't be this hard to see what's happening.

BYATT: I think that complexity is often a problem. We had lots of complexity in the city in the banking sector and look where it got us, and all kinds of clever wheezes. And I think there are an awful lot of clever wheezes going on in the water sector at the moment and I'd like to see it much simpler and much more transparent and the companies required to explain where the money is going. Because I am also a bill payer and I like to know where the money is going and it's not at all easy. And increasingly complicated financial structures emerge from the clever people in the financial world. Well we've seen where they took us.

SIGNATURE TUNE