

Statement of dissent

by Mr C Goodall

Summary

1. This note sets out the reasons why I believe that the water industry regulatory regime will be adversely affected by the proposed takeover of Southern. I provide the outline arguments for my view that the takeover should only proceed on the basis that VWUK divests Three Valleys, one of its water industry subsidiaries, as well as selling its stake in South Staffs Group.

2. I dissent from my colleagues' views in two respects. First, I believe that the majority underestimates the impact on the regulatory regime of the loss of good quality comparative information after the takeover. Second, even the smaller cost to the public interest identified by the majority view would in my view require a stronger remedy than that proposed. My opinion is thus that the detriment is considerably worse, and the remedy less effective, than suggested by the majority.

3. The majority view is that the detriment caused to the regulatory regime is modest and therefore that the remedy should be equally limited. By contrast, I believe that the gradual agglomeration of water companies into groups is likely to have a significant detrimental impact on the regulator's ability to make comparisons of efficiency. The water industry appears to be delivering high levels of efficiency gains, and major improvements in water quality and customer service. I think that some of these successes can be attributed to the operation of an effective regime of comparative competition. A reduction in the number of comparators therefore represents, in my opinion, a substantial potential detriment to the interests that water industry regulation was set up to protect.

The detriments

4. I see three distinct prejudices to the regulator's regime of comparative competition:

- the loss of Southern as an independent comparator and its absorption into the VWUK group. (The majority view is that this detriment is modest; I give it greater importance);
- the almost certain loss of F&D as a separate business. This would reduce the number of comparators from 22 to 21. (The majority see some small detriment caused by the reduction in the

quality of F&D's data. Since I think that the disappearance of the company is the overwhelmingly likely eventual result of the proposed transaction, I give this detriment greater weight); and

- a diminution in the ability of the regulator to force efficiency gains and price reductions upon Southern as a consequence of the inflexible and highly geared capital structure to be used by VWUK to finance the acquisition of the company. (In this respect, the majority is of the view that there is insufficient evidence to conclude that adverse effects for the public interest could be expected as a result of the merger.)

5. I have been strongly influenced by evidence heard by the group that the number of comparators available to the regulator is already only barely adequate. Though other witnesses asserted that the use of alternative, additional techniques might compensate for the loss of comparators, this is strongly contested by the DGWS. But whatever improvements are made to the regulator's toolbox, the fundamental detriment remains—this proposed takeover reduces the quality and quantity of comparative information available to him. It makes the regulatory process less effective. Previous CC reports have seen the DGWS's comparative techniques as broadly sound, albeit with some caveats. No developments have occurred that would suggest that we should change our view today. So I believe that we should continue to see the loss of comparative information as costly to the regulator's ability to carry out his functions.

The loss of Southern

6. Southern is a particularly valuable comparator because it is large and because it is sufficiently efficient to be a candidate to be a benchmark company at the next price review, at least as far as operating expenditure is concerned. If it becomes part of the VWUK group, it is in my view a reasonable hypothesis that its performance will converge with the average performance of the rest of the group.

7. Though VWUK operates its business in a reasonably decentralized fashion, it enforces some financial and operating discipline from the centre. Furthermore, the company told us that it did not intend to be a passive investor in Southern. It will, no doubt, provide Southern management with considerable independence, but will also ensure that Southern abides by certain core VWUK operating rules. It will also enforce these rules on the three other VWUK water companies. This is perfectly reasonable and probably sensible. However, it does mean that Southern will probably become less distinctive as a

comparator. The distinctiveness and uniqueness of each water company tends to enhance, at least in the regulator's mind, the diversity of operating performance and the likelihood of productive innovation. I believe that there is considerable strength in this argument, though the empirical evidence is perhaps not as clear-cut as asserted by Ofwat.

8. VWUK also operates a central services business (Vivendi Water Partnership) that provides substantial operating support to all its subsidiaries. This is, of course, absolutely acceptable within the regulator's ring-fencing rules. Nevertheless, in the central activities run by the Partnership, which include laboratory services and human resources management, the DGWS is probably correct to believe that the number of distinct approaches is not four (the potential number of VWUK companies) but one. As a result, the degree of management innovation or technical progress is possibly less than if the four companies were independent. Of course, this is a contentious argument: one big company might be more innovative than four small ones. Nevertheless, I think it is right to give weight to the regulator's view that diversity of management style is important to securing a variety of different approaches to problem solving.

9. VWUK told us that the RAGs should provide the regulator with some confidence that Southern would be untainted by uneconomic cross-charges from the group centre or from other group companies. I think this is widely accepted; holding companies are not easily able to distort the underlying results of water industry subsidiaries. But nevertheless, holding companies do have central policies and will enforce these guidelines across all subsidiaries. The DGWS's view that joint ownership will tend to generate greater homogeneity of efficiency is, in my opinion, a reasonable one. I therefore think that the movement of Southern from independent ownership to being part of VWUK is likely to have a significant impact and that this impact is increased by the existing position of Southern close to the operating efficiency frontier. It is a reasonable possibility that the DGWS will set less demanding price reduction targets for the whole of the industry at the next review because Southern is no longer an independent comparator.

Folkestone & Dover

10. The likely loss of F&D is the second major detriment I identify. It can be contended that this is not a proper subject for the inquiry because it is not an inherent or definite part of the transaction by which VWUK would acquire Southern. My view is that we are entitled to consider it because the disappearance of F&D is an overwhelmingly likely outcome of the acquisition.

11. F&D is a small water company operating within Southern's sewerage region. It adjoins Southern's water supply areas. From VWUK's point of view, there could be no possible reason for continuing to operate F&D as a separate business. Folding it into Southern would save money and management time. In its discussions with Ofwat in November 2001, VWUK indicated that it would prefer fully to amalgamate the F&D business. Cost savings would accrue to the VWUK group.

12. VWUK management is of the view that the F&D licence should logically be merged with Southern and the operations combined. The DGWS told us that, in cases of this sort, mergers were unfortunate but unavoidable. If a holding company wants to merge two comparators, Ofwat can do very little to stop it. As a result, data sets from the merged companies are either lost, or lose their usefulness. In my view, this means that F&D will almost certainly disappear and, as a result, the regulator will lose a comparator.

13. I accept that the DGWS has the legal power to stop the formal merger of the licences of Southern and F&D. Nevertheless, in reality, the regulator has no way of stopping the gradual merging of activities of two companies. It is not reasonable to assume, in my opinion, that the regulator could ever control the day-to-day management of F&D sufficiently to ensure that its activities remained wholly distinct from Southern. Simple things will happen that result in an almost osmotic merger. A key executive will retire. Management will be unable to find a local replacement, so the person in the equivalent role at Southern will 'temporarily' help out. Little by little, in steps such as this, the independence of F&D will disappear (and in the conventional industry, little would be lost). But, eventually, the usefulness of F&D as a data set in the regulator's comparative work will disappear. At this point the DGWS will, I submit, be perfectly correct to allow the merger of the licences as merely reflecting the underlying state of affairs.

14. VWUK has also argued that F&D is of little value as a comparator. The regulator admits that the company is too small to be used as a credible benchmark for the rest of the industry. Nevertheless, F&D does have unique and important features. It has extremely high standards of customer service. It is very well regarded by its customers. Exemplary performance by a small company can provide a real spur to the efficiency of bigger companies in the industry.

15. Perhaps more importantly, F&D does provide one of the 22 separate data sets for inclusion in the regulator's econometric modelling. In this respect, it is probably less valuable than a large company, but still of substantial value in improving the accuracy of the modelling.

16. Therefore I believe that the eventual loss of F&D would have a detrimental impact on the operation of the regulatory regime.

The use of a highly-gearred financing structure

17. The third detriment that I identify is the loss of the quality of comparators as a result of the financing structure intended to be used by VWUK to acquire Southern. My conclusions on this detriment are tentative for two reasons. First, the details of the financing arrangements are far from certain, and no one can tell exactly how the financing structure will work. Second, even if the transaction eventually occurs precisely in the form identified by VWUK today, the detailed implications for the operation of the regulatory regime can only be a guess. It is tempting, therefore, to ignore the proposed financing of the transaction.

18. In my view, the uncertainties should not exclude us from considering the possible effect on the ability of the regulator to pursue his objectives. Rather, it is precisely the complexities, ambiguities and uncertainties of the proposed structure that should demand our consideration. Its experimental nature should be the subject of concern.

19. Some companies in the water industry have recently introduced highly geared capital structures. They have done this in order to lower the cost of financing their operations. The DGWS has indicated a

willingness to accede to requests for the far greater use of debt in the capital structures of this industry because, in theory, lower financing costs can allow for greater future price reductions.

20. I have serious reservations about the DGWS's policy because I believe that the public interest may possibly not be served by moves to much higher use of debt in the water industry. As the DGWS himself says in the 2002 Ofwat annual report:

Some companies are considering or have proposed to adopt a higher ratio of debt to equity.

This may temporarily reduce the cost of finance—an important aim in an incentive based regime. But it could reduce the financial flexibility of companies in the future.

Any new structure must be consistent with the long-term nature of the industry. Any increase in financial risk is a matter for shareholders and lenders. However we must ensure that customers are protected from undue risk.

21. I have also taken considerable note of comments made by other water companies about the use of securitized and highly geared capital structures. For example, in the announcement of the annual results of Pennon Group, the owner of South West Water, on 30 May 2002, the Chairman, Ken Harvey, wrote:

The Board, together with its advisers, has conducted an extensive review of financial restructuring options including that of a whole business securitisation of South West Water.

The technical feasibility of securitising was established. However, the Board has concluded that securitisation for Pennon Group is unlikely to create sufficient incremental shareholder value to outweigh the significant implementation and other costs and identifiable risks.

However, my view that there is detriment to the regulatory regime from the proposed financial structure of this transaction does not principally derive from my opinion that the water industry should not proceed to much higher gearing levels. It is the specific structure to be adopted by VWUK that gives me the substantial concerns I identify in the appendix.

22. The proposed structure is, in my opinion, a piece of sophisticated financial planning designed to give VWUK control of Southern with a minimum outlay of cash. It is a very complex proposal designed to provide financial incentives to a very diverse group of potential third party equity owners, bond investors and bank lenders to back VWUK's purchase. It establishes financial vehicles whose interest in Southern

may not be entirely congruent with VWUK's. The structure is not a simple swap of debt for equity, and the risks to the regulatory regime and to the interests of water consumers are significantly greater than would be the case if VWUK was merely increasing gearing to 85 per cent of total capital.

23. The majority believe that there is insufficient evidence to conclude that adverse effects for the public interest could be expected to result from the merger insofar as the financial structure envisaged by VWUK is concerned. By contrast, I believe that the nature of the financial restructuring proposed is reasonably likely to have adverse effects on the regulatory regime.

24. If a water enterprise is unable to meet its financial obligations, the DGWS is entitled to step in and administer the company. In my view, this is not adequate protection for the regulatory regime. The failure of large utilities is rarely a simple or clean matter. Prior to failure, performance usually deteriorates and capital projects are delayed or aborted. Failure itself has significant financial costs, and even in a well organized bankruptcy, the disruption to management effort is huge. Our group was often told that the disposal of Wessex after the onset of problems at Enron proved that the regulatory system could cope with financial upheaval. In my view, this is an entirely inappropriate analogy. Wessex was a stable business and able to finance its activities. It could be sold easily; the problems were located elsewhere. This would not be the case for a distressed water company in financial difficulties, possibly with a history of underinvestment. A buyer for such a company could no doubt be found by the DGWS, but probably only after he agreed significant price increases.

25. I believe that the precise impact of the proposed structure on the regulator's ability to control the industry is far from clear. I do want to stress that I regard my concerns as tentative; the implications of the financial innovations proposed by VWUK are far from well understood. However, my concerns were exacerbated by the very limited information that VWUK was able to provide us with about the cash flows within the proposed financing structure.

26. I think that the use of this extremely complex, experimental, untried and highly leveraged series of vehicles to finance Southern is liable to prejudice the regulator's ability to improve efficiency and quality of service. My reasoning is in the Appendix. Because the quantum of the detriment is difficult to measure, it

can be reasonably thought that it should be ignored. I take a different view; it is appropriate for us to consider all the possible adverse impacts on the regulator's work. However, because my concerns about the complex and experimental structure envisaged are necessarily hesitant, I have taken no account of them in determining the appropriate remedy.

Does the loss of quality and quantity of comparative information matter?

27. The DGWS's external statistical adviser, Professor Mark Stewart, gave the opinion that the loss of even a few water comparators would severely affect the ability to use the ordinary least squares technique in relation to whole-company data. This technique is the foundation of the DGWS's econometric modelling. Similarly, NERA told us that when the number of separate sources of data fell below about 20, the explanatory power of the models derived from the ordinary least squares technique declines rapidly.

28. The majority take the view that alternative econometric techniques or the use of data from smaller geographic units within water enterprises might be used to bolster the effectiveness of the econometric modelling and mitigate the loss from the decline in comparator information. I disagree with their conclusion. First, the benefits of these proposed alternative techniques are speculative. Though Ofwat has regularly examined other econometric tools and the use of additional sources of data, it is unconvinced of the benefit. I have no reason to doubt the rigour or openness of its investigation. Second, whatever extra techniques are employed, more water industry comparators will always be better. This point is about as close to an iron law of econometrics as one can find.

29. In some industries, it may be possible to carry out regulation of prices and quality using a smaller number of comparators. But there are good reasons why the water industry needs more. For example, geographic and operating conditions vary enormously between various regions of the UK. In some places, copious quantities of high-quality water are available from boreholes close to dense urban areas. In other areas, river water needs to be extensively purified and is then pumped uphill from large reservoirs at considerable expense. The regulator's job is to decide which water company is most efficient and then base his price review on this performance. Calculating which enterprise is the most efficient among the heterogeneous set of 22 possible comparators is difficult. The more sets of data the better, whatever techniques are used.

30. I think that the detriments **resulting** from this merger will substantially reduce the degree of confidence and effectiveness with **which** the regulator operates his regime. For example, the DGWS will probably be forced to begin to use **other** forms of econometric modelling because the number of data sets available to him may decline to **below** the number required by cross-sectional ordinary least squares regression, his principal current **technique**. Even if these additional techniques are effective, it will be some years before their value is **confidently** known. Before he can rely upon these additional tools for setting prices, he will be obliged to **convince** the industry that the results he obtains are reasonable and robust. This will take several years. **It is** difficult to believe that the additional techniques proposed by the majority will be used with confidence **before** the next price review but one.

31. Much of the work of the **inquiry** was devoted to understanding and assessing the regulator's econometric modelling. I feel that **some of** the other aspects of the comparative regime may not have been given sufficient weight by the majority. **The** impact on the regulator's wider tasks of the prospective loss of an innovative small water company (**F&D**) and the absorption of Southern into a larger water group may be understated. In particular, I was struck **by the** importance some water companies attached to their place in the various 'league tables' of non-economic performance, such as service quality or failures of water pressure. Perhaps even more important, the DGWS stressed forcefully to us that he believed that the degree of productive innovation in the industry was influenced by the number of separate management teams trying to solve problems. This transaction reduces, in his mind, the likely level of overall efficiency change within the industry. In my opinion, this is a severe detriment and one to which the majority report does not give sufficient weight.

The lack of proportionality between the detriment and the remedy

32. So far in this note, I have tried to provide some arguments for my view that the prejudice caused to the regulatory regime is more severe than indicated by the majority. I also believe that the proposed remedy is too slight, even if one agrees with the majority on the degree of detriment.

33. I have three reasons for my view that the sale of VWUK's stake in South Staffs Group is a not a substantial counterweight to the prejudice to the public interest caused by the transaction:

- The sale of these shares does not improve the regulator's ability to regulate the industry; there is no improvement in the quality or quantity of information available to him. South Staffs Water is already, at least in the regulator's view and that of the company itself, an independent comparator. In the last 13 years, VWUK has never exercised any influence over South Staffs Water and I see no reason to expect this to change. (In its role as the major external shareholder, VWUK has been consulted on important holding company decisions, but these have not been concerned with the operation of the water subsidiary, but instead with corporate actions at the holding company level.)
- VWUK's shareholding is held in the parent company, not the regulated water entity. While VWUK could certainly influence the holding company, the water subsidiary is protected from interference. The whole structure of water industry regulation, particularly the accounting guidelines and licence conditions, would oblige the directors of South Staffs Water to ignore any pressure from VWUK unless it was in its own best interests. I am confident therefore that the usefulness of South Staffs Water as a comparator is very unlikely to be affected by VWUK's actions, unless it chose to purchase the entire business, which would trigger a CC reference. Therefore I believe that this particular remedy has very limited value to the regulator.
- South Staffs Water has a turnover half the size of Southern's. Furthermore, because it is not a frontier company for efficiency, it is not as useful to the regulator as Southern. Even if the regulator did believe that South Staffs Water was not currently independent, the loss of Southern could therefore not be adequately compensated for by the hypothetical gain of a much smaller and less efficient comparator.

I therefore believe that this remedy is no more than a small counterweight to the losses caused by the transaction. I stress that I believe that the sale of the VWUK shares would have some small hypothetical value, and therefore should be part of the remedy that I propose.

34. Other potential remedies could include the creation of a new water comparator (Hampshire Water) carved out of Southern, or the imposed sale of one of VWUK's other water subsidiaries. Imposing additional remedies in the form of price reductions would only exacerbate the problems that might be caused by the planned financial structure, particularly since the parties agree that Southern is already one of the most efficient companies in the industry and therefore has limited scope to cut prices and still remain viable.

35. I agree with the majority's view of the unattractiveness of the Hampshire Water option. It would be messy, expensive and would take several years to implement. It would also, at least in my view, only partly remedy the cost to the regulatory regime.

36. I believe that the sale of Three Valleys is a more proportionate remedy and has few of the costs of the Hampshire Water option. Three Valleys has a larger water turnover than Southern's and F&D's water businesses combined, but because it is currently not a frontier company for operating efficiency (although it is the benchmark company for capital maintenance), it is not as valuable a comparator as Southern for the regulatory regime. The sale of Three Valleys, added to the sale of the minority stake in South Staffs Group, approximately equates in my view to the loss of Southern as an independent comparator, and the likely total disappearance of F&D.

37. The establishment of a new independent comparator in the form of Three Valleys has substantial compensating value to the detriment caused by this transaction. I want to stress that I believe that the proposed financing structure could create a substantial separate detriment to the regulatory regime, but one to which I do not attach any weight whatsoever in assessing the correct remedy.

CHRIS GOODALL
23 September 2002

APPENDIX TO STATEMENT OF DISSENT

The implications of the use of a complex and untried financing structure for the acquisition of Southern

(A simplified schematic of the financing structure is at Appendix 3.15)

1. I believe there are five reasons for concern about the proposal:
 - Southern may not be able to respond to the regulator's demands for price reductions.
 - Similarly, debt-financed companies may, for reasons entirely outside their control, lose access to new funds. As events over the past year have amply demonstrated, capital markets can experience sharp changes in sentiment, and fresh financing can become simply unavailable. In the present case, this might mean that Southern would have to curtail its capital expenditure and, possibly, become less efficient in relation to the industry as whole.
 - As many commentators, including the Public Accounts Committee, have discussed, highly geared companies are less able to withstand financial shocks. In effect, financial risk is transferred from shareholders to consumers.
 - In the VWUK proposal, significant powers are given to the third party equity holders. These shareholders are not necessarily long-term investors in the water industry. Their interest, quite legitimately, lies in securing the superior returns offered by this proposed investment. If Southern fails to deliver these returns, for whatever reason, the third party investors can take control of the management of the company. I believe that this would have deleterious consequences for the operation of the regulatory regime.
 - Lastly, I believe that the returns to VWUK in the proposed structure are highly geared to the success or failure of Southern. If unsuccessful, VWUK's equity stake will be worthless. I believe that this is likely to have two main effects. First, it will make VWUK extremely risk averse. Second, it may mean that it is rational in certain circumstances for VWUK to cease to provide finance to Southern. (If, for example, Southern's losses are sufficiently large, it may be inappropriate for VWUK to continue to provide further financing.)
2. These five potential detriments to the operation of the regulatory regime are, by their nature, hypothetical. This is inevitable because the proposed transaction is still at the early planning stage, and no

other water enterprises have a similar financial structure. (AGW is highly geared, but I believe that it does not have outside equity shareholders at the water company level. As I understand it, Glas Cymru is limited by guarantee and is able to build up cash reserves equivalent to quasi-equity.)

3. Despite their hypothetical nature, I believe it is worth discussing more precisely how each detriment might affect the DGWS.

Reduction in ability to reduce prices

4. The imposition of price targets by the DGWS is a five-yearly event. The 1999 price review resulted in significant price reductions for all water companies. Water enterprises can absorb these reductions because they are financed by a large cushion of equity reserves, on which the dividends can vary. The proposed VWUK acquisition of Southern will produce a company that would be somewhat financially constrained if any of the main assumptions on which the deal is based turn out to be too optimistic.

5. Figures provided us by VWUK show a total debt of £1,889 million in 2003/4 for the fully finance entity and an assumed interest rate on this debt of 6.5 per cent. (There is no recourse to any parent company, and Southern stands as a self-contained entity). We cannot, of course, tell whether VWUK can achieve this average rate, but we can carry out sensitivities that will demonstrate the possible effect of failing to achieve it. Very roughly, a rise to 7.5 per cent in the average interest rate on the proposed indebtedness would reduce the amount of cash generated as a return on VWUK's capital in 2003/4 from about £40 million to about £25 million. Expressed in another way, the rate of return on VWUK's investment would fall from 9.8 to 6.3 per cent. Since 6.3 per cent would be below the cost of bond finance, raising new money would be difficult because it would make the overall financial position of the company worse and cause VWUK's return to fall even further. Bond investors would be understandably reluctant to invest in Southern bonds (or rather the bonds of companies higher up the financial structure) if the returns available to service the extra investment were lower than its cost. In VWUK's projections, Southern will need to raise a further £73 million in 2004/5 in external finance. It is therefore reasonable to be concerned about whether the over-stretched nature of the company's financing is likely to affect its ability to find new debt capital. The AFP appears more significantly to limit the financial freedom of action of the regulated entity than other recent replacements of debt for equity in the water industry.

6. I would not want to overstress this point, but it does seem clear that VWUK is intending to finance Southern in a way that leaves little spare money to meet unforeseen circumstances. One obvious such unforeseen circumstance could be the imposition of a tighter than expected price control at the next price review. Put simply, my question is this: how can the regulator use price reductions to force companies to generate efficiency gains if by so doing he makes these companies unable to finance the operation of their business? As I say below, a highly geared and sophisticated capital structure is likely to reward shareholders handsomely if the business does well. If it does badly, the most likely outcome is a renegotiation of the price regime. English and Welsh water businesses will need new capital for decades to come. If the regulator does not revise his price caps, capital investment programmes will suffer. In my opinion, he therefore has little choice but to give in to the demands of water businesses that need to deliver high levels of regular financial return to outside investors, banks and bond holders.

Loss of access to funds required for new capital projects

7. Highly geared companies lose some part of their autonomy. They become dependent on the capital markets to continue their activities, particularly the spending of money on capital expenditure projects. In times of capital market turbulence, highly geared companies will sometimes find it impossible to raise new money for capital expenditure or other purposes.

8. The DGWS approves the capital expenditure plans of the water companies. One of his objectives is to ensure that appropriate capital expenditure projects are completed because these projects help to improve efficiency and/or quality. Without access to the capital markets, highly geared companies such as the proposed Southern entity could not successfully carry out these works. Their efficiency would therefore eventually suffer.

9. In my view, it is a reasonable hypothesis that Southern's proposed highly geared structure, particularly when combined with the de facto restraints on its operating freedom imposed by the rights given to third party investors will, at some stage in the future, result in a lack of access to new capital and therefore a prejudice to the regulator's ability to carry out his functions.

10. *Loss of ability to withstand external shocks.* The Public Accounts Committee commented on this possibility in a report on the National Audit Office's analysis of regulatory regimes. Talking of highly geared financial structures, the Committee said:

There may be risks to consumers arising from these structures. A heavily indebted company may have less flexibility to respond to unexpected events, such as a sudden increase in operating or financial costs, than a company with a substantial equity reserve. If a company has insufficient equity reserves to call on, there is a risk that it may have to pass on unexpected cost increases to consumers through higher prices.

Paragraph 28 adds to this comment by saying, in reference to Ofwat's counter assertion that highly geared companies should respond to external events as well as other companies, 'it was not clear to us how the regulator could avoid allowing higher charges to customers if a company was unable to call on shareholders' funds to withstand a large shock, such as increased borrowing costs'. In my view, this is a particularly pertinent consideration in Southern's case.

The impact of having third party investors alongside VWUK in the proposed structure

11. VWUK is part of the largest water services company in the world and has a clear interest in building a successful business at Southern. However, the other shareholders may have different incentives.

12. The structure of the proposed financing sees third party private equity investors holding £50 million of ordinary shares in FIB, the two external holding vehicles for the investment in Southern. (FIB are two levels higher up the proposed financing structure than the holdings in Southern, and so the percentages of debt and equity may be different to Southern itself.) Other funding sources are providing about £2 billion in investment through these vehicles. The returns to the PEI's are therefore even more highly geared than VWUK's investment since equity is providing only about 2.5 per cent of the funding of these companies. Small changes in the performance of Southern would induce massive swings in the value of the private equity stakes in FIB. (These holdings may be compared to buying a house with a 97.5 per cent mortgage. A ten per cent rise in property prices generates a five-fold increase in the value of the home equity. A similar fall in prices would wipe out the equity four times over.) I believe it is

important to 'look through' the financing of Southern itself up the hierarchy of three layers of financing entities above the regulated company. We need to examine the structure of incentives, rights, obligation and protections associated not just with Southern but also the entities that control the present and future financing of the company. The outline state of the AFP made it extremely difficult to reach an objective and complete view on these matters. Nevertheless, I believe it is appropriate to record my deep concerns about the potential impact of the external entities on the regulator's ability to carry out his functions.

13. One might contend that the risks taken on by these investors are their own affair. Ofwat certainly has no need to bail them out if the investment turns sour. But the situation is not simple; the outside investors appear to have substantial rights to protect the value of their capital. If the financial performance of Southern does not meet predetermined goals, these investors appear to be able to take over the running of the company and then to sell it. The fact that they have this right probably enables them to exert disproportionate control; the costs to VWUK, financial and otherwise, of losing the business are so great that it will be bound to act in the best interests of the PEIs and not necessarily the wider group of stakeholders in Southern.

14. The precise implications for the operation of the regulatory regime of the powerful rights held by the proposed PEI regime are far from clear. I believe that no water business has gone this route before. Nevertheless, I believe it is reasonable to hypothesise that the existence of extremely highly geared vehicles as the primary source of funding for Southern could cause difficulties. (Note that it is not just Southern that is highly geared, it is also the vehicles that will own Southern that use a 'thin-equity' model). This provides a possible incentive for the external equity funders to act in a way detrimental to the long term interests of the company, for example by demanding a reduction in capital expenditure.

15. I believe, though I accept that this belief is not based firmly on fact, that the third party outside investors introduce the possibility of a very substantial asymmetry between what will happen if the underlying business does well, and what will happen if it does badly. Successful outcomes will result in the common shares multiplying in value. Failure will probably mean higher prices for consumers.

The impact of the highly-gearred holding of VWUK

16. VWUK also has a highly geared stake. It will control about 70 per cent of the equity on the basis of a total contribution of less than 20 per cent of the total funds. In order to secure a financial return on its investment, it will have an incentive to be risk averse. If matters turned out badly, its returns could be reduced to zero. In some circumstances, it might lose control over Southern, and probably its entire invested capital in the process.

17. Whether this is prejudicial to the operation of the regulatory regime is a matter of speculation. But I believe, on balance, that excessive risk aversion is detrimental to the efficient operation of the comparative system. Innovation is always risky. A risk-averse company does not innovate, and therefore its efficiency does not improve as fast as it might.

