PUBLIC INQUIRY INTO THE APPLICATION TO INCREASE THE TOLLS AT WHITCHURCH BRIDGE

TO BE HELD ON 19th MAY 2015 AT THE GEORGE HOTEL, PANGBOURNE, READING RG8 7AR

Witness statement by Michael Beckley, MA, FCCA

1. My name is Michael Beckley. I am a Fellow of the Chartered Institute of Certified Accountants, with more than 40 years of experience in finance and financial management. I am Chairman of the Committee of Management of the Company of Proprietors of Whitchurch Bridge.

2. I have been associated with the Whitchurch Bridge Company for 40 years, and am familiar with the history and background of the Company. In my professional capacity I have assisted the Company with its financial management, including the development of forecasting models to enable the Company to plan its financial requirements, and therefore to determine the level of tolls required in order to meet the statutory requirement that the annual revenue of the Company should not be either substantially less or substantially more than adequate to meet such expenditure on the working, management and maintenance of the undertaking and such other costs, charges and expenses of the undertaking as are properly chargeable to revenue, including reasonable contributions to any reserve, contingency or other fund and, where appropriate, a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge as defined in Section 2 of the Whitchurch Bridge Act 1988

3. The Whitchurch Bridge Company is in principle a relatively simple organisation from a financial point of view – it has a single objective, the maintenance of the bridge crossing at Whitchurch, and a single source of income, the revenue from tolls. It is a statutory undertaking, with its toll levels being fully regulated by the various Acts previously referred to

4. Some have said that the Bridge should be owned by a local authority, not by the Company. I have to tell you that in the last 40 years that I have been associated with it, and to my knowledge for many years before that, no approach has ever been made by any local authority to any such effect. Some bridges that are owned by local authorities also still charge tolls and are regulated under the same legislation as Whitchurch – the Tamar Bridge and the Southampton Itchen Bridge for example. So the ownership of a bridge is not relevant to the means of financing it.

5. Indeed as noted in my opening remarks, the Whitchurch Bridge Acts specifically state that the bridge shall not be a burden on the local authorities for its financing, and for that reason the £6.5m reconstruction has been undertaken and will be financed specifically at no cost to the local authorities. In this respect its financing is no different to that of other public utilities such as water companies. My remarks therefore relate entirely to the process of financing the Company under the current legal and statutory regime within which it operates.

6. I should also mention that as a regulated public body Whitchurch Bridge is not required to charge VAT on its tolls, unlike other private toll bridges – the Dunham Bridge for example recently had to put up its tolls by 20% because of government and EU legislation requiring that private toll bridges should charge VAT, but the Company has succeeded in getting Whitchurch exempt from this imposition.

7. The recent reconstruction represents the fourth major investment in maintaining the bridge over the River Thames between Whitchurch and Pangbourne since 1792, and the next major work is anticipated to be in 100 years' time. This investment has provided significant benefit to the community and has been maintained to a high standard at no cost to the taxpayer or local ratepayer.

8. The toll charges for the Company were last reviewed in an application dated October 2008, which was approved following a Public Inquiry in May 2009. At that time it was estimated that the Bridge would need to be reconstructed in 2013 at a cost of some £4m. Since then the Bridge has indeed been reconstructed, but the actual cost incurred over the period 2013–2014 amounted to £6.5m. The reasons for this significant increase are set out elsewhere. This increase combined with a lower than expected volume of traffic crossing the bridge results in a significantly different financial situation for the Company, necessitating a further toll increase application.

9. The financial issues that will need to be considered here arise, however, from the fact that the primary asset of the company, the Bridge itself, has a very long life cycle of over 100 years, which is significantly beyond the typical horizon of a normal company. Therefore the entire financial management of the company has to be geared to a single once per 100 years event whose cost, as we have seen, cannot be accurately predicted more than 5 years in advance

10. Even now that we know the actual cost of reconstruction, the financial projections necessary to establish the level of tolls required to provide a revenue to the company that is neither "substantially less or substantially more than adequate to meet such expenditure on the working, management and maintenance of the undertaking and such other costs, charges and expenses of the undertaking as are properly chargeable to revenue, including reasonable contributions to any reserve, contingency or other fund and, where appropriate, a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge as defined in Section 2 of the Whitchurch Bridge Act 1988" requires estimates to be made of a number of variables for a period of the next 20 years, and these are set out in the Toll Application and the Statement of Reasons.

11. The most significant assumption is that regarding traffic volume across the bridge, as that together with the toll charge per crossing are the sole determinants of the level of the Company's income. As noted in the Statement of Reasons, traffic volume in the last year before closure of the bridge was already 7% below that projected at the time of the last toll application just six years' ago, and current indications based on data post reconstruction is that volumes are still falling, at the rate of 1 – 2 % per year. Our assumption in the forecast used in the toll application is for a decline of 1% per year, but that may turn out to be optimistic. This must be taken into account in assessing the current toll application. A graph showing current and projected traffic volumes is included in the Statement of Reasons.

12. The company has made four toll applications over the last 20 years, rising from 10p in 1998 (equivalent to 15.7p today) to 60p in this toll application. These increases are parallel to and entirely driven by the increase in reconstruction costs from an estimate of £640,000 in 1997 to an actual cost of £6.5m in 2014. Meanwhile the discount from cash tolls to average tolls has increased from 6% in 1993 (when only paper tickets were available) to 25% in the current proposal, due to the active encouragement for all regular users of the bridge to take advantage of the automated bridge card scheme. The expectation of the current application is that the proposed toll will be sufficient to provide the required level of income through the period to 2029, and the proposal has therefore been designed to give the optimum balance of financial contribution over this 15 year period. Now that reconstruction has taken place

there is much more certainty over the future financial projections and there is no reason to expect significant changes in future other than to deal with normal levels of inflation.

13. During the last 17 years:-

    i) The average toll increased from 9.5p to 27.8p per crossing – an increase of 6.5% per year compared with inflation of 3% per year for the same period.
    ii) These increases have been entirely driven by the increase in construction costs, as operating costs rose from £79k to £137k – an increase of just 3.3% p.a. Cost efficiencies have been maximised during this period. Operating costs as a percentage of revenue have decreased from 60% to 33%.
    iii) Meanwhile traffic volumes crossing the bridge have fallen by some 15% over the same period, from 5,500 per day in 1997 to 4,700 per day now. (90% of this volume is within the normal hours for toll collection).
    iv) Dividends have remained at less than 2.3% of net assets – a lower percentage than that for comparable regulated businesses.
    v) The Reserve Fund increased from £750k to £3.0m net of capital expenditure during the period of some £400k.
    vi) Total assets showed a commensurate increase from £1m to £3.3m largely as a result of the increase in the Reserve Fund where toll operating profits have regularly been transferred to the Fund and used for the reconstruction project.

14. The analysis of sources and use of funds over the relevant period shows a balance between operating revenue and revenue from investments, most of which was allocated to reserve funds, and loan finance from banks and shareholders in order to meet the investment requirements of the bridge reconstruction. Over this period of 17 years the operation has had outgoings of £7.7m, including the reconstruction costs, and this has been funded by a combination of internally generated funds (£4.3m or 56% of total funds generated) and loan finance (£3.4m or 44%) 92% of the funds raised have been used to fund the Bridge, including the reconstruction costs. During this time £0.6m has been paid to shareholders, but these same shareholders have contributed £0.5m in funds for the reconstruction

15. The Whitchurch Bridge Company is therefore a small organisation managing effectively a significant responsibility for managing and reconstructing the Bridge at Whitchurch, managing both operating income and income from investments to optimise use of funds, and with shareholders receiving modest dividends well below those in comparable regulated businesses. However the continuing escalation of reconstruction costs has meant that the Company has had to borrow substantial funds in order to complete the work. It has been able to do so due to its track record of prudent management and its statutory position as a regulated utility governed by Act of Parliament.

16. The requirements of the operation over the next 15 years are entirely different from those of the last 20. During this period

    a. There is no investment income available until the end of the period, as all reserve funds have been expended on the reconstruction

    b. There is a necessary commitment to repay the loan funds, with interest, over this period

    c. It is necessary to account for an expected continuing slow decline in traffic volume, in line with the trends consistently observed over the last 10 years

    d. There is a requirement for some further expenditure on the bridge, in particular a proposal to upgrade the footpath on the Pangbourne side

e. There is a requirement enshrined in statute for funds to continue to be put aside for future replacement of the reconstructed bridge at the end of its useful life. This funding should be at least equal to the depreciation provision on a replacement cost basis, amortised over 100 years, as noted above

f. There is a requirement to pay a reasonable return on the investment of the Proprietors in the assets of the Bridge, as with any other regulated utility

17. Over the next 15 years effectively all of the Company's income must therefore come from toll revenue, which must cover

    a. operating costs of £200,000 per year, including maintenance,

    b. loan repayment and interest costs of £320,000 per year,

    c. capital expenditure and reinvestment of £110,000 per year and

    d. dividends of £65,000 per year (or £1,250 per year per shareholder),

    totalling £700,000 per year. With forecast average traffic volumes in collecting hours of 1,400,000 vehicle movements per year, this gives an average required toll charge per vehicle of 50 pence.

18. The Toll Application to increase the cash toll to 60p, and the supporting Statement of Reasons, show that when taking account of the policy of giving a discount to regular users this is the minimum level of toll charges required in order to fund these requirements. The toll application document clearly shows that at the present level of tolls this funding is not feasible. Applying the current average toll of 33 pence to the projected traffic volume gives a toll income of £460,000, which is clearly inadequate. A cash toll of 50 pence, with the current 25% discount for regular users, gives an average toll of 41 pence, or an income of £570,000 per year – again clearly inadequate to meet the required and committed levels of expenditure.

19. Assuming an increase in the cash toll to 60p from mid-2015 - 16 as proposed in the toll application:-

    a. The average toll in pence is forecast to increase from 33p to 49.6p with the discounted toll for Bridge Card users changing from 30p to 45p.

    b. The commitment to loan interest plus repayments of £320,000 per year can be met

    c. Dividends remain at 1.3 % of total net assets.

    d. Operating costs are controlled at below-inflation increases for each of the forecast years.

20. The published Statement of Reasons, Tab 14, which lays out all these matters in some detail, shows that of the average toll charge that would result from this application of 50 pence per crossing

    a. 15 pence is accounted for by operating costs

    b. 23 pence is required to cover loan interest and repayments

    c. 8 pence will be reinvested back in funding future requirements, including the upgrading of the Pangbourne footpath

    d. Just 5 pence goes to the shareholders

21. Concerning dividend policy, which is examined in Tab 15, The Company of Proprietors of Whitchurch Bridge is a public body governed by Act of Parliament, and therefore subject to

the provisions of the Whitchurch Bridge Acts 1792 and 1988 and the Transport Charges &c (Miscellaneous Provisions) Act 1954. The dividend policy of the Company is therefore determined in accordance with this legislative framework for the operation which refers to "a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge as defined in Section 2 of the Whitchurch Bridge Act 1988", the relevant definition of "the Bridge" being "the Whitchurch Bridge of the Company and all the lands, easements, rights, Toll houses, Toll-gates, signals, offices and other assets of whatever description for the time being held or used by the Company in connection with that Bridge"

22. The operation of this policy requires therefore the determination of two factors:

    a. What is the value of the assets encompassed by the definition of "the Bridge", and

    b. What is a reasonable return on this investment.

23. These questions can be answered by reference to the accounts of the Company and to comparable definitions for similar types of regulated undertaking, e.g. water companies. The Statement of Reasons shows that actual return in terms of dividends paid over the last 15 years and planned over the next 15 years has been and will be constrained below what would normally be regarded as a reasonable level of return in order to repay loans and build up reserves within the Company

24. The Balance Sheet of the Company as at 30th June 2014 defines the assets of the Company at £3,328,277. The reconstructed bridge was still in the course of construction at 30th June 2014: it is now complete and the final total cost of the project is £6,549,453. This valuation will be shown in the accounts as at 30th June 2015, together with other assets valued at approximately £500,000. This will be matched in the balance sheet as at 30th June 2015 by long term loans of £3.4m, giving approximately the same valuation of net assets as at June 2014. The effect of our accounting policy is that the value of the investment of the Company in the assets of "The Bridge" is defined consistently whether the Company is building up assets towards replacement, or whether the bridge has just been replaced but with the assistance of a loan, which reduces the net value, or whether it is part way through its life, as it will be in 2025, but with funds already being built up towards replacement in 100 years' time. These same accounting principles are applied, with a vastly greater degree of complexity, by all regulated industries

25. The issue of a reasonable return on investment can likewise be considered by reference to the cost of capital in other regulated industries. This approach depends on an assessment of the standard Capital Asset Pricing Model (CAPM) which takes into account the weighted average cost of capital between loan and equity finance. For most regulated industries the cost of equity capital is higher than the cost of loan capital, as equity cost is based on the risk free rate, plus the general equity risk premium, adjusted for the specific risk associated with the particular undertaking. The risk free rate can currently be assessed as about 2.0%, being the rate of return on government securities, and an equity risk premium of 3.5 – 5.5% is typically used in regulated industries to give an expected return on shareholder assets of approximately 6%. This rate of 6% is also the rate used for a return on investment to shareholders and approved by the Secretary of State in the specifically parallel case of the Dunham Toll Bridge Inquiry, which has been recently updated.

26. In the case of Whitchurch Bridge the dividend yield is the correct measure of the rate of return on equity as the Whitchurch Bridge acts do not allow the distribution of the Reserve Fund, and therefore the dividend payment is the only possible source of return to shareholders. A dividend yield of 2.3% was included in the Toll Application which was approved in 2009, but a lower rate is assumed here because of the need to finance the loan

costs, which are higher than anticipated at that time. It can be seen that in this context the actual and forecast return on investment for the Company is significantly below what would be regarded as a reasonable return in any other situation, being comparable only to that on index linked gilt securities. The reason for such low returns to shareholders is that historically because of low toll levels the Company has for a long time been in a situation where the sums available for transfer to reserve funds have lagged behind the ever-increasing costs of reconstruction, and the present toll application in effect perpetuates this situation as for the next 20 years the Company will be either repaying loans taken out to finance the reconstruction costs or building up reserves for the next replacement.

27. As indicated above, the Company has had to take out loans of £2.9m from Barclays Bank and £0.5m from its own shareholders in order to finance the cost of reconstruction. These loans are repayable over 15 years. It is unusual for a bank to loan funds to a small company such as Whitchurch over such a long period, and the interest rate payable on the Bank loan reflects the normal rate that is payable in such circumstances, as evidenced by the letter from the Barclays Bank manager, Andy Cranstone, who comments that “. There is no fixed policy in relation to loan terms as each case is reviewed on its own merits however when it comes to cashflow loan terms are shorter than those loans such as normal commercial mortgages where you have …for example, a building which is easy to sell …The original loan term of 12 years was already a stretch on normal parameters ….When we were hit with the massive delays and overspend caused by the floods we reviewed the position again and very reluctantly increased our funding and extended the term from 12 years to 15 ….All of the funding provided has been assessed on the ability of the Co. to generate strong positive cashflow and the projected increase of the toll formed a fundamental part of being able to satisfy the Bank that the Company could repay the debt over the extended period it has committed to”

28. As the projected return on assets to Whitchurch Bridge shareholders is lower than the cost of loan capital, it follows that a higher proportion of loan capital increases the weighted average cost of capital (WACC) to the company. The result of a low return on equity plus the cost of loan finance from the Bank is that, despite paying normal small company rates for loan finance, the WACC in this case is significantly below the average allowed for other regulated industries, and falls over time, from 3.18% in 2016 to 2.4% in 2025, both of which are significantly below the average weighted average cost of capital approved over the last five years for multiple regulated industries of 4.38%. The most recent Ofwat report setting price controls for the water industry for 2015-2020 for example, dated January 2014, indicated a target WACC of 3.85%, based on a post-tax equity rate of return of 5.65%. Therefore both the return on investment to shareholders and the average cost of capital to the business are well below the level that would be regarded as reasonable in any other regulated industry.

29. In considering the level of tolls for the current application, we took the view that we wished to continue to operate a discounted toll for regular users, both as a benefit to the local community and for reasons of operational efficiency and effectiveness. It therefore followed that in order to achieve the required average of 50 pence the cash toll would need to be higher than 50p. This approach is in line with our long standing policy and is in line with many discussions that we have had with representatives of the local community who tell us that they want to see a continuation of this benefit. The Company is prepared to commit to maintaining a discount of 25% on the cash toll for discounted cards during the currency of the proposed 60p cash toll.

30. The company has been managed consistently and effectively to meet as far as possible its unusual mission to manage a single very long life asset by prudent management and funding

policies. The Company's financial management policy and the level of tolls required to fulfil its statutory obligations are therefore dominated by the impact of the requirement for periodically renewing or reconstructing this single asset, at intervals of approximately 100 years. Probably no other small public company in the country has such a difficult problem of controlling this one per 100 year investment which is equivalent to more than 10 times the gross revenue of the business, and which is subject to all the uncertainties of managing a major reconstruction project across a navigable river. Since the last toll application in 2008-9 the financial scenarios have been severely impacted by a very specific one time increase in the estimated cost of reconstruction of the bridge – this cost has increased over the last 10 years by 300% or more than £4m compared with previous estimates, and by more than £2m compared with the anticipated cost at the start of the project. An immediate increase is required in the cash toll to 60p, while maintaining the company policy of substantial discounts for regular users by means of the bridge card scheme in order to give an average toll over the entire period 2015 – 2030 of 50 pence per crossing. At this stage the reconstruction is complete and the funds are committed. There can be no argument with the facts of the situation, which clearly and unequivocally compel this increase.

31. The Company will retain that level of tolls as a sustainable rate for the long term through 2030, enabling the Company to repay borrowings of £3.4m and to cover normal operating expenses and investment for the future, including a very low return to shareholders. This approach is entirely within the framework of the permitted funding allowed by statute, as it results in a level of tolls that is neither "substantially less or substantially more than adequate to meet such expenditure on the working, management and maintenance of the undertaking and such other costs, charges and expenses of the undertaking as are properly chargeable to revenue, including reasonable contributions to any reserve, contingency or other fund and, where appropriate, a reasonable return upon the investment of the Company of Proprietors of Whitchurch Bridge in the Bridge as defined in Section 2 of the Whitchurch Bridge Act 1988"

Michael Beckley, MA, FCCA
16th May 2015