STILL STANDING

Shareholder equity has shored up Thames but the resilience, structure and regulation of the water sector remains exposed.

Speaking at the Future of Utilities conference on 21 June, before she was unexpectedly catapulted to the position of joint interim chief executive on Sarah Bentley's abrupt departure, Thames Water's Cathryn Ross said insufficient equity was the "single biggest constraint" on what the company might be able to deliver. She said the ability to spread the cost of investment over time was one of the "crowning glories" of the current model, and that we need to address the lack of a compelling equity story for investors.

Fast forward a week or so, and the need for that story became a very public problem for Thames. To briefly recap, a risk emerged that the company may have insufficient funding to continue to meet its debt obligations, operate effectively and progress its turnaround improvement programme. The two principal issues were: £14bn of debt, half of which is RPI-linked and which has become a struggle to manage since interest rates have spiked and because bills are now tied to the lower CPI metric (the company spent £476.5m servicing its debts during the year to 31 March); and long-running struggles with operational issues (traditionally leakage, and more recently, storm overflow discharges as well), which brought both reputational damage and ODI penalties. Ratings agency DBRS Morningstar pointed out: "TW has reported large losses in FYE22 and FYE21 of £973.3m and £198.5m, respectively. These losses have made raising the additional capital from its current investor base even more difficult."

And raising capital was an essential part of the company's plan. A year ago, Thames' shareholders committed to inject £1.5bn of new equity into the business: £500m in the 2022-23 financial year, and an additional £1bn to be approved before 2025, as long as Thames' turnaround stayed on track. £500m was put in in March 2023, but the other £1bn was not forthcoming – probably a result of deteriorating prospects for the company on fronts including an increasingly toxic public reputation, patchy turnaround progress, huge investment demands for AMP8 and beyond, tightening regulation and high costs, on top of the existing issues of debt liability (with refinancing need) and poor performance.

Reports swirled that Thames was on the brink of financial collapse and may need to undergo emergency nationalisation via the Special Administration Regime – where public support would be provided in the absence of an alternative, amounting to temporary public ownership.

The lifeline

The industry generally regarded this as overblown, with the discussion of contingency plans seen as a sensible precaution rather than a likely outcome. Thames' shareholders were widely expected to put their hands in their pockets to avert the immediate crisis. Other shareholders in the sector have done likewise: Macquarie poured £1bn into Southern Water when it bought a majority stake in 2021; Anglian has voluntarily deleveraged; and in the last few weeks, Yorkshire Water has raised £500m from its shareholders.

Indeed, on 10 July, Thames announced shareholders had agreed to provide £750m of new equity in AMP7, with an acknowledgement of a far larger need in AMP8, indicatively £2.5bn. This was preceded by more good news: the appointment of a highly experienced and steadying influence in the form of infrastructure and utilities specialist Sir Adrian Montague as chair, effective 10 July. Sir Adrian replaced Ian Marchant who announced in April he would step down once a successor was found.

With this largest equity support package ever seen in the sector, the immediate crisis was averted, though the company is far from out of the woods.

The rescue package came with important caveats: undefined "appropriate regulatory arrangements" for the release of the AMP8 support; and a transition to a "more focused Turnaround Plan – this targeted approach focuses expenditure on a smaller number of initiatives that will deliver substantial and sustainable improvements in key performance metrics over the next three years".

While not unexpected, exactly what this focus on the basics means remains to be seen. Thames' more progressive work – for instance on natural flood management and smarter catchments – could well be for the chop, as could other important programmes such as net zero. Mike Keil, senior director of policy, research and campaigns at CCW, commented: "Customers will be reassured by the additional financial backing for Thames Water but they will be unhappy at any suggestion that the company intends to scale back its turnaround plan. Thames sits bottom of the league for customer experience and people need to see and feel a marked improvement, particularly when trust in the sector is at an all-time low."

Thames' performance

There have been green shoots emerging from the turnaround plan to date, including – according to Thames' full year results which were published alongside the news of the equity injection: a record £1.8bn investment in assets, a 60% increase in two years; complaints down 28%, the second consecutive significant year-on-year reduction; improvements in several key performance commitments including a reduction in sewage discharges, internal sewer flooding, and sewer blockages; and a leadership stance on river health and transparency, with Thames setting the pace on publishing live data on sewage discharges.

That said, the results also highlighted Thames' ongoing struggles. Operational performance including in the key areas of leakage and pollutions was impacted by the summer drought, and ageing assets proved consistently challenging. Only 55% of annual performance commitments were met. There was also colour amid the chaos this month in the form of a £3.3m fine handed out by Lewes Crown Court after Thames pleaded guilty to polluting the Gatwick Stream and River Mole with untreated sewage in October 2017.

Meanwhile, financial performance was impacted by high inflation and investment in leakage: EBITDA was down 3% to £1.1bn, reflecting higher operating costs, on revenue up 4% to £2.3bn, largely reflecting tariff growth. Gearing fell 3.2 ppts to 77.4%, its lowest level in ten years.

Ross and Alastair Cochran, interim co-CEO, commented: "It was an extremely challenging year for Thames Water and the water industry. Our network came under unprecedented pressure from record temperatures, a drought and a freeze / thaw event. At the same time, economic factors also impacted our financial results with high inflation driven by a surge in energy and chemical prices. In short, our performance was not as we – or our customers – wanted it to be.

"Despite this, we are in a robust financial position. We had £4.4bn liquidity as at 31 March 2023 and are extremely fortunate to have such supportive shareholders. Their commitment to delivering Thames' turnaround and life's essential service is reflected in the largest equity support package ever seen in the UK water sector, whilst taking no dividends out."

Industry financial resilience

All of this would have been bad enough had it only affected the country's biggest water supplier, but concern has been fuelled by the fact that Thames is not an isolated case. Other water companies have issues in common, including infrastructure challenges today, soaring expectations for tomorrow, inflationary and interest rate pressures, public hostility, and (to varying degrees) debt liability.

More than half of the sector's debt costs are linked to inflation. There has been a lot of focus in reports on the fact that companies were privatised with a clean balance sheet but how have £60bn of debt, most of it taken on when borrowing was cheap. Now inflation is high, companies face shocks but some lack a sizeable equity buffer to absorb it.

Members of The Water Report Expert Forum, our own vehicle for polling sentiment in the sector which we run in partnership with Accent, offered the following insights on whether Thames stands alone:

- "They have a clear set of problems that are Thames Water's own, but variations of these are to be found in many more companies. For many it can be summarised as having little capacity to improve."
- "It would appear to me that Thames is unique in having a 'full house' of issues combining at the same time debt, performance and public pressure. The three would appear to be interlinked in a bit of a death spiral."
- "I think the problems at Thames are probably heightened by the fact they are Thames but I think they are by no means isolated… I am sure other companies will face similar challenges over the coming months. Hopefully all parties will stop pointing at each other over blame and move into solution mode."

Ofwat's position is that the sector remains financially resilient. In a statement, it said: "Overall, the sector is continuing to attract international capital and is especially attractive to long term investors such as pension funds. Indeed, there has been an additional equity injection of around £2bn since 2020, with companies acting to strengthen their financial position."

This view was supported by water minister Rebecca Pow in answering an Urgent Question in Parliament. She said: "The sector as a whole is financially resilient" and pointed to "Market confidence in the sector is demonstrated by new acquisitions, such as Pennon's purchase of Bristol Water, and by shareholders being willing to inject new capital." Moreover: "Debt to equity fell last year by 4% in the water industry, actually making it more resilient."

However, DBRS Morningstar said: "TW's current unstable financial position and infrastructure problems will likely have a

> The rescue package came with important caveats: undefined appropriate regulatory arrangements for the release of the AMP8 support; and a transition to a "more focused Turnaround Plan.

> Thames is unique in having a 'full house' of issues combining at the same time debt, performance and public pressure. The three would appear to be interlinked in a bit of a death spiral.

bearing on other sector participants, adding to sector credit risk and the ability for companies to raise capital at a reasonable cost."

Raising capital

That's bad news all round, and will compound an increasingly worrying position regarding future investment. All respondents to The Water Report Expert Forum survey said the industry has become unattractive to capital in terms of risk/return. Comments included:

- "Clearly the risk return model is being reassessed now interest rates have increased and appear to be remaining higher than expected for longer than expected."
- "For the first time investors are having real concerns. They are taken for granted by Ofwat and others but they should not be."
- "The Thames crisis however resolved has damaged the whole industry."

It's especially bad news for companies depending on new equity imminently. Southern Water confirmed it is looking to shareholders to inject £550m of equity into the group by October, £375m of which will be in the regulated business to maintain prudent gearing, when it published its annual report – the same day Fitch downgraded its ratings.

Fitch moved Southern from BBB+ with negative outlook to BBB with negative outlook. It explained: "The downgrade reflects increased pressure on SWS's credit profile…In particular, gearing headroom is not sufficient to offset AMP7 weak average cash and nominal post-maintenance interest cover ratios." It noted the case assumed £169m of ODI penalties in 2023-25, relating to wastewater asset health, pollution incidents, internal sewer flooding and CMeX.

The Fitch action produced a credit rating downgrade 'trigger event', blocking dividends. The company confirmed: "Dividends will be suspended until these trigger events have been resolved." Note though that shareholders have not received a dividend anyway since 2017, and no dividends are anticipated for the rest of this AMP.

For the first time investors are having real concerns. They are taken for granted by Ofwat and others but they should not be.

Southern Water pointed out that it had been grappling with above inflation cost increases and higher funding costs. Net financing costs increased by £82.4m to £278.6m, largely driven by higher index-ation on inflation-linked debt.

Despite these struggles, it said it was making "good initial progress" on its turnaround plan. "For instance, we fully expect to be awarded two-star Environmental Performance Assessment rating by the Environment Agency for 2022, which compares to one-star for 2021. We recognise we have further to go, and the Turnaround Plan sets out our ambition to reach a three-star EPA rating in 2025."

Meanwhile last month, Ofwat further tightened its grip on shareholders and executives. It published guidance on the factors it expects to consider in assessing companies' compliance with the new dividend policy licence condition. This requires dividends to take account of a range of matters including service delivery for customers and the environment, current and future investment needs and financial resilience over the longer term.

The regulator also confirmed it will press ahead with plans to claw back water company executive bonus payments that are not justified by performance, so customers do not fund them. Its March consultation on the issue generated 25,000 responses from members of the public, the largest ever response the regulator has received.

Future ownership and structures

Legitimate questions over the industry's financial fragility have re-opened the debate about ownership that last surfaced under Jeremy Corbyn's Labour manifesto ahead of the 2019 general election. Boris Johnson's landslide victory put pay to that, and nationalisation is no longer Labour policy. But now more than then, public ownership of water has entered the national discourse, and seems to be gaining traction as an idea.

Existing pro-public ownership groups snapped up the opportunity of Thames' predicament to find an alternate route to their end goal. A WeOwnIt petition, for instance, called on business secretary Kemi Badenoch to permanently nationalise Thames Water, and to use legal powers to protect bill payers rather than bailing out shareholders and creditors. Director Cat Hobbs said: "Thames Water needs to go into special administration and then stay in public ownership. This kind of model has been used before, with Railtrack becoming publicly-owned Network Rail.

"The situation is precarious with Thames Water and the other private English water monopolies. The responsible thing for the government to do would be to get ready for more private companies to collapse by setting up shadow public sector bodies in every region to take over from failing water companies. These should involve councils and communities in developing a plan to sort out leaks and sewage." The petition secured 10,000 signatures in less than 24 hours.

While Labour no longer has full nationalisation in its sights, shadow environment secretary Jim McMahon openly criticised the current organisational arrangements. He said: "The Conservative Party's cycle of privatising profit, usually for multibillion-pound foreign sovereign wealth funds, and nationalising risk is not sustainable, and neither is it a fair deal for working people." In a letter sent to environment secretary Therese Coffey while Thames' future was still uncertain, he seemed to suggest private entities should stand but profit be spent solely on investment. How that would attract the billions of pounds of new capital required was unclear.

Meanwhile, the Liberal Democrats have suggested reforming water companies into 'public good' companies, transforming their boards and priorities in the interests of the environment and consumers. In a 4 July debate in the Lords, Baroness Bakewell of Hardington Mandeville urged Defra's Lord Benyon to "take back control and sort out this essential service". Lord Teveson offered: "It seems to me that there is a real cultural arrogance within the management of water companies, and a feeling that however fast and loose they play with financial engineering, they are too important to fail."

The Government, however, has defended the current model. Water minister Rebecca Pow argued among other things: "Since privatisation, total capital investment has outstripped dividends by 250%" and "Since privatisation, capital investment in the water industry has been 84% higher than it was pre-privatisation—we need to get that out there and on the table…Privatisation has enabled clean and plentiful water to come out of our taps. It has unlocked £190bn of funding to invest in the industry. That is the equivalent of £5bn annually, and is double what we had pre-privatisation."

Lord Benyon reflected: "I have certainly questioned some of the practices of certain water companies, but I think the model is right and we need to get behind it, as did the previous Labour Government. I hope that all future Governments of any persuasion will recognise that this is the best way to get significant investment into protecting our environment for the future."

However, reported moves by Severn Trent's Liv Garfield to rally her fellow water industry chief executives and the Labour front bench to reform companies as privately-owned, profit-making "social purpose" companies that give greater weight to the needs of customers, staff and the environment suggest some in the sector at least see maintenance of status quo as unrealistic. Many online commentators have condemned the move as greenwashing.

The overall sentiment of The Water Report Expert Forum was that change in some form is needed in governance/ownership terms, to bring greater accountability and control in the context of severely damaged trust. On trust, comments included:

- "I was recently told by a customer we are now less popular than the tax inspectors. How did it come to that for an industry full of passionate people trying to do the right thing?"
- "It's at rock bottom and the issues are so serious it's hard to see recovery within the next ten years."
- "The sector needs support to regain trust but unfortunately the press and politicians are in the business of headlines and the water companies are easy prey."

Regulation in the dock

Regulators were already out of favour for tolerating spills and leaks for too long. Labour has signalled it plans to reform Ofwat and the Environment Agency.

Some of the recent headlines have focused on why regulators have allowed companies to gear up, pay shareholders out and underdeliver for customers and the environment. The sentiment was articulated by Labour MP Angela Eagle, who said in Parliament: "When they were privatised, water companies had all the debt written off, so they started with zero. Since then, they have borrowed £53bn much of which has been used to help pay £72bn in dividends. The investment has been made by borrowing and putting it on to customers' bills. Now, the ratings agency S&P has negative outlooks for two thirds of the UK water companies it rates, because they are over-leveraged and took out too much debt in an era of low interest, which they now have to pay back. This is not a triumph but a huge problem for the resilience of our water industry."

This is largely a historic rather than current issue; Ofwat has recently acquired more powers over water company licences, finances and corporate behaviours. But that has not stemmed the criticism. There was particular scrutiny of Ofwat following chief executive David Black's appearance at the House of Lords Industry and Regulators Committee's most recent evidence session (see box), with most subsequent headlines focusing on why the regulator had not stepped in to control borrowing sooner, as well as the reluctance of Thames' shareholders to put

SNIPPETS FROM OUR ARCHIVE

Fight for financeability – February 2020 (ahead of PR19 acceptances/appeals)

"Financeability will be the deciding factor for most firms. Initial reaction from the ratings agencies to the final determinations was mixed. Moody's immediately put 12 operating and two holding companies on review and flagged the risk of multi-notch downgrades. Fitch meanwhile took a more positive line, saying firms could maintain their credit ratings with strong operating performance."

Thames accepts its FD - March 2020

(Thames) is left with a huge challenge in its water network plus price control. Ofwat did not allow anything like the entire system upgrades the original Thames plan had rooted for. The FD "inevitably means that we will not be able to proceed with the full range of projects we had planned to de-risk the network, increase resilience and establish a more secure supply for our customers," said Thames chairman Ian Marchant in his acceptance letter to ofwat. …

Marchant made that explicit: "Our central expectation is that we will incur net overspends and net penalties."

…The Thames executive team and both the operating and holding company boards are understood to have been split over the FD response, and the final choice to have taken factors like reputation into account as well as the numbers. But for the shareholder base, in particular, it is hard to understand why they would have accepted the deal, unless they are planning to bail out at an opportune moment. Where all that leaves Thames, and London's water network, by the end of AMP7 remains to be seen.

Interview with Sarah Bentley, former Thames CEO - May 2021

Bentley is frank about the fact that fixing the basics, while critical for the turnaround, will only get Thames so far. "What we all need to see is progress. The 'fix the basics' can show we polluted a bit less, leaked a bit less, and customer service improved a bit. But we're not going to suddenly go from bottom of the league table. On one of the metrics, a 30% improvement gets us to sec- ond bottom. We're not going to be turning around and going 'ta-dah! look what we did!' in 18 months."

"Ofwat judged our plan fairly. They said we needed to invest more money and they said there needed to be a (shareholder) contribution for that. You can't argue with that. and although they're stretching performance commitments, it's what customers want. So we've just got to get our act together and start delivering on that."

Interview with Jonson Cox, on his departure as Ofwat chair – July 2022

Cox says his greatest mistake that was in his control was "not pushing harder and faster on financial resilience"…

The problems were not of Cox's making. He inherited a sector where structures he perceived as risky were already established: sector gearing was at 70% of RCV in 2013 compared to the no- tional 60%, with some companies over 80% gearing. Financial returns dominated management time, with dividend yields on equity in the mid-teens per cent, even reaching 24%, compared with today's 4% guideline. Cost of capital was also high, leading to water assets being in high demand and company sales reaching over 130% of RAV.

Should Ofwat ever have let such structures take hold? Cox tries, briefly, to stop short of criticising his predecessor but concludes: "I suppose there is no way of knowing about the bush: it was a failure of Ofwat at the time not to consider the consequences of all the gearing up. But equally it was a failure of those who bought the water companies that they thought they could load more risk on."

more equity in and the prospect of bill rises from 2025.

Some, even Conservative, politicians seem to be growing impatient with Ofwat. Robert Buckland, for example, said aspects of Ofwat's operation do not seem to be in customer interests. Robert Fuller called for better oversight of the regulator. However Pow has robustly defended Ofwat and insisted regulation was fit for purpose.

There is a growing narrative, too, of regulatory capture. An Observer piece, for instance, reported 27 former Ofwat directors, managers and consultants are now working in the industry they helped to regulate. Some have suggested regulators are closer to companies than they are to consumers.

Those closer to the industry might also pour over the following:

- Long-term awareness of Thames' vulnerability – Ofwat gave the 'significant scrutiny' company the lowest 'D' grade in its Initial Assessment of Plans (IAP) ahead of PR19 for "securing long-term resilience".
- Squeezed cost efficiency at PR19: Thames' original business plan at £11.7bn totex was over £2bn adrift of Ofwat's IAP figure of £9.4bn. Sector totex then at £56bn was 13% above the level Ofwat considered necessary, with a 7.9% gap on wholesale base costs on average and a 30% gap on enhancement costs. By the Final Determination stage, the disparity had closed considerably but on base costs, Anglian and Yorkshire faced a significant challenge, while on enhancement costs, there are material gaps for five firms, including Thames.
- The pledge this time last year by Thames' shareholders to inject £1.5bn of equity was a huge win for Ofwat. It boosted the PR19-agreed business plan from £9.6bn to nearer the £11bn originally sought by the firm, and came after considerable cajoling by former chair Jonson Cox. The message seemed clear: if price determinations are set too tight but companies choose not to appeal them, it is shareholders' rather than customers' problem. Recent events suggest this is less clear cut. Even Thames' shareholders' new commitment to £750m + £2.5bn is not binding.
- Incentives that reward efficiency – some argue these have led to short-term cost cutting at the expense of long-term resilience.
- Prioritisation of low bills – Ofwat rejects this argument, but many contend it has been an overriding concern. Ofwat's narrative now, however, acknowledges the need for a step up in investment and acknowledges there will be bill implications from this.

Comments from The Water Report Expert Forum on regulation included:

- "[Regulation] has to change. A new Labour government will seek new models."
- "I really hope there is a change in approach and tone from the regulators. I am not confident there will be. I think a return to measuring more specific outputs may be needed to demonstrate the commitment and progress. That does not seem to be the current direction of travel. PR24 really needs to move to a longer than five year look where resilience in the fullest sense is taken seriously. We seem to be in a pattern of diminishing returns in every sense at present."
- "Questions should be raised about the performance of Ofwat, not so much now but when the Thames issues were really started ten years ago…Ofwat has always regulated in response to issues that have occurred; [there's a] real need for proactive regulation."

GOVERNMENT RESPONDS TO LORDS' REPORT ON OFWAT

The Government said it had "no plans to introduce a single social tariff" and would not update its Strategic Policy Statement for Ofwat, as it responded to the House of Lords Industry and Regulators Committee's report, *The affluent and the effluent: cleaning up failures in water and sewage regulation.*

The Committee had recommended both actions. Elsewhere, though, the Government said its Environmental Improvement Plan and Plan for Water had addressed many of the Committee's recommendations, including: to produce a National Water Strategy; to deliver a National Policy Statement for water resources infrastructure (this was laid in Parliament in April); and to ban plastic wet wipes (the Government will change the law to ban the sale of wet wipes containing plastic, subject to public consultation).

Elsewhere, the Government indicated some Committee recommendations were already being dealt with – for instance, the recommendation for a greater outcomes focus and the elevation of nature-based solutions in the Water Industry National Environment Programme. Nor did it offer anything new regarding demand reduction.

Finally, the Government response sidelined recommendations that were not related to the focus of the inquiry: Ofwat.

The Committee is now holding further evidence sessions in light of responses from Government and Ofwat, and other developments since the publication of its report, such as Water UK's sewage apology.

Looking ahead

The bulk of Cathryn Ross' Future of Utilities presentation – herself the former CEO of Ofwat – was about the need for systemic reform. She called for:

- Address the challenge of an ageing asset base – "we are not replacing our asset base in a sustainable way" she said, referencing the hundreds of years assets are expected to last based on current investment levels. We need a "radical step up in replacement rates," she said, accepting the costs of companies who propose this will look out of line with Ofwat models because these use lagging indicators. Ross said she still sees big advantages in the outcomes and totex approach she brought to Ofwat, but accepted incentives for delivering outcomes that are not in-period are "relatively weak". Delivery and performance comes at the expense of resilience, and "it's time to redress that balance".
- Build new infrastructure – there is a high degree of consensus on what needs to be done, Ross said, but work needed on the 'how'. The more specific the government can be in its directions – for instance via the National Policy Statement and to Ofwat – the better for avoiding challenges. She also hankered after a "chief knocker-together of heads" – "maybe via expansion of the NIC".
- Affordability reforms - Efficiency is needed as a hygiene factor, and we need a longer term approach to regulatory settlements for strategic infrastructure. But even with efficiency, there will be higher costs for customers. Support should be fair, not a postcode lottery. "It feels like the time is right for a national social tariff," she concluded.

Little has been said about PR24 amidst all the drama. But that is an imminent concern. What was already looking to be a difficult balancing act – with investment rising during a cost of living crisis – has got immeasurably harder. Trust has sunk further, with financial as well as operational competence in the dock. And after many years of good times, some shareholders will surely be thinking twice about where they put their money.

One Expert Forum member said: "We cannot carry on as we are. I sincerely hope this is a low point where we are about to have a sea change in approach from all parties around the importance of the industry and sustainable long term planning, properly funded. Then we can move to a better future for the industry and the communities we supply." TWR