

Kicking the Thames can down the river – the cost to the environment, to the economy and to the rest of the industry

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Thames Water is a disaster. It is a disaster of its own and the regulators' making. Badly managed and financially engineered, it now has the audacity to demand a 40% increase in bills and – most extraordinary of all – a cap on fines for its failures to meet the expectations of regulators and of environmental law. If ever there was a case to pull the plug, re-set and get a new set of owners and managers, Thames Water is the case study par excellence.

It is not as if Thames Water's boards did not know what the company was doing. Its boards have been stuffed with ex-regulators. It has had a past chief executive of Ofgem on its board, and a past chief executive of Ofwat as its regulatory and then acting chief executive. With the possible exception of RWE, the various owners of Thames Water have been well-versed in utilities. Macquarie is the leading infrastructure investor in the UK and Europe, and OMERS and USS are pension funds which should know a lot about utilities. Until recently, Thames Water's chief executive was ex-Severn Trent Water, and its chair ex-SSE. Few utilities can claim to be so much part of what could be described as the regulated establishment.

The failures at Thames are comprehensive. It has been the subject of pretty extreme financial engineering, topping out at around 80% gearing. Its operational performance and efficiency have languished in the league tables of its peers. Its environmental performance has been lamentable, including not appearing to be aware of the scale of the pollution it has been causing. Customer service has not been a shining success story. The list goes on and on.

So why won't the regulator and the government pull the plug?

If Thames does not merit being put into special administration, then it is a good bet to assume that no major utility ever will. And yet the government, with its Project Timber,

seems hell-bent on rescuing the company from its own follies, patching it up so it can limp on. Tellingly, Labour is in a similar place. Labour seems to think that if only it could increase regulation of executive salaries, make directors criminally liable, and merge the Environment Agency and Ofwat, this would do the trick. Both parties seem scared stiff of challenging Thames, and neither wants to renationalise the company. They both end up in the default position of kicking the can down the river.

How is this to be achieved? The answer is at considerable cost. Someone will have to bail out the debt holders and help the shareholders, all of whom are embedded in the byzantine edifice that is Kemble Water. Instead of a simple structure of a listed, regulated and licensed utility, the debt and equity are interwoven in Kemble. Quite why this sort of structure is appropriate for a water utility is very hard to fathom from a public interest and environmental perspective.

There are three possible candidates that could be forced to pick up the tab: the customers; the taxpayers; and the environment. Bills could go up, the government could add in more subsidies, or the environmental targets could be watered down. Customer bill and taxpayer increases would have to be more than those applicable to an efficiently run and financially robust company; they would have to underpin the costs of failures so far. The failures on capital maintenance will not go away and someone has to make good the shortfalls. More sewage in the rivers than is necessary would be one of the environmental costs.

Crisis management might hold the line, and the company could limp on through this year and into next. It would continue on its life support of customers' bills and lower environmental requirements. That is why it demanded a price increase of 40% and a cap on fines. That is what it says it needs to limp on.

So again, why won't the government and the regulator pull the plug? The fears are twofold: that it might lead to wider systemic failures in the water industry; and that it might scare off foreign investors. Both are very real possibilities. To these might be added costs to the Treasury, which are largely unfounded and a misunderstanding of how special administration should work and be paid for.

Thames Water may be extreme, but there are other private equity water companies out there whose finances are also highly geared, and whose investors might balk at putting more money into businesses that are no longer yielding what their investors expected, and what Ofwat allowed. Behind these water companies lies a whole host of other privatised utilities with private equity-style gearing. The electricity distributors, key actors in the drive to net zero, have some considerable exposure. The fear is that there is a much bigger house of cards that might just fall down.

The foreign investors' dimension is the most serious obstacle to decisive action. The UK has almost no savings, net of capital depreciation. It is overwhelmingly dependent on foreign investors, and behind them foreign savers, to finance not only UK utility infrastructure but the government too, and to balance the current-account trade deficits with capital inflows. The UK is overwhelmingly dependent on the kindness of strangers, and there is no evidence that the British electorate and the politicians it elects are going to force a switch from consumption to savings at home, or that companies are going to use profits as retained earnings for investment rather than paying out profits in dividends.

Take a look at the investors in Thames Water. Only USS has serious ongoing British contributions (and USS has stretched itself by also investing in Heathrow Airport, the only main utility more heavily geared than Thames, at 95%). OMERS, the Abu Dhabi Investment Authority, British Columbian Investment, Hermes, China Investment Corporation, Queensland Investment Corporation, Aquila, and PPGM offer just the sorts of foreign savings the UK needs to attract to carry through its wider infrastructure programme, including net zero and the creation of whole new supply chains for the electrification of transport and heating, as well as 50GW of offshore wind, nuclear power stations and a radical upgrading of the transmission networks for electricity – in addition to the major water investments.

These parties are all very good at lobbying and they are particularly good at frightening the Treasury and the Chancellor and Shadow Chancellor with dire threats as to what will happen if Thames is put into administration. A government and an opposition would need to be brave to withstand this pressure. Better, it might seem, for the Prime Minister to parachute in his adviser banker. Better for Labour to stand up to the

nationalisers in their party, especially since it was Jeremy Corbyn and John McDonnell who thought this would be a good idea, overwhelmingly backed up by public opinion.

Why sticking plaster is nevertheless a very bad idea

Whilst the affected parties are bound to lobby hard, and dire threats are whispered in private, the reason why the UK has attracted a bean feast of foreign investors into the utilities, and why there have also been many takeovers in what should be pretty boring and stable assets, is because the UK has a reputation for clear and transparent rules and regulations, with independent regulators to oversee the monopolies and with clear appeals mechanisms. Put simply, investors know where they stand.

In the case of Thames Water, the rules are very clear. The company has a licence, and the Water Act 1991 and now the Environment Act 2021 set out the legal framework, so it knows what is expected. Thames's licence requires it to deliver the services, and in return, it is entitled to earn a reasonable rate of return. Compared with almost any other country in the world, UK water companies have a rules-based framework. Their job is to deliver, and if they outperform they can earn above-normal profits, and if they underperform they will get less. If they fail, special administration is the default option.

Where the rules are less clear is in respect to borrowing, gearing and dividends.

Investors were very surprised back in 1995 when the regulators stood aside and let them gear up the companies, and pay out dividends from the borrowing. It became a very different game. Indeed, it became a game of financial engineering and the main source of returns, further reinforced as the regulators repeatedly overestimated the interest rate for each forward period. These were companies privatised with a green dowry – cash-positive – because the balance sheet was supposed to underpin investment. It was never the intention that the balance sheets should be used to mortgage the companies' assets and allow investors to run off with the proceeds. This was the biggest regulatory failure of all, and it was allowed to happen in water and electricity distribution. A once-in-a-generation opportunity to rebuild Britain's water and electricity networks was squandered. It is hard to blame investors confronted with a very wide and open goal for taking the opportunities they should not have been presented with.

To be fair to some of the regulators, there was the suggestion that if investors took the money out, then later they could expect to be made to put it back in. Regulators seemed to have failed to notice that the birds flew the nest, and subsequent investors who bought the companies seemed to have neglected to notice the implicit liabilities. In the Thames Water case, the passing of the parcel had been revealed to be a case of passing the bomb.

To further reinforce the clarity and credibility of the UK regulatory regime, the obvious thing to do now is to apply these rules. This includes the special administration regime, which is tailor-made (and recently updated) for a case like Thames. If it is not applied now, investors know that the game in future will be one of political and regulatory arm-twisting, and that is a world of lobbying, uncertainty, and votes. It is not a world of regulatory clarity.

Let's imagine that Ofwat, in its interim determination in the summer, comes out with a price increase significantly less than the 40% that Thames is demanding, and again in the final determination at the end of the year. The process is well-defined: Thames can appeal to the Competition and Markets Authority (CMA). What should the CMA do? It is complicit in allowing the balance sheet to be used for financial engineering in the numerous cases it has already opined on. But it should also know that the investors have been on notice about putting the money back, and it should only allow for spending that reflects the delivery of the licensed services and the legal requirements at an efficient level.

If the essence of the UK regulatory system and its international reputation is the transparent and clear application of the rules, it should apply them now to retain that reputation. If it reveals that the rules will apply only as a cushion but not as a cap, then it will show the UK system to be a one-way bet. That would be disastrous: the incentive to do the job properly would slip, for the sanction would not bind. But perhaps this is what investors mean when they demand clarity – the clarity of a one-way, upwards-only regulatory system.

Why the rest of the industry should welcome decisive action on Thames

Suppose the government and the regulator are brave enough to pull the plug and put Thames into special administration. Would it be the disaster the lobbyists claim it would be? On the contrary, the special administration procedure could be seen to be transparent and a technical exercise. The administrator would be appointed, the business would continue since the bills pay not only for the operating costs and underpin current investment, but for the regulatory asset base (RAB) as well.

The administrator carries on the business, and seeks buyers for the assets. New buyers will look at the state of the business, note that there is a lot of remedial work that needs to be done, and bid less than the full value of the RAB by the amount of the shortfall. The new investors get the RAB – it is a regulatory accounting number. But they also get the bill for the remedial works. The business sells at say 40% or 60%, or whatever represents the value of the shortfall from the RAB. The exiting investors take a bath, and this may extend to some of the debt holders too. Indeed, even in advance of possible administration, both equity and debt holders have already made considerable write-downs.

Would there be lots of new bidders? Yes. Even in the case of Southern Water, there were bidders. There is always a price at which the business will be picked up and the liabilities to make good the failures will be taken on.

Better still, new buyers may suggest to the administrator that the company be broken up. They might bid for just the London area, for example. Given that Thames Water is already far too big to manage properly, and has scared some politicians into thinking it is too big to fail, break-up might be very beneficial.

Properly administered, special administration would improve the transparency and predictability of the regulatory regime. This would be good news for the rest of the industry. The incentives (and penalties) would be sharpened, and those companies that have been better run and most successful would be seen to be worth emulating. Others might realise that being listed is a good idea, and that gearing should be lower to create more stability and predictability for the companies.

Above and beyond these benefits to the rest of the industry, the greatest gain from putting Thames into special administration would come from the lifting of the Thames cloud over them. More experience of a failing Thames would further undermine the wider reputation of the industry and lead to calls to nationalise not just Thames, but all the rest of the industry too.

A final benefit to the rest of the industry would be that management would have more clout in standing up to investors. In the private equity world, managers are too easily rendered as passive instruments of investors' wills, especially when it comes to gearing and dividends. Delivering on the legal and licence requirements becomes a more forceful requirement that managers can insist on if the credible threat of special administration lies in the background.

The fear of nationalisation and public finances

This is misplaced. Special administration is often described as nationalisation, which it is not. The role of the government whilst the company is temporarily under the control of the special administrator is to ensure that the business continues to deliver the services.

There are three parts to these services: the day-to-day delivery of water and the taking-away and treating of sewage; the continuation of capital projects; and ensuring that Thames Water's supply chain continues to function smoothly.

The general advantage that the special administrator has is that the bills provide more cash than needed to fund the day-to-day business, because the bills incorporate a return on the RAB. Only the supply chain presents a temporary difficulty and it may be necessary for the government to stand behind efficient contracts in the interim period.

Any interim costs to the government can be recouped as part of the sale of the company and its RAB. The costs could be incorporated in the sale documentation and the buyer would further discount the price bid to reflect this. The implication is that the costs of administration fall on the existing owners, as they should.

The main focus in respect of government exposure should come not from special administration but from the possibility of eventual full nationalisation. A continuing

failure of Thames, constrained by its financial legacy, would strengthen the case for full nationalisation and a return to the Corbyn agenda. Supposing that Thames survives the current crisis, there remains the constraints of finance. If the company is forced to limit dividends to prioritise remedial capital maintenance and the rebuilding of its sewers, investors are not going to be happy. The argument from existing investors that putting more money into the business is unattractive in a world of dividend controls becomes ever more powerful if the investors, having lost considerably already, continue to face losses in the future and in particular little prospect of future dividends. There will be an inevitable short-term focus on cash, and that in turn will hinder any turnaround, and that will encourage more demands for nationalisation.

Though there are important differences with the example of the gradual collapse of the railway industry back into public ownership, a messy process yet to be completed, there are also worrying similarities. Successive Labour and then Conservative governments had no ambition to re-nationalise. Network Rail as a response to the failures of Railtrack was set up as a not-for-dividend company, which the Office for National Statistics eventually reclassified as publicly owned because of the debt provisions and guarantees. Continuing performance problems and financial difficulties for the train operating companies led to their default nationalisation on a piecemeal basis. Only now is there any plan to bring the whole industry back into public ownership. In the rail case, as now with Thames, the intention was not to nationalise, but it happened because the response to the Railtrack collapse was essentially a short-term one.

What government and opposition have to ask themselves is whether they think that internal write-downs by the existing investors are going to be anything other than the application of short-term sticking plasters, and whether they really believe that the management of Thames, remaining hooked up to the complex Kemble finances, is a serious answer to the need for a major overhaul of the water and sewerage infrastructures for some 14 million plus people and can provide the basis for a sustainable mid-twenty first century utility. That is the question, and the answer is probably no.

The consequences for the environment

Whilst the government continues to try to work out how to kick the Thames Water can down the river, the environment continues to take the hit. The River Thames and its tributaries are not in an acceptable state. Why would anyone seriously think that this situation will be urgently addressed by continuing with the existing state of affairs at Thames Water?

To kick the can along, the existing management are right to focus on the revenue side, and this is where the 40% comes in. With enough customer money at the company and by implication Kemble, it can be a financially viable business. But few think that enough will indeed be thrown at it to make the numbers add up – to make it the one-way bet some assumed the water regulatory regime to offer.

Ofwat is right to stand its ground, and it will be a terrible day for the industry and its customers if the government and the regulator cave in to Thames's demands. Arm-twisting and independent regulation do not and should never mix. But suppose the regulator cuts the 40% back. Say, for example, it is 25%. What follows? The answer is that something else has to give, and this will no doubt be the capital expenditure (CAPEX) programme. Cleaning up the rivers will be pushed back into the more distant future, and environmental standards would have to be implicitly or even explicitly relaxed. Thames might not get its 40%, but the regulator would be hard pushed to both cut the price increases, and hence cut and delay the CAPEX, and insist on full and uncapped fines and penalties.

As so often happens, financial constraints do indeed lead to CAPEX cut-backs, and in the case of Thames Water, that is very bad news for the river and for attempts to clean it up. What gives in this scenario is the state of the river, the sewage discharges and efforts that are increasingly needed to clean up not just the sewage but all the other emerging pollution in the river. There is a very large and serious cost to the environment of kicking the Thames Water can down the river.

This might be somewhat alleviated if the plans to deal with the sewage problems were better designed, and if others (notably farmers) were required to play their part. The current plans are all about building larger storage tanks, and less about dealing with the

problems at source, and in particular the limiting of run-off and storm flows *before* they get to the sewerage works. Reducing farm pollution is one of the cheapest and best options for the rivers. But with farmers exercising their political muscle to demand the rights to continue pesticide pollution, retain red diesel subsidies and gain greater trade protection, and every sign that both the government and the opposition are caving into their demands, the chances of reducing this major source of river pollution (equal to that of the sewer overflows) are diminishingly small.

Two possible futures for Thames Water and the water industry

Crises often provide the opportunity to take stock of existing models and think about serious structural reforms. The crises swirling around the privatised water industry are financial, environmental, managerial and regulatory. The 1990 model is no longer fit for purpose. The industry has been badly regulated, allowing structures like Thames and its financial engineering to emerge, and neglecting the primary purpose of privatisation, which was to create a private sector balance sheet, without debt, to serve a once-in-a-generation programme of major capital upgrades of the water and sewerage assets – from the leaking pipes to the reservoirs and new water resources, through to the modernisation of the sewers. All of this is driven by environmental concerns.

34 years later, Thames is the stand-out example of how not to achieve these worthy objectives. Having failed to deliver over these 34 years, it would be surprising if “one more heave” with the existing model will do much better. Regulators at the Environment Agency and Ofwat have had three decades to work out how to do all this better. They have failed, and Thames Water is the unsurprising outcome. 80% gearing should never have been allowed, full stop.

There are two ways forward. The first is the depressing possibility of yet more of the same. The second is to seize the opportunity for a re-set, laying the foundations for the mid-twenty first century water industry that could meet the environmental requirements, and in particular fulfil both the letter of the 2021 Environment Act and its statutory targets and the 25-year plan. It is perfectly possible to leave the water environment and its rivers in a better state for the next generation and clean up the mess that has emerged. It is perfectly possible for people to fall into the River Thames (or, after the annual boat race between Oxford and Cambridge, be thrown into the River

Thames) and not get ill. Major infrastructure upgrades are possible, and they can be delivered to cost and timetable, as in the case of the Thames Tideway.

To achieve the second necessitates putting the current model out of its misery, and calling in the special administrator. The administrator should carry out an immediate audit of the capital maintenance required to address the failings, and this should be attached as a requirement in the sale documentation. The special administrator should seize the opportunity to consider splitting the business up as between London and the rest of the catchment, and also splitting water from sewerage.¹ Thames is just too big to manage properly. Do this now, and the environment and the customers can look forward to a much brighter and cleaner future.

Failure to bring in the special administrator postpones the problem, but it does not go away. What is unsustainable will not be sustained. Waiting for matters to get worse will just make the eventual cost of the reckoning much greater, and may encourage beliefs in palliatives like nationalisation as “the answer”. Whatever the relative merits of public and private ownership, the problems will not go away with nationalisation. The sad recent history of the railway industry should provide a cautionary tale for those who think that Treasury control of CAPEX is the route to an environmental and customer nirvana.

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¹ See Helm, D. (2024), “[Putting Thames Water into special administration and breaking it up](#)”, 7th March.