UK Water: The Price of Inaction and the Cost of Change

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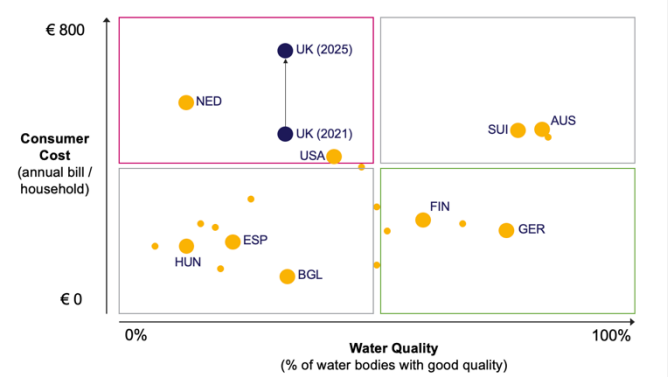
The UK water sector is at a critical juncture. Ofwat's PR24 final determination, released in December, has led to an unprecedented six water companies appealing to the Competition and Markets Authority (CMA). Sir Jon Cunliffe, chair of the Independent Water Commission, has launched his investigation into the four regulators of UK water (Ofwat, EA, NRW, DWI). Thames Water is moving from one court room to the next in its effort to avoid defaulting on its debt and falling into special administration. Meanwhile, consumers have just seen their water bills increase once again, whilst continuing to endure poor water quality relative to most European peers (see box).

UK water is now more expensive and of lower quality than most OECD peers

Relative to OECD peers with privatized water systems, UK water is significantly more expensive[1]. On an average annual bills basis, **UK water costs have risen to ~70% above the US and ~50% higher than France.**



Debt servicing costs are a substantial factor driving up prices, as companies struggle to balance their financial obligations with necessary infrastructure investments.

At the heart of the crisis lies the issue of risk allocation and equity injections. Water companies estimate they will need around £7 billion in new equity over the next five years. Ofwat projects that this figure could rise to £12.7 billion unless companies make significant cuts to their dividends. For Thames Water, *Vallorii* estimates the **cost of equity (CoE) as close to 14%** (in real terms), driven by heightened default risk and poor operational performance. The most recent 9.75% bond yield (excluding fees) speaks for itself, and equity investors can be sure that Thames will be unable to pay dividends, and continue to have to pay tens of millions of pounds in penalties for poor environmental performance over the coming years.

Recent equity raises indicate that others are not far behind this extreme case. Pennon raised around £500mn equity in January 2025 at a **10-20% discount** to their current notional equity[2], not accounting for their Regulatory Asset Base (RAB) increase of ~25% between 2024 and 2029. Severn Trent also raised new equity, around £1bn in September

[1] Based on EurEau (2020), Forbes (2024), Canstar (2024), BBC (2025) and UN-Water SDG 6 Data Portal

[2] Notional equity is based on the 60% notional gearing on the Regulatory Asset Base (RAB) during AMP7. In AMP8, Ofwat has reduced the notional gearing to 55%, increasing the notional equity.

2023. While this was traded at a ~20% premium to its notional equity, it also falls substantially short of their **~45% increase in RAB** between 2024 and 2029.

These figures indicate that investor expectations are substantially larger than the **5.1% allowed return on equity (aRoE)** estimated by Ofwat in December. Using the Capital Asset Pricing Model (CAPM), Ofwat estimates this aRoE without significant differentiation between companies or to the previous regulatory decision in 2019. The aRoE is the central tool through which Ofwat allocates risks between consumers, investors, and government. Setting aRoE this low does not mean that that risk is mitigated—it just means that the **14% Thame Water investor risks are implicitly allocated to consumers instead**. Consumers will continue to bear the risk of underinvestment, most likely through continued deterioration of environmental performance and customer service.

While Ofwat has taken first steps towards more explicit risk allocation between investors and consumers, they are bound by their mantra of keeping consumer costs low and regulatory decisions 'consistent'. The CMA, however, may have more room to set a fair risk and return allocation, in part owing to its recent change in leadership. The obvious choice is to increase the aRoE, although the high number of 14% is likely too great for already dissatisfied consumers to tolerate and politicians to support. Raising the aRoE alone also does not guarantee sufficient investment without wider regulatory reform.

A more feasible approach would be to mirror the models of Tideway and Sizewell C, with explicit risk pass-through from investors to government. For Sizewell, the pass-through of electricity market risks and most construction risk to the government means reducing the CoE around 800bps. This requires an active allocation and management of risks by the regulators instead of the current model where utilities and investors themselves pick which risk they are willing to take on.

Since water companies are facing different risks and passthroughs, such a model translates to different CoEs across companies. Wastewater assets are riskier than water assets since most companies don't fully understand the sewer systems they own. A straightforward solution to this would be to split the aRoE between water and wastewater assets, such that companies with a more wastewater assets will see either higher aRoE or higher risk pass-throughs. This has the additional advantage of enabling a fair breakup of Thames Water into its business units.

The UK already has some of the highest water bills in Europe and among the worst water quality. The current regulatory framework has failed to deliver the necessary investment, and the CMA's decision will be pivotal in shaping the sector's future. If the goal is long-term sustainability, then a serious debate is needed about how much consumers are willing to pay and how much risk they are willing to take on. As we will explore in our next note, this does not depend on the water sector alone but is closely tied to other infrastructure sectors, economic growth, and forced saving rates.