

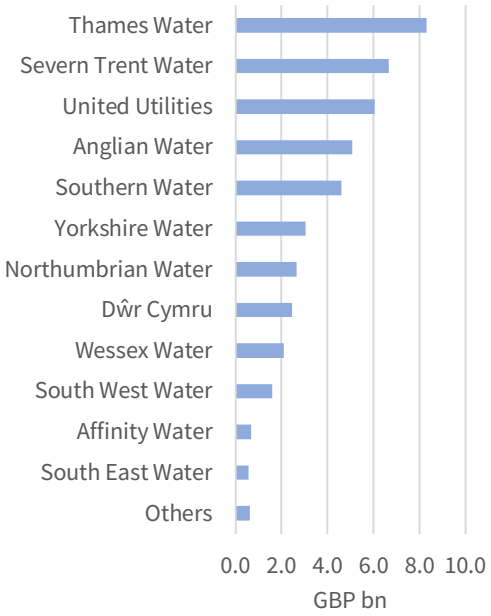
Rebuilding confidence in the UK water sector

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The UK water sector is in a precarious position. While Thames Water is closer to an agreement over an emergency loan, concerns over its long-term outlook persist, both from a financial and environmental perspective. Ofwat, the regulator, has highlighted the need for more investments across the sector in its 2024 price review (PR24) final determinations.[1]

Over the period 2025-2030, Ofwat envisions a quadrupling of new investments to GBP 44bn.[2] Figure 1 shows how these expenditures are distributed by company. Higher bills are inevitable to finance these investments, but debt capital markets will have a role, too. In recent years, water companies have issued sizable amounts of labelled bonds to underpin their sustainability credentials and attract investors. However, these structures have not provided the desired sustainability outcomes and level of accountability. At the same time, public trust in water companies has deteriorated significantly, particularly in areas related to the environment.

Figure 1. Ofwat's proposed allowances for enhancement expenditures in 2025-2030 (in GBP bn). Source: AFII, Ofwat, accessed 24 Feb 2025.



In this analysis, we explore the potential for debt capital markets to furnish the water sector with greater investment and put it on the road to a more sustainable future. In summary:

- The emergency loan could provide Thames Water breathing space to negotiate a comprehensive debt restructuring and find new equity investors. While financial considerations dominate, thought should also be given to sustainability considerations.
- Investment needs across the water sector will increase in the next years. Combined with debt rollovers, we expect bond issuance to remain high. This is an opportunity for investors to engage with issuers and align incentives across stakeholders.
- Including sustainability-linked elements in future debt issuances could help to rebuild investor confidence and establish accountability mechanisms that allow for better sustainability outcomes.

[1] "Ofwat approves £104bn upgrade to accelerate delivery of cleaner rivers and seas and secure long-term drinking water supplies for customers", Ofwat, 19 Dec 2024.
[2] "PR24 final determinations: Expenditure allowances", Ofwat, 19 Dec 2024.

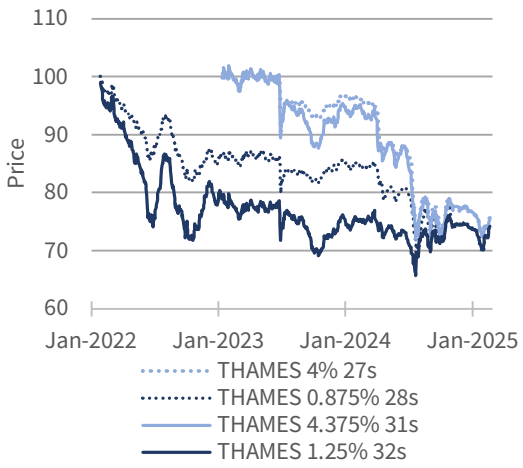
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Some breathing space for Thames Water

Thames Water, the UK's largest water utility, has dominated headlines in recent weeks. Following a week-long court hearing in early February, the High Court approved an emergency loan of up to GBP 3bn from the company's senior creditors.[3] The terms of this loan, which ranks super senior to existing debt, are controversial due to the high interest rate of 9.75% and additional fees. The two creditor groups representing Class A (senior) and Class B (junior) bondholders had put forward different lending proposals, and the Class B bondholders can appeal against the court ruling.

When the emergency loan is finalised, Thames Water should be able to avoid an immediate cash crunch and continue operations. However, monthly disbursements from the first GBP 1.5bn tranche are only expected to see the company through to autumn of this year. The transaction would also involve an extension of existing maturity dates and scheduled amortisation payments of all debt classes by two years, lowering the company's immediate repayment burden. However, fundamental questions over its long-term viability remain and a major restructuring still needs to be negotiated. Bond prices continue to reflect the ongoing market stress, as illustrated in Figure 2.

Figure 2. Thames Water – price of green EUR bonds. Source: AFII, Bloomberg, as of 24 Feb 2025.



Meanwhile, the search for equity investors continues. A few potential investors have submitted non-binding offers to buy stakes in Thames Water.[4] Interest may ramp up now that an emergency loan is being finalized and Ofwat's PR24 has been published, as it gives companies and investors more clarity on the operating environment. However, in January Moody's downgraded Thames Water's corporate family rating to Caa3 from Caa1, stating that "*the final determination, even if improved from the draft published in July 2024, does not provide an attractive risk-return balance for existing or new investors*".[5] The room to increase bills is an ongoing area of contention as Ofwat allowed a 35% increase over the next five years, far lower than the 53% that Thames Water deems necessary. The company appealed the rate cap to the Competition and Market Authority (CMA), which is a condition of the second tranche of the emergency loan.[6] If Thames Water cannot continue as a going concern with private financing, the government could (temporarily) renationalise the company through a special administration regime, though this would create fiscal challenges.[7]

While its financial difficulties have captured press attention, Thames Water also faces an investigation over delays to its environmental improvement schemes,[8] adding to its already poor track record of sustainability performance.

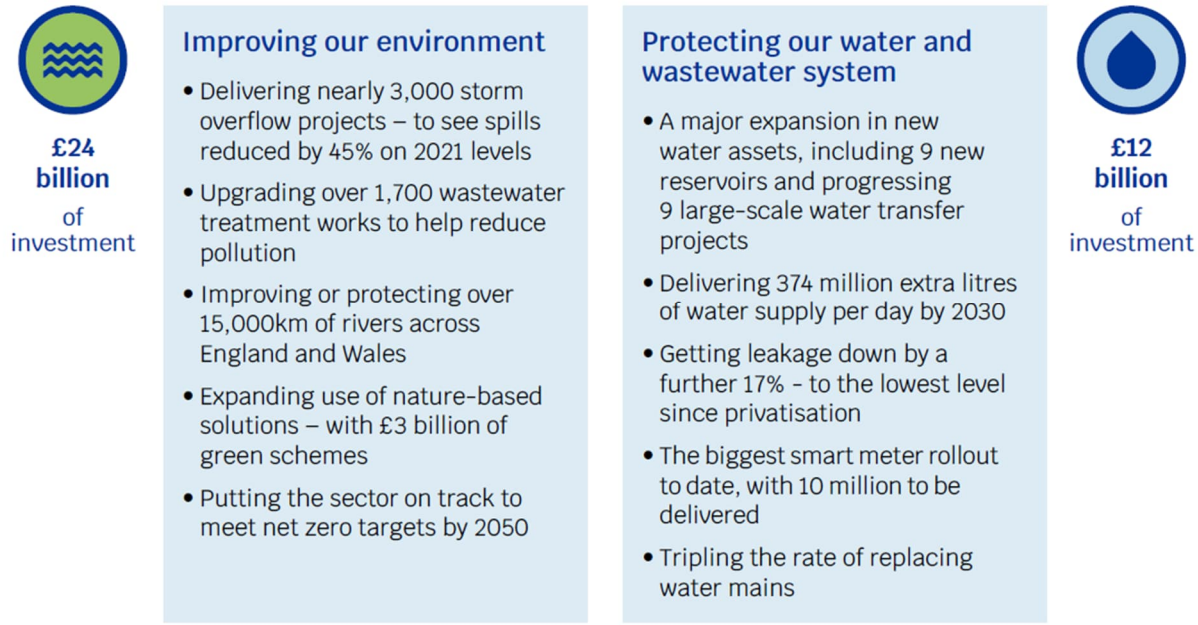
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[3] "In the matter of Thames Water Utilities Holdings Limited and in the matter of the Companies Act 2006", Courts and Tribunals Judiciary, 18 Feb 2025.
[4] "KKR submits £4bn bid to take majority stake in Thames Water", Financial Times, 19 Feb 2025; "Thames Water receives £7bn bid from Hong Kong's CK Infrastructure", Financial Times, 21 Feb 2025.
[5] "Moody's Ratings downgrades Thames Water's CFR to Caa3, stable outlook", Moody's, 23 Jan 2025.
[6] "Thames Water appeals to competition regulator over cap on customer bills", Financial Times, 14 Feb 2025.
[7] "Treasury seeks clarity on cost of Thames Water renationalisation", Financial Times, 17 Feb 2025.
[8] "Ofwat to investigate Thames Water on delayed environmental schemes", Ofwat, 12 Feb 2025.

Urgent need for more investments

Ofwat's final determinations set out the operating environment for the water sector and emphasise the need for greater investment. For the next five years, the overall expenditure allowance is set at GBP 104bn, a 71% increase relative to the previous price review in 2019. This headline number includes a record GBP 44bn for investment in new infrastructure and resources, aligned with the government's strategic priorities for the sector.[9] Key areas are summarised in Figure 3. One priority is greater action to protect and enhance the natural environment. The expectation is that greater investment will deliver better sustainability performance, to be assessed against regulator-set targets. Failure to meet these targets will result in penalties, while exceeding them will be rewarded.

Figure 3. Select areas of investment mentioned in the final determinations for the 2024 price review. Source: Ofwat.



Higher bills are needed to finance these investments, but capital markets – both equity and debt – will have a role to play, too. However, it is an open question whether the permitted return on water sector investments, of around 4% (real, CPIH) – roughly 30bps higher than the amount set in Ofwat's draft determinations – is sufficient to attract investors.[10] In recent years, water companies have turned to labelled debt to burnish their sustainability credentials and attract investors.

Sustainability in the water sector at a crossroads

Water utilities represent critical infrastructure and operate as regulated monopolies in their respective regions. In the context of climate and nature, the companies play a dual role as they have exposure to climate change (e.g. flooding, demand and supply changes, risk of draughts), which requires mitigation and adaptation measures.[11] At the same time, several companies have a

[9] These priorities are protect and enhance the environment, deliver a resilient water sector, serve and protect customers, and use markets to deliver for customers. For details: "UK Government priorities and our 2024 price review final determinations", Ofwat, 19 Dec 2024.
[10] This number is based on 5.1% allowed return for equity and 3.15% allowed cost of debt, as outlined in Ofwat's final determinations.
[11] "Climate change", Ofwat, accessed 18 Feb 2025.

negative impact on natural ecosystems due to pollution (e.g. sewage discharges).[12] Accordingly, most of their operations and capital expenditures are related to sustainability considerations in some form.

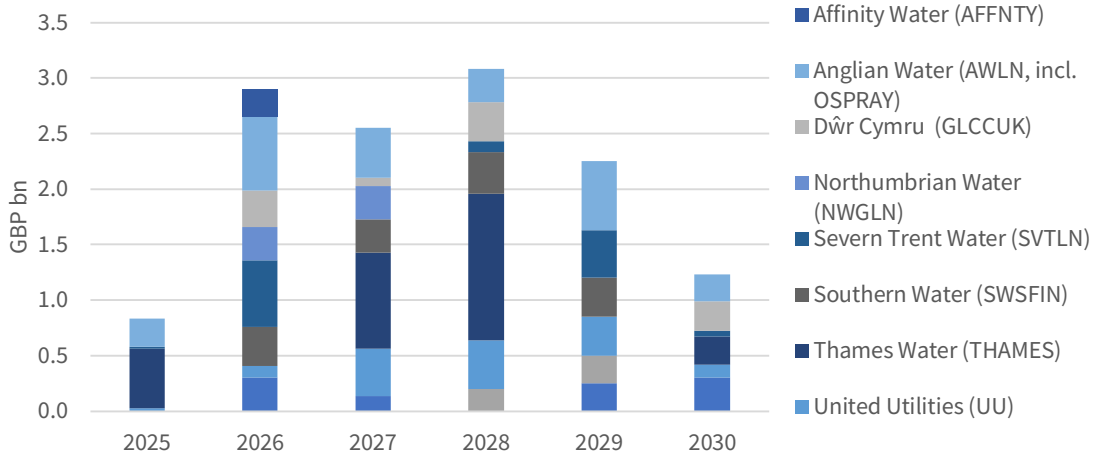
As utility companies operate in a regulated environment, they report on a wide range of indicators, including sustainability metrics. Ofwat assesses the largest waste and wastewater companies annually and poor performance has financial implications. In the regulator's latest sector review,[13] three companies were categorised as "*lagging behind*", fewer than the previous review, but none is considered "*leading*" in the context of their performance commitments. Internal sewer floodings and pollution are issues the sector continues to grapple with, and as things stand it is far behind target to reduce leaks by 30% in 2020-2025.

Moreover, public trust in water companies has deteriorated significantly. An annual opinion survey gauging sentiment toward the sector produced record-low scores across the board, particularly in areas related to the environment.[14] At the same time, a recent study argues that the water companies have prolonged their environmental underperformance by manufacturing doubt and deflecting blame for sewage pollution, tactics that mirror those historically used by other large polluting industries.[15]

Bond markets as a lever for change

The need for more investments and the relevance of sustainability considerations, raises the question which role debt capital markets can play as a source of funding to enable the transition of the sector. Looking at issuance in the past years, investors have been important providers of capital. This role is unlikely to change anytime soon considering high investment needs and upcoming bond maturities (see Figure 4). Accordingly, investors have an opportunity to influence the direction of companies and emphasise sustainability in their decision making.

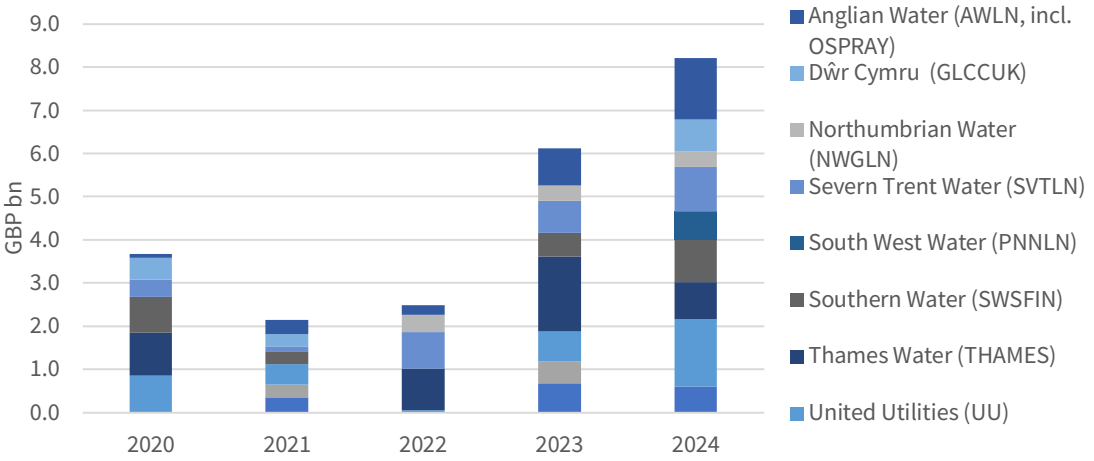
Figure 4. UK water sector - bond maturities 2025-2030 (in GBP bn). Source: Bloomberg, AFII, as of 24 Feb 2025.



[12] "Pollution and water quality", Ofwat, accessed 18 Feb 2025.
[13] "Ofwat calls on water sector to improve its performance after companies fall short on targets", Ofwat, 8 Oct 2024.
[14] "Water Matters 2024", CCW, 22 May 2024.
[15] "Water industry strategies to manufacture doubt and deflect blame for sewage pollution in England", Ford, Singer, Hammond, and Woodward (2025), Nature Water.

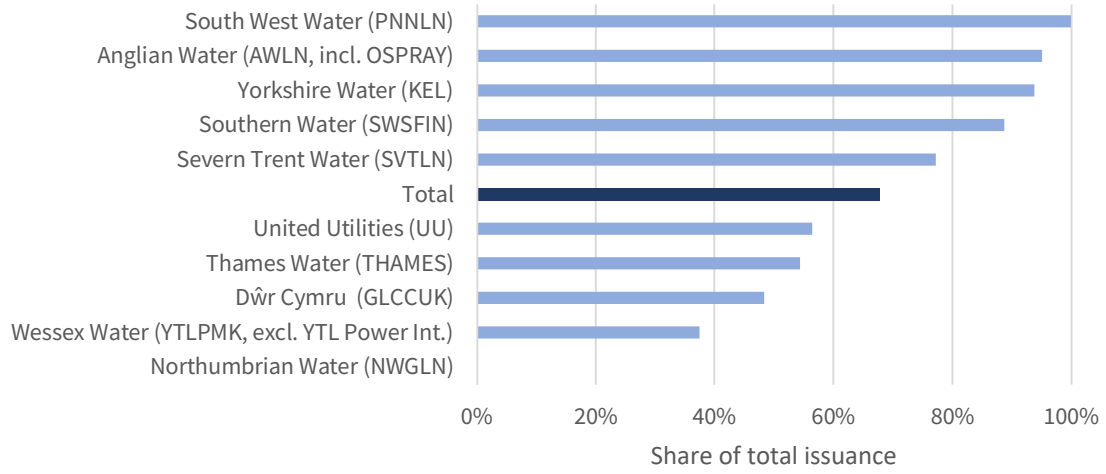
In recent years, water companies issued significant amounts of bonds. As shown in Figure 5, an equivalent of more than GBP 14bn was issued in 2023/2024 – much more than in the years before.

Figure 5. UK water sector - bond issuance from 2020-2024 (in GBP bn). Source: Bloomberg, AFII, as of 24 Feb 2025.



In 2020-2024, two-thirds of total issuance were labelled bonds, mainly use-of-proceeds (UoP) instruments like green or sustainability bonds.[16] This year's first issuances (Severn Trent Water, SVTLN 3.875%, 2035, EUR 850mn; United Utilities, UU 3.5%, 2033, EUR 650mn) were UoP bonds, too. Significantly, Anglian Water issued an SLB in 2021 (OSPRAQ, 2%, 2028, GBP 300mn) and has several outstanding loans linked to sustainability benchmarks, with comprehensive reporting.[17]

Figure 6. UK water sector – labelled bond issuance from 2020-2024 (as share of total). Source: Bloomberg, AFII, as of 24 Feb 2025.



As shown in Figure 6, the share of labelled bond issuance for 2020-2024 was above 80% for several companies. This suggests water utilities are incentivised to issue such bonds. Besides signalling good intentions, it's an opportunity for issuers to access a broader pool of investors, including funds designated as 'sustainable'.

[16] Use-of-Proceeds (UoP) bonds, place restrictions on the projects that can be (re)financed by the debt: 'green' for projects that are entirely environmental in nature and 'sustainable' where they also include a social component.

[17] "Sustainable Finance Impact Report 2024", Anglian Water Group Limited, accessed 10 Oct 2024.

Conceptually, UoP structures can be value-additive to water utilities as they have sizable investments needs and generate recurring cash flow from their operations to service the debt.

However, setting up a framework to (re)finance eligible projects is not enough if overall business practices are not fully aligned to it. Such a framework did not provide the desired accountability in the case of Thames Water, nor the hoped-for sustainability performance.[18]

Unlike UoP bonds, Sustainability-Linked Bonds (SLBs) are instruments where the proceeds are used for general corporate purposes (GCP) and the coupon payments vary depending on the achievement of set sustainability performance targets (SPTs). They can therefore incentivise issuers to improve their sustainability profiles. We believe SLBs could be a way to rebuild investor confidence and trust in the water sector. Ofwat's final determinations can act as a reference for SPTs linked to such bonds, thereby aligning incentives and objectives across stakeholders.

Rebuilding public trust and investor confidence should be in the interest of all stakeholders, from environmental and financial standpoints. In a recent commentary, Moody's said the UK water sector suffers from a *"deterioration in business risk and overall regulation being less supportive of utilities' credit quality*".[19] It adds that this is partly due to "*negative public perception resulting in more regulatory powers and increased focus on enforcement, demanding targets leading to greater penalties for operational underperformance and resulting higher cash flow volatility*". This has also led to "*uncertainty associated with government review of the sector and its regulation*".

Continued access to a broad pool of investors, including funds designated as 'sustainable', requires companies to address this negative perception. At the same time, Ofwat's CEO stated there is "*stark evidence that money alone will not bring the sustained improvements that customers rightly expect. It is clear that companies need to change and that has to start with addressing issues of culture and leadership. Too often we hear that weather, third parties or external factors are blamed for shortcomings.*"[20]

While the sector as a whole is under close scrutiny, it is not homogenous. Certain companies are financially healthier than others. Thames Water is in distressed territory (rated Caa3 by Moody's[21] and CC with negative outlook by S&P[22]) while Southern Water was downgraded to speculative grade by Moody's[23] – though it is still rated BBB- by S&P[24] (on negative watch). However, most other companies are in the BBB rating bucket. Meanwhile, Anglian Water is rated A3 by Moody's[25] and A- by S&P[26], both with a negative outlook, however. But in all cases, a stronger commitment to sustainability could support ongoing relationships with stakeholders.

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[18] "Why does it always rain on Thames Water?", AFII, 21 Oct 2024.
[19] "Moody's UK Water Webinar", Moody's, 15 Nov 2024.
[20] "Ofwat calls on water sector to improve its performance after companies fall short on targets", Ofwat, 8 Oct 2024.
[21] "Thames Water Utilities Ltd. - Update following downgrade to Caa3 stable", Moody's, 30 Jan 2025.
[22] "Thames Water Utilities Ltd. Rated 'CC' Pending Restructuring; Outlook Negative", S&P Global, 17 Dec 2024.
[23] "Moody's Ratings downgrades Southern Water to Ba1, on review for further downgrade", Moody's, 13 Nov 2024.
[24] "Southern Water Services Ltd.'s Debt Downgraded To 'BBB-' On Challenging Financing Conditions, Remains On Watch Negative", S&P Global, 31 Oct 2024.
[25] "Moody's Ratings places Anglian Water's A3 ratings on review for downgrade", Moody's, 13 Nov 2024.
[26] "Anglian Water Services Debt Ratings Placed On CreditWatch Negative On Potential Revision To Regulatory Framework Support", S&P Global, 6 Nov 2024.

SLBs as a tool to increase accountability

SLBs can drive greater transparency on sustainability among issuers, while also providing a financial hedge against poor performance for investors. Several case studies testify to the instrument's utility in holding companies accountable to their sustainability promises.

Italian utility Enel is a prolific issuer of SLBs linked to its emissions targets. When the company missed its 2023 emissions intensity target, over USD 10bn of SLBs were affected by the subsequent coupon step-up. However, the company communicated well with the market, offered reassurance it was on track to reduce its emissions as promised, and returned to market with a very strong issuance.[27] Another example is Italian oil company Eni. It had an emissions-related SPT due for observation at the end of 2024, one it can use carbon offsets to achieve, even though these may prove more expensive to purchase than the step-up coupon payments would be.[28] This suggests the company has a high financial motivation to meet the target.[29]

Certain issuers have also successfully used SLBs alongside UoP debt, to diversify their own capital stack and offer more choice to sustainability-minded investors. Examples include Italian utility A2A,[30] the two European Transmission Services Operators Gasunie and SNAM,[31] and Belgian Dutch supermarket Ahold.[32]

Conclusions

While Thames Water remains in the spotlight as it negotiates with creditors and looks for new equity investors, its financial troubles are not representative of the overall water sector. However, there are broader issues around accountability, governance and sustainability performance. To rebuild public trust and investor confidence, water companies have to change. Last October, the government launched an Independent Commission into how the sector and its regulatory regime operate. It is expected to report back this year with recommendations on how to address systemic issues. These are expected to form the basis of further legislation to attract long-term investment.[33]

In the meantime, Ofwat envisions a quadrupling of new investments to GBP 44bn in 2025-2030 to align the water sector with the government's own ambitions. Capital markets will have to supply some of the financing. Given high investment needs and debt rollovers, we expect water sector bond issuance to remain high. This represents an opportunity for investors to engage with issuers. With the capital they provide, investors can influence the direction of companies, promote stronger accountability, and push for sustainability to be incorporated in their decision making.

SLBs have the potential to incentivise issuers to improve their sustainability in more meaningful and holistic ways. In our view, SLBs could help to rebuild trust and confidence in the water sector. The regulator's final determinations could even act as a reference for performance targets over the next five years, thereby aligning incentives and objectives across stakeholders.

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[27] "Enel returns to the SLB market: per angusta ad augusta", AFII, 21 Jun 2024.
[28] "SLBs: a summary of 2024 targets", AFII, 9 Jul 2024.
[29] "Eni and Hapag-Lloyd among firms in danger of SLB step-up in 2024", Responsible Investor, 11 Jul 2024.
[30] "A2A goes for gold with an EU green bond", AFII, 23 Jan 2025.
[31] "European gas TSOs: one pipeline to transport them all", AFII, 26 Nov 2024.
[32] "Relative value is in the eye of the Ahold-er", AFII, 18 Mar 2024.
[33] "Governments launch largest review of sector since privatization", UK Government, 22 Oct 2024.

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