House of Commons

Environment, Food and Rural Affairs Committee

Oral evidence: Thames Water Finances, HC 402

Tuesday 12 December 2023

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Watch the meeting

Members present: Sir Robert Goodwill (Chair); Ian Byrne; Barry Gardiner; Dr Neil Hudson; Cat Smith; Derek Thomas.

Questions 1 - 167

Witnesses

I: Alastair Cochran, Joint Interim CEO, Thames Water; Sir Adrian Montague CBE, Chair, Thames Water; and Cathryn Ross, Joint Interim CEO, Thames Water.

II: David Black, CEO, Ofwat; and Iain Coucher, Chair, Ofwat.

Examination of witnesses

Witnesses: Alastair Cochran, Sir Adrian Montague CBE and Cathryn Ross.

Q1 **Chair:** Welcome to this special session of the Environment, Food and Rural Affairs Select Committee. We are very pleased that the senior management at Thames Water have come in to talk to us and to hopefully clarify the situation on some of the items that have been reported in the press, which seem to be at some odds with what we were led to believe the last time you arrived, but no doubt that will all become clear. The second part of this session will be with Ofwat, the regulator. Could I ask our witnesses to introduce themselves briefly, starting with Sir Adrian?

Sir Adrian Montague: I am the Chair of Thames Water and of Kemble as well. I took up those positions on about 10 July.

Cathryn Ross: I am one of the interim Co-Chief Executives of Thames Water.

Alastair Cochran: Good afternoon. I am Co-Chief Executive and Chief Financial Officer.

Q2 **Chair:** Yes, so it is probably a good idea to start with you. You published your annual accounts recently. When you appeared before the Committee in July, you said that you were brought in with a whole new executive team to turn around Thames Water. How is that going?

Sir Adrian Montague: Sir Robert, would you mind if I just started with an apology? An apology is in order. As you said, when we were here in July we described the shareholders' contribution of £500 million as equity. That is a description that has been fiercely challenged.

Chair: Yes. We are going to come on to that on question 3, but you can make a brief statement to start.

Sir Adrian Montague: We stand by what we said, and I will explain why when we get to question 3. However, we were not clear enough in unpacking the different elements of the shareholders' contribution, so I am sorry if we caused any confusion.

Q3 **Chair:** Yes. No doubt we will explore that in a little bit more depth when we come on to Mr Gardiner's questions.

Alastair, how is the turnaround going? I know that the previous management resigned two years into an eight-year plan, and you guys came in to, would it be right to day, pick up the pieces or continue the great work?

Alastair Cochran: It is a combination of both, I suspect. How is it going? When we were last here, we explained that we were pivoting away from an eight-year turnaround plan. We were refocusing that plan. On the back of that, we have over the course of the autumn defined a three-year turnaround plan to deliver an improvement in both operational and financial performance. At the same time, we have submitted our business plan for the next regulatory review to the Committee, so it has been a very busy six months.

You certainly have seen our results from last week, the first six months of this year. As part of that turnaround plan, we are now focusing on six core operational priorities. They are aligned to what our customers care about the most. In three of those we have demonstrated and delivered improvement over the first six months of this year, albeit I would stress that this turnaround will take some time. We will not complete the job in three years. It will take both this—

Q4 **Chair:** Is your three-year turnaround just basically the first three years of the eight-year plan or are there some fundamental changes that you have made?

Alastair Cochran: It will deliver substantial improvements in those six key priorities. For example, in water quality, which is the most important measure for our customers, that they get safe, clean drinking water, we are targeting an 80% reduction in what is called the compliance risk, the risk of not having safe water. In fact, we delivered that in the first six months, so good progress on the most important measure for our customers. However, we are cognisant that we still have to do a better job on a number of other measures where we are falling short. For example—

Chair: Leaks, for example?

Alastair Cochran: —on pollutions, our performance is not good enough. We reported 257 pollutions in the first half, so that was an increase of 40 on the prior period. Our complaints from customers increased to just over 38,000 after two very good years of reducing that. Our health and safety performance, measured by lost time, injury and frequency rate, also increased a fraction. There is a lot to do, but we do believe we have a comprehensive plan in place that over three years will deliver material improvements in performance for our customers.

Q5 **Chair:** You are planning to do in three years what might have taken five under the old plan? Has carbon neutrality become less important compared with sewage discharges? What are the decisions that were made at board level that this plan will be a better and more effective plan and a plan that is more financially viable for the company?

Alastair Cochran: There are two things to highlight in particular. First of all, the reflection that we as a board and an executive management team came to over the course of the spring and summer last year was that we simply could not deliver everything at once. It was not feasible, nor was it sustainable. Therefore, we did have to prioritise and hence why we focus on those six core operational priorities.

We have also made a large number of changes to how we are prosecuting that plan. It is now a data-driven plan. It focuses on the root causes of underperformance and discrete and direct interventions to change and improve those root causes. We are dedicating resources to it. Instead of asking our people to not only deliver their day job but to also deliver turnaround, we have dedicated resource focused exclusively on the turnaround while other individuals, other colleagues, focus on delivering business as usual.

There are a large number of changes. We are also simplifying our processes and our systems, and we continue to invest in improving services. One of the highlights of the last six months was a record £1 billion of investment into our assets to improve performance for our customers and the environment.

Q6 **Chair:** In terms of the financial performance of the company, your pre-tax profits fell 54% in the six months to September, while your revenues climbed 12%. Is this the impact of interest rates on a very highly geared company or are there other factors that have come into play?

Alastair Cochran: It is not that at all. Our underlying profitability improved. The cash measure of profit, EBITDA, is up 22%. We hedge through derivative instruments, so swaps, exposure to interest rates, foreign exchange changes and inflation. Those swaps are designed to protect customers so we can plan ahead and invest. The consequence of putting those swaps in place is that every six months we have to review the balance sheet value of those swaps. Accounting rules require us to reflect the change in that balance sheet value through the P&L. It does introduce some volatility into our reported profit. The true test is if you look at our cash profit it was up and, indeed, our operating cash flow was up. It is that operating cash flow that is so important that underpins the increased investment.

Q7 **Chair:** We are going to go into the debt situation in more detail with Mr Byrne later on.

The shares are not traded, as many companies are, openly on the stock market, but we did notice that the Ontario Municipal Employees Retirement System, OMERS, had written down its stake in Thames Water by 30%. Is that a reflection of the core value of the company, so if it had been a quoted company your shares would have fallen 30%? For what reason has it done that, just to take into account some of these debt issues and the expectations of the pensions it will be paying out?

Alastair Cochran: It is its view of the valuation of the company. You are right; we do not have publicly quoted shares, so we do not have a transparent, liquid share price to measure the value of the company. Each of our investors will periodically review what they think the value of the investment is. If it declines, they are required under their rules to write that down. It reflects the value of the business as they see it at a particular point in time.

Q8 **Chair:** If you have a company that is 80% geared and its value falls by 30%, does that mean you are, in effect, in negative equity or is that not something that concerns you?

Alastair Cochran: No, there is certainly equity value. It did not write it off completely, to the best of my knowledge. There still is some equity value. Clearly, the value—

Q9 **Chair:** You see the point I am making. If I have a house with an 80% mortgage and the value of the house falls by 30%, I owe more than I own. Does that parallel work or am I very naive in my understanding of the finances of big companies like yours?

Alastair Cochran: You are right; there is a thinner equity buffer, if you like. The valuation of the equity is much more sensitive to the overall enterprise value. It is the value of the equity and the debt added up. If the debt was worth more than the company value that is when you would get negative equity value, as you can do in a house. In our scenario, OMERS has not written it down to zero, to the best of my knowledge and, therefore, it still believes there is some equity value in this company.

Q10 **Chair:** Will that impact the level of risk for your credit rating and the levels of interest you might need to pay on borrowings or is it because a lot of the borrowing is from your owners, in effect, that they take a slightly different view than an external bank that would be looking at risk much more seriously?

Alastair Cochran: Lenders will take a different perspective. They will typically look at the credit rating of a company. We have a strong triple B credit rating that allows us to borrow money at reasonably attractive rates of return. Of course, those interest rates have risen as interest rates have increased over the last 18 months. The question for an equity provider ultimately—like OMERS and USS and others that we have—is whether the return they will get from putting more money into a company will deliver an adequate return for the risk they are taking on board. That is a judgment they will take from time to time as and when they are asked to provide additional equity.

Chair: Thank you. Apologies for making you answer all the questions, but as Finance Director they were particularly important. Barry Gardiner, I will turn to you.

Q11 **Barry Gardiner:** Mr Cochran, when you appeared before this Committee in July you will recall that I asked you about the way in which a clause had been included in a previous debt issue that would have required the immediate payback of £560 million of outstanding debt in the event of nationalisation. You claimed not to recognise either the figure or the clause. I think there were four senior secured notes that contained the nationalisation clause. They were in 2018 and 2019. I was surprised, given that you had been and still are the Chief Financial Officer, that you were unaware of that, but you kindly agreed to investigate and write to us. Why did you not do so?

Alastair Cochran: We did write to you after the Committee. If you have not seen that letter, I will quite happily—

Barry Gardiner: I checked with the Committee Clerk earlier today and no such letter was received by them.

Alastair Cochran: I can just reiterate that we did.

Q12 **Barry Gardiner:** Thank you for that. The purpose of the four senior secured notes that were issued privately in 2018 and 2019 by Kemble Water Finance was to insulate the structurally senior bits of the company—that is those bits in the holding group outside what the public would recognise as Thames Water—from the potential financial losses that they would incur if Thames Water were to collapse to such a point it had to be nationalised. Is that correct?

Alastair Cochran: There is no obligation for those loans to be repaid in the event of nationalisation.

Barry Gardiner: There is not?

Alastair Cochran: No.

Q13 **Barry Gardiner:** What were those clauses doing?

Alastair Cochran: It was explained to me that they were designed to provide some protection to creditors, but they—

Barry Gardiner: Against nationalisation.

Alastair Cochran: As I say, they—

Q14 **Barry Gardiner:** Are you saying that those clauses were poorly written and did not provide the protection they were supposed to?

Alastair Cochran: That is correct.

Q15 **Barry Gardiner:** Sir Adrian, does Kemble Water generate any income aside from that drawn from Thames Water?

Sir Adrian Montague: Not materially.

Q16 **Barry Gardiner:** Just so that we are absolutely clear, Kemble Water Holdings Limited's annual report says there is a separately managed property business through which you sell land and other property that is no longer required by the appointed business. Can I take it that the "appointed business" is Thames Water? Is that correct?

Sir Adrian Montague: Yes.

Q17 **Barry Gardiner:** Fine. Everything that comes to Kemble is from Thames. That is what I wanted to establish. You are the Chairman of Thames Water?

Sir Adrian Montague: I am the Chairman of Thames Water.

Q18 **Barry Gardiner:** You are also the Executive Chairman of Kemble Water, all the other directors being non-executive. Is that correct?

Sir Adrian Montague: I don't recognise "Executive Chairman". I am certainly the Chairman of that company.

Barry Gardiner: Okay, but all the other directors are non-executive?

Sir Adrian Montague: As I think I am as well.

Q19 **Barry Gardiner:** The accounts of both companies are filed from the same address and by the same company secretary. Is that correct?

Sir Adrian Montague: Yes.

Q20 **Barry Gardiner:** From the point of view of a lay member of the public, they might struggle to see how Kemble Water is not the same thing as Thames Water, but you and I will accept that legally, in company law, they are separate. When we last met in July we discussed the way in which Macquarie, a previous owner of Thames Water, had piled the company with debt and extracted huge dividends, weakening the company financially such that it struggled to carry out some of its vital public-facing obligations.

You were kind enough to reassure me that this could not happen now. Indeed, you said it was ancient history if I recall. Is that your recollection as well?

Sir Adrian Montague *indicated assent.*

Q21 **Barry Gardiner:** Yes. It is important to understand why it is that the £500 million of what you insist in your letter to this Committee is new equity is, in fact, new equity and not debt that Kemble Water could use to extract excessive payments from Thames Water, just as Macquarie did. I take it that we are agreed that that is the essential purpose of this session.

Sir Adrian Montague: Exactly right.

Q22 **Barry Gardiner:** Because, of course, that is what you have been accused in the media of doing, the same thing as Macquarie. We are agreed that originally the £500 million was not provided directly to Thames Water Utilities Limited but to Kemble Water Holdings as what we technically refer to as a convertible note with 8% interest attached. The debt is held by Kemble Water Holdings, is that correct?

Sir Adrian Montague *indicated assent.*

Q23 **Barry Gardiner:** Okay. The money when it was cascaded down to Thames Water Utilities Limited became equity.

Chair: Nods do not work on *Hansard*. If you would like to just say—

Sir Adrian Montague: Yes, that is correct. All those propositions are correct.

Chair: We can all see you nodding, Sir Adrian.

Q24 **Barry Gardiner:** The transcript will record that Sir Adrian Montague nodded his assent, yes. Of course, when you take an equity stake in a company, you normally get shares in return. However, when Kemble Water Finance gave the money to Thames Water it could not take shares because it was already 100% owner of the company so it would have been a bit odd, wouldn't it? That is why it might have looked odd. Let's focus on this convertible note.

Sir Adrian Montague: Willingly.

Barry Gardiner: That was the one that was provided to Kemble Water. If I may quote Julia Roberts in "Pretty Woman", "Slippery little suckers", aren't they, those convertible notes? One of the main distinctions between equity and debt for a convertible note is, first and foremost, whether the conversion is mandatory. Do you agree? If the holder can decide not to convert, it is not really regarded as equity from the ratings point of view. It looks like debt. Would you agree?

Sir Adrian Montague: It may help if I say that I agree that that note is debt.

Q25 **Barry Gardiner:** The £500 million convertible note with 8% interest that Kemble Water received, is the conversion mandatory?

Sir Adrian Montague: I don't believe so. I think it can be repaid, but the expectation is that it will not be repaid, and it will be converted.

Q26 **Barry Gardiner:** If the holder can decide not to convert, it is not regarded as equity?

Sir Adrian Montague: I don't think it is equity. To be clear, I do not think it is equity. It is not our proposition that that note constituted equity.

Q27 **Barry Gardiner:** The second distinction between equity and debt for a convertible note is whether the coupon is required to be paid in cash according to a schedule or can be compounded and paid at a later date. If it is a cash payment, it looks like debt. If it can be compounded and paid later, it is regarded as equity. You agree. Does the £500 million convertible note require cash settlement?

Sir Adrian Montague: No.

Barry Gardiner: It doesn't?

Sir Adrian Montague: The provision is that outstanding payments, interest payments, are satisfied by further notes, so the interest is rolled up and carried forward to a future date.

Q28 **Barry Gardiner:** That makes it look more like equity, doesn't it? Would you agree?

Sir Adrian Montague: It could be.

Q29 **Barry Gardiner:** From a ratings point of view, you and I know that it would be regarded more as equity because it can be compounded and paid at a later date.

Sir Adrian Montague: I think it is properly categorised in the accounts as debt. It is not our proposition that it is actually equity. It looks a bit like equity, but it is correctly categorised as debt.

Q30 **Barry Gardiner:** The other important thing about convertible notes is their tax treatment. If the coupon is tax deductible, it clearly indicates that the convertible is debt, and the issuer has told the tax authorities it is a debt. Please tell us how the coupon is treated for tax purposes.

Sir Adrian Montague: I do not think I can answer that question. Mr Cochran may be able to help.

Q31 **Barry Gardiner:** You would not wish this Committee to think that you had structured this £500 million in such a way that you could claim to us it is equity but then claim to the tax authorities that it is debt, would you?

Sir Adrian Montague: I am not claiming to you that it is equity.

Barry Gardiner: No, but I am asking you to claim something, Sir Adrian.

Sir Adrian Montague: I am claiming—

Barry Gardiner: I want to know what the tax treatment is.

Sir Adrian Montague: I am telling you that it is in our accounts we believe accurately categorised as debt. I am afraid I cannot answer the question about tax deductibility. We can certainly write to you on that subject immediately afterwards, Mr Gardiner.

Q32 **Barry Gardiner:** This matters because, of course, you have told us that Kemble Water generates its income exclusively from dividends received from Thames Water. If Kemble Water needs to service its debt or faces some other financial difficulty, where would it look to get the money from except from Thames Water and its bill payers?

Sir Adrian Montague: The practice is that it draws the revenue it needs to pay interest and eventually repay the debt from distributions from Thames Water.

Barry Gardiner: That is just what I said, isn't it?

Sir Adrian Montague: Yes, I am agreeing with you.

Q33 **Barry Gardiner:** In other words, ultimately it would be Thames Water and the bill payers that ended up paying for whatever trouble the holding company got itself into. You have structured it differently, I will grant you that, but this is exactly what Macquarie did and what you denied could happen under your chairmanship to this Committee only five months ago.

Sir Adrian Montague: There is a very important difference. Thames Water pays those dividends if it seems in the best interests of Thames Water to do so. It is not obligatory for Thames Water to pay those dividends. The Kemble lenders—

Q34 **Barry Gardiner:** You have told us it is not obligatory either for Kemble Water to pay in a scheduled way the interest that is due on the note.

Sir Adrian Montague: Forgive me. I think it is important to separate different debt instruments at the level of Kemble.

Q35 **Barry Gardiner:** Slippery little suckers, aren't they?

Sir Adrian Montague: No, because there is this convertible note, which we say is debt and I think you are agreeing with me, and there are separately some borrowings that Kemble Finance has taken on in the past that will need to be serviced in the usual way. It is those borrowings for which in the past Thames Water has paid dividends to put Kemble in the position where it can service that debt. We are under no obligations to do so, and we do so if it is considered in the interests of Thames Water. Perhaps if I can—

Q36 **Barry Gardiner:** In October you paid £37.5 million dividend to your parent company. We understand that Ofwat may be deciding whether or not to investigate that payment as a potential breach of your licensing conditions. You would agree with that?

Sir Adrian Montague: It is seeking clarification. It is not at this stage investigating.

Q37 **Barry Gardiner:** No, I said it is considering. Is it appropriate to be paying dividends at the same time as failing to meet key environmental and performance targets? You said that you would only pay those dividends in the situation that it was in Thames Water's best interests to do so. It seems to me that it may well have been in Kemble Holdings' best interests to do so.

Sir Adrian Montague: Well, I think it is true that it was in Kemble's interest to receive the payments from Thames. That is clearly right, because otherwise it would not have had the means to discharge those interest payments. Can I turn to the position of the Thames board because I do think this is very important and the crux of the issue?

Barry Gardiner: Please.

Sir Adrian Montague: I think we are agreed that Thames is under no obligation to pay dividends to Kemble. It is a dividend. It is a discretionary payment within the control of the Thames board.

Barry Gardiner: It is not a debt. We are agreed.

Sir Adrian Montague: These payments to Kemble are not new. Thames has been making those dividend payments consistently since 2017. I think we are also agreed that Kemble's solvency is reliant on those dividends. That is my proposition; I guess you would agree with it. If Kemble was allowed to go into default, our concern from the Thames board perspective is that that would curtail or at least derail the possibility of receiving further equity from our shareholders. Without that equity, we are going to have to curtail expenditure and that would be unfortunate for our customers.

Q38 **Barry Gardiner:** Absolutely. Look, I understand what you are saying, and I agree. It would be extremely unfortunate. That is why I would question the £37.5 million dividend payment that you did make. You are aware that, given the situation with Ofwat and its potential to investigate that and the controls that it has taken to itself, Ofwat could potentially fine you 10% of your revenues for the breach of your environmental and performance targets. That would blow a hole in the capacity of the holding company to be in the position that you want it to be in and why you say you paid the £37.5 million in the first place.

Sir Adrian Montague: Long story short, we paid that £37 million to keep Kemble secure. We need to keep Kemble secure because a failure to do so will prejudice our new equity, and our new equity is needed to sustain the provision of services to our customers in the long term. We said in our business plan—and we have said consistently—that to some Thames is faced with a pretty unappetising series of choices on the way forward. We took that decision in October because we wanted to preserve the corporate structure of interest to Thames because it allows us to access new equity. That is the key thing here. We must have new equity as the shareholders have conditionally agreed to subscribe for.

Q39 **Barry Gardiner:** To what extent does Ofwat's controls of dividend payments threaten the business model that you have established, though? It is clamping down on your ability to make dividend payments to the holding company. Without those dividend payments, you have just admitted to this Committee that the prospects of you securing additional investment from shareholders recede. I will not say it reduces to zero, but I will be charitable and say it recedes.

How are the controls and constraints that Ofwat can put on you, which are for the public benefit—maybe not for the company's benefit, but for the public benefit—going to impact on your ability to secure that investment? Previously, you told this Committee that your investors wanted to see Ofwat relaxing its controls and not imposing fines.

Sir Adrian Montague: Not quite the same thing. Perhaps I will ask Cathryn to elaborate on that in a few minutes. Ofwat's new provisions regarding dividend came into effect, from memory, in March or May this year. We had submitted our dividend policy to Ofwat ahead of that time and it had given it a green light. Our discussion and the areas where Ofwat is seeking clarification are to understand how the dividend we declared sits in relation to that dividend policy. If you like, perhaps Cathryn can pick up the other point that you mentioned.

Q40 **Barry Gardiner:** We will move on to that shortly then. In your discussion with the Chairman—or perhaps it was Mr Cochran, sorry—you said if the debt amounted to more than the company value, then it would be written down to zero, but OMERS had not done that, to the best of your knowledge. However, it is only looking at Thames Water, isn't it? That is why you have had to put debt into the holding company. If anybody looked at all this together, you have what the market describes habitually as a byzantine structure with Kemble Holdings, Kemble Finance—

Sir Adrian Montague: We can certainly agree it is complex.

Q41 **Barry Gardiner:** If anybody looks at that whole structure, the game is up. Last time, when you were assuring us that this was new equity finance coming in, you did not explain just what a slippery trick you were using with those notes and that was the point, I think, of your apology to the Chair at the beginning.

Sir Adrian Montague: No. To be fair, we have missed an element, Mr Gardiner. I think that I do need to mention this for completeness. I think it is common ground between us that the moneys came into Kemble as debt in this slightly strange convertible note that we have already discussed once.

Q42 **Barry Gardiner:** Well, it faces both ways, for the reasons that we outlined, and I know each convertible note is very carefully structured to do what you want it to do in this byzantine world. However, I do still want your written response about how it is treated for tax purposes.

Sir Adrian Montague: We will certainly provide you with that.

Barry Gardiner: I think that is key.

Sir Adrian Montague: We are very happy to provide you with that. However, once the money was received by Kemble Holdings it was successively passed down through this byzantine, to use your word, complex chain, to use my words, of companies. When it got to what we describe as the ringfenced group, which is the operating group of the three companies at the foot of the chain—

Barry Gardiner: What people would recognise as Thames Water.

Sir Adrian Montague: At that stage it was applied in the purchase of new shares. I think that is the key point. Once you have new ordinary shares, as it happens, no bells and whistles, just ordinary shares, they were subscribed by Thames Water Utilities Holdings, the immediate parent company, and the proceeds of that application were passed down to Thames Water. That is the reason why we believe the transactions are correctly described as equity to Thames Water.

Q43 **Barry Gardiner:** I understand that. You will understand why anyone looking at this says they have taken on debt as a group. They have translated it into equity when it comes into the regulated asset. That regulated asset does not have to pay a dividend and, therefore, it can be regarded as not being a debt. The trouble is when that debt is called in and the holding group has no money to pay it, the only place it can get it from is from Thames Water, and that means the bill payers.

Sir Adrian Montague: Don't forget that we have two classes of debt at the level of Kemble. We have the convertible debt to the shareholders, which as we have said is not like an ordinary, straightforward instrument. It is not like a straightforward instrument because they are shareholders, and this is a loan with special characteristics because they are shareholders.

Q44 **Barry Gardiner:** But it is at 8% interest.

Sir Adrian Montague: This was settled in the light of market conditions at the time. In our capital raising in October, from memory we paid 8.25%, so it was in the realm. That interest is always satisfied in notes. It is rolled up. It is no cash drain to the company on account of interest. If we agree that that is in one pocket, the other pocket contains all the market borrowings of Kemble. It too depends on a flow of dividends from Thames Water. I do not think there is any suggestion that that is not the case. There is an instalment that will fall due early next year, in April, as has been reported in the press.

Q45 **Barry Gardiner:** That is £2.6 billion.

Sir Adrian Montague: No, £190 million.

Barry Gardiner: Sorry, that is the £190 million, yes.

Sir Adrian Montague: We will talk to the lenders about that maturity early in the new year. Our proposition to the lenders is going to be please will you extend the maturity, because everything about Thames Water will be much clearer from a financial perspective after we have received Ofwat's determination, preliminary in June and final in December. Then it will be much easier to see Thames's future and to decide how to restructure that debt.

Q46 **Barry Gardiner:** That determination from Ofwat could go against you, couldn't it?

Sir Adrian Montague: It could, certainly.

Q47 **Barry Gardiner:** Given the changes that were made at the beginning of the year that you referred to earlier in Ofwat's capacity for enforcement, it is more likely to go against you than it would have been at the beginning of the year.

Sir Adrian Montague: I do not think that is a conclusion you should be drawing. It has enhanced controls over dividend payments, but this is a core feature of many groups' financing plans. I am sure you will ask Ofwat this yourself, but many companies in the utilities sector have this structure.

Q48 **Barry Gardiner:** The £2.6 billion that I was referring to of debt in the parent company, when does that have to be repaid?

Sir Adrian Montague: I must ask Mr Cochran to help here.

Alastair Cochran: There is £1.35 billion of external debt that is owed by the holding company. The maturities range from April 2024 through to 2028.

Q49 **Barry Gardiner:** Sorry, just remind me. The first payment is due in April. What amount is due to be paid in April?

Alastair Cochran: It is £190 million, one, nine, zero.

Q50 **Barry Gardiner:** Does the holding company have that money?

Alastair Cochran: Not currently, no.

Q51 **Barry Gardiner:** Where does it propose to get it from?

Alastair Cochran: That is exactly why Sir Adrian said the shareholders are proposing to discuss with lenders the options for extending that facility until such time as we have clarity on PR24 and, indeed, the equity subscriptions by shareholders.

Typically what would happen is if there was that clarity, particularly around future equity flow, which is so important to increase investment for our customers and the environment, if you have that clarity, lenders are then willing to refinance that facility in the normal way that many companies and, indeed, Kemble have done in the past.

Q52 **Barry Gardiner:** Ms Ross, you were going to come in and elaborate on what Sir Adrian had said.

Cathryn Ross: I do just want to clarify one of the things that Sir Adrian was saying.

I think you referred to Ofwat taking new powers. Sir Adrian was right, Ofwat did reach the end of its consultation and make a formal decision to amend company licences earlier this year, but I do not believe that those provisions actually enter into force until April 2025, at the start of the new control period.

What those provisions do is they give Ofwat the ability—and I am emphasising the word "ability" because this is rather important—to place the regulated business in what it calls cash lock-up, so no cash must leave the regulated business, if the credit rating of that regulated company drops to one notch above investment grade. The reason I am emphasising the fact that the new provisions in the licence give Ofwat the ability is that—and you will need to explore this with Ofwat, of course—I do not think Ofwat would regard that as an automatic thing that it would do. I think that it would want to look at the circumstances of the case and decide whether that cash lock-up was in the round in the best interests of the regulated business. If we were to be in that situation, that is the conversation we would have with Ofwat at that point, but I do not think it is automatic.

Q53 **Barry Gardiner:** Thank you for that clarification. When we last met, I asked you and Mr Cochran about the redundancies that the company was proposing to make. Mr Cochran, I think you said that you did not recognise any redundancies. Since then, how many redundancies have there been?

Cathryn Ross: We are currently consulting on 172 redundancies.

Q54 **Barry Gardiner:** Yes, and a further 90 for the end of the year, is that right?

Cathryn Ross: I am currently aware that we are consulting on 172, of which 56 are voluntary and 116 we currently envisage as compulsory.

Q55 **Barry Gardiner:** Those redundancies you are aware are preventing you currently from performing some of your statutory duties?

Cathryn Ross: I would not accept that.

Q56 **Barry Gardiner:** You would not accept that. If we look at the review of leak allowances, what percentage of leak allowances are you able to review at the moment?

Cathryn Ross: In terms of our leakage performance?

Q57 **Barry Gardiner:** No, your leak allowance. You know what a leak allowance is just as well as I do.

Cathryn Ross: I am not sure I do. I know what leakage target we—

Q58 **Barry Gardiner:** Goodness me. A leak allowance is when somebody says there is a leak from their supply and that they are paying too much for their water as a result of that and you then make an allowance because of the leak.

Cathryn Ross: I understand.

Q59 **Barry Gardiner:** You are obliged to conduct a review of the leak and the leak allowance. You are not doing that, though, at the moment in many cases, are you?

Cathryn Ross: We have changed our policy, and our policy is switching to asking customers to pay to fix their own leaks. As far as I was aware, we are still reviewing the leak allowance that we give to the customer. I do not think we have stopped doing that activity.

Q60 **Barry Gardiner:** That is not what has been reported to Ofwat from other sources.

Cathryn Ross: I have not heard what has been reported to Ofwat.

Q61 **Barry Gardiner:** Up to 40% of leak reviews are not taking place.

Cathryn Ross: I can look into that and come back to you. I haven't got the statistics.

Q62 **Barry Gardiner:** How is it appropriate to be sacking, making redundant, 171 posts when you are not able to perform your key environmental and performance targets? You are reducing your capacity to deliver on your essential functions.

Cathryn Ross: I would not accept that. What we are doing, and it is the same as any business in any environment does, is looking at the resources that we have available to us in terms of people and money, and we are trying to make sure that we are aligning those resources with the priorities of our customers.

Q63 **Barry Gardiner:** The reason that you are not able to perform those tasks has nothing to do with the staffing levels that you have in place to complete those tasks?

Cathryn Ross: I certainly do not believe that the redundancies that we are currently consulting on, and I stress that we are consulting on those redundancies, are related to our reduction in looking into leak investigations and leak allowances for customers.

Barry Gardiner: Or any other key performance targets.

Cathryn Ross: The majority of those redundancies that we are proposing are in the retail area. A significant proportion is in our digital team, so looking at our systems that support the business. None of those redundancies is frontline. We are prioritising allocating the resources that we do have on being frontline in terms of fixing leaks, tackling pollutions and driving down customer complaints in line with the priorities that we have set out in the turnaround plan.

Q64 **Derek Thomas:** Sir Adrian, given that we ultimately care about our customers, the clean water they drink and that they have enough of it, and that everything that goes through our drainage system goes in the right place and is treated correctly, how does this complex arrangement of companies, as you have described it—I will not quote Barry's description—help the customer?

Sir Adrian Montague: I must beg Mr Gardiner's pardon for saying what I am about to say. This is a structure that has been put together over the years. A lot of it is very long standing. The companies in the group have their individual functions in terms of raising the borrowed money that we need to carry on our activities. That is the way we present it. They are part of the overall structure designed to allow us to finance this business efficiently because efficient financing of the business is in the interests of customers. We need to keep the cost of the borrowed money as low as we can, so efficiency in financing is a fundamental requirement.

Q65 **Derek Thomas:** As Ofwat has sought to tighten up legislation, the Environment Act and other bits and pieces, and has sought to shed some light on what is going on within water operating companies, does that present a real problem for you or is it acceptable that Ofwat can only manage or scrutinise Thames Water but none of the layers of companies above?

Sir Adrian Montague: That is the way that the legislation has been set up. Ofwat's function is to regulate the water and waste water companies. In our case it is Thames. There are other companies involved in the structure, of course, but that is the focus of its regulation. I strive, we all strive, to have the right constructive relationship with Ofwat. I said last time, I think, that we try to do this on an open-book basis. I have regular conversations with the Chairman just to tell him what is happening.

Q66 **Derek Thomas:** As you have helpfully described, this has developed over time, this complex arrangement and nature of companies. With you as Chairman now, do you see your task as trying to sort that out, resolve it, simplify it, or is it not possible to do that? Does it make everything too vulnerable?

Sir Adrian Montague: I would love to do that, and I have asked the question. I think I probably need to ask it several times more before we make any progress.

Derek Thomas: Okay. I suspect that is all I had to ask.

Q67 **Ian Byrne:** Thanks for the evidence so far, Sir Adrian. I note what you had to say there, Sir Adrian. I am just listening to what you are saying. I think that 69% of the nation wants water nationalisation. After listening to this, I think that it will be nearer 100%. It has certainly strengthened my view and I think it will be strengthened even more, but listening to the whole financial structure is very worrying.

Going on to the debt issue, you have identified that your shareholders, including China Investment Corporation and the Abu Dhabi sovereign wealth fund, would individually have the power to veto this injection of the £750 million and the further £2.5 billion by 2030. How much risk does this veto pose to the future of Thames Water and the supply of water to millions of people in this country?

Sir Adrian Montague: I have one very small precision and then I will answer. They act individually in relation to new investments. All these institutions are accountable to their own investment committees, so they will take decisions one by one. That is just a small precision.

We have made no bones about the fact that to finance all the improvements in service we want to create for customers and our business plan for the next five-year period is something like a 40% increase in spending. It is a huge amount of money we are trying to raise and spend. We need the support of the customers because they likely will be paying their bills. We need the support of the equity investors because we must arrange for them to support the borrowing by the company.

That is broadly how the water industry has been structured. You mentioned nationalisation. It is important to be clear that if nationalisation were to occur, then the burden of financing all these things will fall on the Treasury, not on private capital. The emphasis over the last 25 or 30 years has been to involve private capital, debt and equity, in financing the activities of the utilities. It is just how it works.

Q68 **Ian Byrne:** Just touching on that, Professor David Hall of the University of Greenwich said that if the Government were forced to take over the running of Thames Water, which might happen looking at the complexity of where we are in the financial structures and the absolute mess it is in, the cost to the taxpayer would not necessarily be high.

If you go through special administration, the shareholders take the hit if the company is not viable, and that is what the shareholders are for. Then the process needs to not be nationalisation but to set up regional local authority bodies to take over. You transfer the company as a going concern to those regional local authorities. There are other avenues without scaring people by saying it is the Treasury that takes the hit.

Sir Adrian Montague: I am not trying to scare people. I am just trying to project what I think is likely to happen. The goal of trying to enhance regional participation is a very worthy goal, but those regional bodies that would inherit the stakes in the water companies have to finance themselves somehow.

Q69 **Ian Byrne:** You have come to this late and I understand that, I really do. Worryingly, what you said before was lots of the other water companies are structured in the same way. Looking at it from the outside with a little bit of honesty, I know you are inside now, but if you looked at it before you were appointed to this role, would you say that the entire structure is an absolute shambles and needs ripping up and starting again?

Sir Adrian Montague: It is difficult, Mr Byrne—and I accept that this is not an answer to your question, but it is a factor to be taken into account—because this complex financial structure is a structure that people who lend money to the companies are familiar with, and they would say it works. Viewed from the outside, I think this debate we are having now has focused attention on capital structures in a way that it has not previously been focused on. As I said, I have sympathy with the fact that this appears to be and is a complex structure, but it is there for a purpose, which is to allow us to raise money.

Q70 **Ian Byrne:** It is the purpose that we are scrutinising, isn’t it? We just touched before on the potential £3.25 billion that will be required by 2030. If this money does come through this structure, will it be in the same way as the £500 million that you have just had the discussion with Barry about?

Sir Adrian Montague: To be honest, I don’t think we have got to that stage yet. It could be. It might be in a different way.

Ian Byrne: Cathryn, would you like to add anything to that?

Cathryn Ross: No. We just do not know at the moment.

Sir Adrian Montague: Shall I just talk for a moment about where I think the shareholders are? The shareholders have not had a dividend for six years. It has not been a great investment for them. I think they are saying, "We want to know that this is an investable company. We want to know at least what the general lines are of the outcome of the determination that Ofwat is making. We need to understand whether sufficient cash is going to come into the company to support further investment by the shareholders". I speak to them two or three times a week because I think it is important that we help them along, jolly them along, until we get to a point of decision. We are not yet at a point of decision. We will be as soon as the white smoke emerges from Ofwat.

Chair: I am sure they are watching this session. I would be if I were them.

Q71 **Ian Byrne:** I am sure they will have an interest. Alastair, can I touch on capitalisation of interest payments? Page 143 of the annual accounts states that £215.2 million worth of borrowing costs were capitalised in the period, this year, 2023. It was worrying because I have spoken to people about Carillion, and Carillion utilised the same capitalisation of interest. Ofwat called it imprudent, but you are carrying on with that same practice. Can you outline why you are utilising the same practice? What are the advantages and why are you doing it if Carillion utilised that practice as well? We all know what happened to Carillion, with millions lost, jobs lost, livelihoods lost.

Alastair Cochran: I think that Thames Water is in a very different position to Carillion.

Ian Byrne: Explain then.

Alastair Cochran: As you know, we reported we had £3.5 billion of liquidity. That is more than sufficient without raising any more money to see the business through and continue its investment programme through to essentially the next regulatory period. Once we have clarity on that period, you would expect to continue, and we expect to continue to raise money through this period as well. We are a liquid company. We also have a strong credit rating. We have continued to borrow money, even since we last met this Committee. Last month we raised £625 million either through new facilities or extending old facilities. Lenders still want to lend to this company because they see it as a viable business.

The equity is very important to this business. We have increased investment significantly over the last four years to the benefit of the customers and the environment. We are proposing to invest another essentially £4 billion these next two years and beyond that we—

Q72 **Ian Byrne:** What is the idea behind the capitalisation of interest?

Alastair Cochran: Typically, for Thames Water—Thames Water, to be absolutely clear—most of that interest is cash interest, but on our swaps some interest is capitalised and then added to the principal that gets repaid on maturity.

Sir Adrian Montague: Can I help with one point regarding Carillion?

Ian Byrne: Yes.

Sir Adrian Montague: The nature of the business is very different. Carillion was a contracting company. It is sometimes quite difficult in long- term contracts to work out how much profit you are making from them. We have in that respect a simpler business. We provide services to customers. They pay us. It is real cash. I think it is a more stable business.

Q73 **Ian Byrne:** Yes, but you also have the potential of being told no; you cannot increase the bills to the extent that you want to increase them.

Sir Adrian Montague: I think that we would say that some of the problems that we are now encountering were because our bills were kept deliberately very low over the last period. Perhaps it is the case that we would say that, wouldn't we—

Ian Byrne: Absolutely, yes.

Sir Adrian Montague: —but there is some substance to that view.

Ian Byrne: Thames Water customers would not say the same thing.

Sir Adrian Montague: There is some substance to that view.

Q74 **Dr Neil Hudson:** I want to explore some of the environmental issues. We have touched on this in some of the backdrop to the financial discussions that we have had. Your latest results show that the number of pollution incidents has increased during the six months to September, and you have admitted that your performance has deteriorated. To people watching this and to your customers, what assurances can you give this Committee that you are fully taking the steps necessary to address these environmental issues, including these very important pollution incidents?

Cathryn Ross: I can pick that up. You are right to point out that pollutions are going in the wrong direction. We are very disappointed with that. As you know, one of our priorities for our turnaround plan is to drive down the number of pollutions.

One of the things we have been doing, and it is part of our turnaround plan to do this, is that we are thinking differently about how we understand the root cause of pollutions. This is something that Thames has not been particularly good at over a number of years, getting to the root cause of why something is wrong and what is really going on here. In that regard, what we have been doing with pollutions is trying to understand when we have a pollution incident which part of our asset base, if you like, caused that pollution incident.

What we found is there is a very different picture if you look at sewage treatment works and if you look at our network, so the pipes. Sometimes, for example, we get a pollution incident that is caused by a fault in a pipe: you get a burst sewer, or you get a burst rising main or, indeed, you get a burst clean water main that discharges chlorinated water into a river. We are not doing badly on those, and those pollutions are coming down because we are managing our network better and we are improving some of the aspects of network quality.

However, on sewage treatment works we are doing worse. What that is telling us is that we need to invest much more in improving the quality of the effluent that is coming out of the sewage treatment works; improving sewage treatment works capacity and things like that. That is what we are investing in.

If you look at our plan for PR24, for example, we have I think nearly £900 million-worth of investment there to improve our performance on storm overflows, which is one source of pollution. We are investing heavily to improve the sewage treatment work estate in terms of the quality of the assets but also to provide better for population increase and climate change. That understanding now of what is actually driving those pollution numbers is helping us to get on top of it and target the investment in the right way.

Q75 **Dr Neil Hudson:** Targeting that investment—coming back to some of the financial discussions—are you confident that you have the financial capability backing resources to invest so that these unacceptable sewage outflows are stopped? Are you confident that you can say that to people?

Cathryn Ross: We would like to do more and in the current control period we would certainly have liked to have done more. You may be familiar with the fact that although we are delivering something like 91% of the environment schemes that we are supposed to deliver in this control period, there are a number that are slipping into the very beginning of the next control period. That is mostly to do with the fact that we had a dreadfully slow start in our capex programme at the beginning of this control period. That was entirely down to us. There is nobody to blame for that but us. We simply find ourselves unable to make up the run rate that we lost at the beginning of the control period, so we are delivering some of this investment later than we would have liked.

I told you about the big plans we have in the next control period. Whether we are able to do all that obviously depends on Ofwat's decision on funding and efficiency challenge and things like that.

Q76 **Dr Neil Hudson:** You mentioned Ofwat. I guess you are limited in what you can say. There is an ongoing investigation by Ofwat. It has just announced today that it is asking water companies such as yourselves for further clarification, and you will be able to provide information on that. I guess you are limited what you can say, but there is an ongoing investigation then for the regulator looking at your performance and what you are doing. Do you acknowledge that?

Cathryn Ross: Yes. That investigation has been ongoing for, I think, two years now. We have been completely fully co-operative—as Adrian says, open book—with Ofwat about what is happening across our estate and what our performance is in respect of the areas that it is investigating. This morning it has issued a statement on that, which we will consider, and we will continue to interact and co-operate with it.

Q77 **Dr Neil Hudson:** It has given its provisional findings to you and is asking you for additional information. It will then make decisions as to where it goes from there.

Cathryn Ross: Yes. It is very much an ongoing process.

Q78 **Dr Neil Hudson:** Okay. You recently told an online meeting held with Thames customers that you potentially had left yourselves with too much to do in too little time to reach your 2025 improvement targets. How did that happen?

Cathryn Ross: It is a good question. That was the point that I was referring to earlier on. We had a very slow start to the beginning of this control period, for a number of reasons. We submitted a poor quality plan to Ofwat in the last price review. From memory, that plan asked for something like £14 billion of cash from our customers and, I think, again from memory, we ended up getting about £9.5 billion comparatively, like for like. The plan was very poor quality.

There is no doubt about it, it took the business some time to get its head around the determination that Ofwat had given it and to work out what it was then going to do. We had a bit of turbulence in senior management at the time. We lost the then chief exec. We had our Chairman coming in as an Executive Chair for a while. We simply had a very slow start to the beginning of the control period. When I came in to Thames three years ago, we had something like £100 million of our capex programme on contract with the supply chain, which is woeful.

This year we have something like £800 million on contract, which is much more like it. It is all very well doing that in years 4 and 5 but you cannot make up what you did not do in years 1, 2 and 3. That is why we are ending up just having to tip over from the end of AMP7 into the beginning of AMP8 to deliver some of these schemes.

Q79 **Dr Neil Hudson:** There is more to do, and you want to do things more quickly, but in December you have now said that you are getting rid of your pledge to try to become net zero by 2030 because you need to prioritise improving performance on sewage. Why does one have to be ditched to achieve the other?

Cathryn Ross: Let me just explain a little bit about what we are doing. You are right, and Al said this earlier on. One of the things that is different about our three-year turnaround plan from our previous turnaround plan is that we need to prioritise. We just cannot make progress on everything. We really cannot do that, and we have learned that more than we ever knew it in the last 12 months.

One of the things we have prioritised is leakage, pollutions, health and safety, supply interruptions, complaints and things like that, all the things that matter most to our customers. Our customers do care about net zero and they do care about wider impact on the environment, but it is way down the list compared to those things that they care most about. We are trying to focus on those things that they do care most about.

Q80 **Dr Neil Hudson:** Do you have a revised target from 2030 to a later date then?

Cathryn Ross: Yes. We are still aiming for net zero operational carbon by 2035, but what we are doing, and this is important, is we will achieve progress on the road to net zero because we do desperately need to become more efficient in our use of energy. Of course, a big thing for us is whether we can use less energy. Another big thing is whether we can generate more of the energy that we use from our own renewable sources. As we are doing that and delivering efficiencies for the business that then result in lower bills for customers, we will also be on the road to that net zero operational carbon by 2035.

Q81 **Dr Neil Hudson:** Do you have targets on improving your performance in sewage outflows? Do you have set targets or is it just broadly, "We will try to do better and hope we do not have too many outflows"?

Cathryn Ross: No, we do. We are targeting by the end of 2030, so that is the end of the next control period, a 28% reduction in storm overflows.

Q82 **Dr Neil Hudson:** I am aware I have mentioned that there is this ongoing investigation, but I think we can talk about previous investigations and court rulings. Back in July, Thames Water was fined £3.3 million for discharging millions of litres of sewage into two rivers, killing more than 1,400 fish near Gatwick airport. I think that was in 2017. Thames Water admitted four charges in an Environment Agency prosecution, but the judge in that case, Justice Christine Laing KC, said she believed that Thames Water had shown a deliberate attempt to mislead the Environment Agency by omitting water readings and submitting a report to the regulator denying responsibility. What is your response to that?

Sir Adrian Montague: Can I step into this?

Dr Neil Hudson: Yes. What is your response to that?

Sir Adrian Montague: From inside Thames, we do not consider that finding to be soundly based, but it is the finding.

Q83 **Dr Neil Hudson:** Why don't you believe it is soundly based?

Sir Adrian Montague: To be honest, I am not sure. For the business, it is the finding of deceit that is so dangerous, so damaging to us. That suggests—

Q84 **Dr Neil Hudson:** You do not believe you misled the Environment Agency then?

Sir Adrian Montague: I don't think it matters what we believe. What matters is the judge's finding.

Q85 **Dr Neil Hudson:** Forgive me, I think it does matter what you believe. If the judge has said that perhaps there was a deliberate attempt to mislead the Environment Agency, were there attempts at all or not? You are denying them, are you?

Cathryn Ross: Perhaps I can come in. I did sit in the court to hear the judge's sentence on the Crawley prosecution, and I have read the file. There is no doubt about it. We did not handle that incident well. There is no doubt about it. We did not handle the provision of information to the Environment Agency well either. In particular, there were different parts of Thames Water that were looking at the same thing and coming up with different conclusions, and some of those found their way to the Environment Agency quicker than others. It was a complete screw-up.

The incident should not have happened. It was a dreadful incident. I completely apologise to everybody who was impacted by that incident. We also did not handle the reporting to the Environment Agency well. Personally, I did not form the view that it was deliberately done, but I can see why the judge did and we completely accept the finding.

Q86 **Dr Neil Hudson:** Not deliberately done but accidentally done is what you are saying?

Cathryn Ross: We screwed it up.

Q87 **Dr Neil Hudson:** So inaccurate water reports were sent in, or the wrong water reports were sent in?

Cathryn Ross: There were different views within the team about what had happened. Some of those views were passed to the Environment Agency. Those views were more favourable to Thames Water. There were other views from different parts of the team, and they did not find their way to the Environment Agency, I believe, until the Environment Agency specifically asked for more information and then they did.

Q88 **Dr Neil Hudson:** As a Committee, we now have a court of law that has questioned some of the things that you have done and said. We have had two sessions with you now. Sir Adrian, in your introductory comments you apologised and said perhaps you had not unpacked some of the information that you had given us back in July. To people watching this, is there a culture of not unpacking the information properly or giving wrong information? Should we have confidence in what you are doing at Thames Water?

Sir Adrian Montague: I will say that that was six years in the past. It does not reflect well on Thames. We are quite clear that it does not reflect well on Thames. The finding that the judge came to is deeply concerning because we want to be sure that there is not a cultural weakness inside Thames. We have to address that and one of the ways of addressing it is through our turnaround plan.

We have talked about the previous turnaround plan. I would say that this one, which is the product of the new management, is exhaustive—300 pages' worth of plan. It is properly resourced because we have some external managers helping us devise this plan. It has the full support of the board, and it will have to look at two things. It is first, as Al was saying earlier on, going to look at our processes in relation to the major types of water and waste water management action. We will look at our process minutely and that is where a lot of the efficiencies will come. It also has to look into the deeper culture of the organisation. It has to look at accountability. It needs to look at the way we set objectives and the way we manage performance.

It is going to be root and branch. It has to be root and branch because we must turn Thames into what it, I think, has a right to claim. It is a long way from it. It is the biggest water company in the country. We serve 15 million people. It needs to be up there with the best. It is not there. That is the ambition.

Q89 **Dr Neil Hudson:** I take your point and you said you will be looking at the culture of your organisation. You have said that some of this is ancient history, it is a few years ago, but today my colleague Mr Gardiner has been talking about modern history. We have been talking about how you have provided us evidence just a few months ago and then we have asked you to come back to clarify it. Is there this culture that needs to be looked at about how you present information?

Sir Adrian Montague: No. If we go back to July, we described this £500 million of equity. I hope we have satisfied you that it is equity. There was no misdescription about it. I agree with Mr Gardiner that it is a complex financial structure, but it is equity. We stand by what we said in July.

There is only one way to approach these problems and that is with frankness and openness, and that is what we are trying to do here today. I have said that we are trying to address cultural issues within Thames Water.

Q90 **Dr Neil Hudson:** This is my final question. Are you confident that we are not going to be asking you to come back in three or four months' time to clarify things further?

Sir Adrian Montague: Yes.

Dr Neil Hudson: Are you confident of that?

Sir Adrian Montague: Yes. External events may impact on this, but we are dedicated to trying to sort this culture out once and for all.

Q91 **Chair:** There is one question from me. Cathryn, having been a regulator yourself, do you think Ofwat could do its job better if it has an overview of Kemble and the various bits of Kemble and Thames? Would that give it a little bit more perspective on what is happening?

Cathryn Ross: I don't know. I think you would have to ask Ofwat. I think that it does pretty well. The information, for example, that it has asked us for to clarify why the Thames Water board decided to pay the dividend is comprehensive and thorough. We will provide that information. We will provide it under condition M. I feel it has a lot of information to look at and it is up to Ofwat to decide what it chooses to do with it.

Q92 **Cat Smith:** On the customer satisfaction scores for water companies, Thames Water is bottom. Why do your customers think you are so rubbish?

Cathryn Ross: Yes, we do not do well, I completely accept, on the Ofwat measure of customer experience. We have been 17th out of 17 for some time.

A lot of the issues come up through complaints. The biggest single category of complaints relates to billing, so we have a lot of dissatisfaction with billing. We have also been undertaking quite an extensive metering programme in this control period. In fact, we will continue it into the next control period. We get a lot of complaints about that metering process as well. Sometimes it is as simple as, "Somebody said they were going to turn up to my house and they didn't show up", which is a good reason for somebody to complain. Sometimes people are not happy to have a meter. Sometimes they are not happy with the bill they get, when they get the first bill after their meter reading. Billing and metering are probably the two biggest areas of complaints for us.

Q93 **Cat Smith:** When it comes to billing, do you think your customers will be more or less satisfied if Ofwat is to allow you to have the 40% increase in water bills?

Cathryn Ross: Well, I think customers will certainly see a significant improvement in service on some of the things that they care about and that is why we are targeting what we are targeting. To give you some examples, the plan that we are proposing for the next control period, we have already talked about 28% reduction in storm overflows. We are targeting a 30% reduction in pollutions. We are targeting a 17% reduction in sewer flooding. We are targeting a 22% reduction in leakage. Those are all the things that our customers tell us they care most about.

Q94 **Cat Smith:** If a customer was to have a complaint about a bill and was to telephone your customer service centre, would they have a positive or a negative experience? What things do you think would influence that?

Cathryn Ross: That is a good question. I think they would have a more positive experience now than they would have done a couple of years ago. One of the things we have done over the past 18 months or so has been that we have brought back our customer telephone agents. They were outsourced to a different company based in Durban in South Africa. We have now brought them—

Q95 **Cat Smith:** Where are they based now?

Cathryn Ross: Swindon. We are basically employing 175 more people in Swindon to deal with customer contacts over the telephone than we were a couple of years ago.

Q96 **Cat Smith:** There are some customers who are particularly unhappy, I believe, in Camberley. I know that yesterday you issued an apology to the residents there for leaving 200 tankers of sewage through the hottest months of the year. Councillors in Surrey are requesting a reduction of bills. Why is it that when customers are faced with having sewage in the middle of a heatwave making their town stink that they should not be entitled to some level of compensation?

Cathryn Ross: Let me just recap on Camberley. I will completely accept that the residents of Camberley have not had a great summer and we have apologised to the residents of Camberley for that. What happened was that we had a problem with one of our large digesters at one of our sludge treatment centres in Hogsmill. We found ourselves having more sludge than we could treat and the only place that had capacity to store that sludge was at the sludge treatment centre in Camberley, so that is what we did. Unfortunately, that did lead to a large volume of sludge being stored in Camberley during the summer, with potentially predictable impacts on the local residents.

I completely understand why they are not happy. We have been down there; we have talked to them. Our operations director for Thames Valley and Home Counties has explained this. We have had discussions with the local MP as well. The fact of the matter is that if you look at the regulatory regime, odour from sewage treatment works and sludge treatment centres is not something that we are required to compensate customers for.

We did address the issue as quickly as we possibly could. We did address the issue as quickly as we possibly could. We cleaned the sludge treatment tanks down in August and the odour was mitigated properly in September, so we did do what we said we would do when we said that we would do it. However, I do recognise that it has left the residents of Camberley feeling rather dissatisfied.

Q97 **Cat Smith:** You must spend a lot of time saying sorry to people when you work for Thames Water, mustn't you?

If Ofwat does not grant you the increase, what would the implications be for shareholders to support Thames Water and what is the financial viability of the company if Ofwat was to not grant that?

Alastair Cochran: Perhaps I can pick that up. In practice we would revisit our business plan and reduce our expenditure to fit the available funds. To the extent that we needed equity, we would seek that equity from our existing shareholders. If they determined that it was not an attractive enough return to invest in it, we would have to go to other investors to seek equity from them.

Q98 **Cat Smith:** For any of your customers who have been watching this afternoon's exchange, do you think that they are going to be more or less satisfied with Thames Water, given your responses to the Committee today?

Sir Adrian Montague: As I said, we understand that our performance has not been good enough; it has not been good enough for several years. We do have a turnaround plan to try to address these deficiencies. It will require us not only to look at each step in the process but to think about the culture of the organisation. The commitment that we have made is that it will become better.

This is a seminal moment for Thames. We were very fragile in July. The chief executive resigned, without notice, 10 days before a change of chairman and the financial markets took fright. We have stabilised the business and we have finalised our business plan. We have raised more money, and we have a turnaround plan. There is a process under way to try to identify a new chief executive. That will happen when it happens, but we will have new leadership and we need to make a fresh start. I know that management always says this, but it is true in this case, because this is a fresh team.

Q99 **Chair:** On that point, when are the interim chief executive officers going to be normalised, or replaced?

Sir Adrian Montague: Relieved from duty, I think is what you are looking for. When the new chief executive arrives. I cannot tell you when that is going to be. I am too long in this game to give promises that are difficult to establish. Then they will go back into the line positions. They have done magnificently. We could not have got through this period without them.

Chair: Thank you very much indeed for coming along at the first opportunity following our getting in touch with you. I appreciate the candour—at times, at least—that you have shown to the Committee. Thank you very much indeed.

Examination of witnesses

Witnesses: David Black and Iain Coucher.

Q100 **Chair:** Welcome back to the second session of this investigation into the goings on at Thames Water. We are very pleased to have Ofwat, the industry regulator, to see us. Would you introduce yourselves for the record, please?

Iain Coucher: Good afternoon, I am the Chair at Ofwat.

David Black: Chief Executive, Ofwat.

Q101 **Chair:** Thank you. You and I were together at the Department for Transport for a while, were we not, when you were running trains?

Iain Coucher: We were.

Q102 **Chair:** You have been listening to the first session, so you will be well aware of some of the concerns that we have. In July, you expressed confidence in Thames Water's financial position and resilience. Do you still hold that view?

David Black: In July we set out that we had two concerns about Thames. One was its operational performance and the second was its financial resilience. We were clear at the time that there was a lot of discussion about Thames having cash-flow issues, or short-term financial issues. We thought that those were overstated but we remained concerned about the operational performance—you have just heard more about that—and the overall financial resilience. We identified in 2022 our concerns about its lack of financial resilience: its levels of debt, its financial structures.

Q103 **Chair:** I think that 60% is your recommended level and this has reached 80%, which is way above.

David Black: Yes, it is the most highly geared company in the sector. There are a number of measures that we look at companies on every year and we produced a report in September. Not surprisingly, this year and the previous year we have identified—with a group of other companies—where action is required for the company to improve its financial position.

Q104 **Chair:** How did Ofwat allow this situation to develop where the borrowings at Thames were way ahead of recommended safe levels?

David Black: As a regulator, up until relatively recently, we have not had the powers to control the financial structures of a company. Provisions were put in its licence some time ago, when it was increasing its level of debt, requiring it to have a minimum investment-grade credit rating. That was designed to ensure that companies had adequate financial resilience.

We have taken a number of steps since that time to require companies to have improved financial resilience. We have talked about the dividend controls that we have recently introduced. Back in the 2019 price review we introduced a financial incentive for it to de-gear the business. We have been using the tools that we have had at our disposal as a regulator to encourage companies to have more prudent financial structures.

None the less, a principal regulation has been that it has been that it is up to companies to make the choices as to the level of debt and equity that they choose to finance at, subject to the provisions in their licence about minimum grade credit rating. It is a choice for management and the shareholders as to how it raises that balance of debt and equity. Our view is that it should have and does need more equity in its structure.

Q105 **Chair:** The turnaround plan, its investment plans, its plans to improve customer service, to reduce sewage and leaks and everything else, we heard in the first session how it has gone from an eight-year long-term plan to a three-year plan. Were you fully involved in those changes and were you content that those changes were still going to deliver for customers?

David Black: It has been presenting its revised turnaround plan to us and seeking to provide assurance to us about that plan. We had another session with the company this morning to talk about its turnaround plan. We are examining that plan, and it is too early to say whether we are satisfied that that plan will succeed and turn around the business.

Q106 **Chair:** Thank you very much indeed. What assessment have you made of the chances of Thames successfully delivering these improved services and reduction in pollution incidents? If I was sat on the board of Thames, the financial stability is the thing that would keep me awake at night. I would worry about sewage bills, but I would lie awake at night worried about the debt.

David Black: It does face an extremely challenging situation. It has its financial position, which there are a number of concerns about, and it needs to address those concerns. Related to that there is the operational performance. It needs to turn around that business. We can point to other companies in the sector that have faced challenging operational turnarounds and have succeeding in improving their performance.

It runs a monopoly business, and the challenges of that business are known. It ought to able to institute a turnaround plan and ought to be able to address those issues. It has been very open that it has not had the information and it has not had the management processes to drive the performance that it should have done in that business. It is setting about remedying those, and we are confident that it can make the improvements. The question is whether it will make those improvements. That will require backing from shareholders, which you have been talking to them about.

Q107 **Barry Gardiner:** I went back and checked the record of our conversation when you were here before the Committee in July; perhaps you did as well. I asked you, "Are you confident that, going forward, no part of the ownership of the company will be able to receive the level of returns that Macquarie was extracting from Thames Water?" You replied, "We have changed the licence to give us the power to do that but, furthermore, we now have more flexibility with the licence. If we think further changes are required, we will introduce them".

When you appeared before the Committee in July you welcomed the £500 million of equity secured by Thames Water from its shareholders. You did not mention anything about the structure of that funding, the additional debt that it loaded on to the ownership of the company, the holding company, Kemble Water. Did it blindside you or did you blindside us?

David Black: No, I do not think that either of those two points is right. From our perspective we look at Thames Water, which is the regulated business. As Thames has explained, there has been £500 million of equity injected into the business. We welcome that and still do. It needs more equity.

Q108 **Barry Gardiner:** You know very well that if holding companies have to pay off the £190 million that they are due to pay in April and they have to pay off the debt that it has now incurred, the £500 million debt with the note of 8% interest, that the only place that they can get that from is Thames.

David Black: Yes, that is exactly right.

Q109 **Barry Gardiner:** Why did you not tell us about that? Why did you not expose that structure? Did you not know it, or did you know it and simply think that this Committee might not be interested?

David Black: We regulate Thames Water, the regulated business. The £500 million is equity into that. You are absolutely right that the risk is that it then makes dividend payments to support debt at the holding company structure, which is why we are asking further questions around it.

Q110 **Barry Gardiner:** The £37.5 million?

David Black: Yes, that is right, and we are asking it to explain that to us. If we are not satisfied with that explanation, we have the ability to open enforcement action and take enforcement action against Thames Water. That position remains.

Q111 **Barry Gardiner:** You have not answered my question. My question was: were you aware of the structure of that equity injection and the debt that it left with the holding companies at the time when you appeared before this Committee? If you were, why didn't you tell this Committee about your concerns, your proper concerns, that ultimately that could rebound on bill payers?

David Black: The question at the time of the hearing was about the ability to protect customers with the controls over dividends. In terms of what we knew, every year it provides its financial returns to us. It did that on 15 July, which was about the same time as I appeared at the Committee. At that time, I had not been through that information, so I was not aware of the source of that financing.

Q112 **Barry Gardiner:** Thames blindsided you?

David Black: No, it informed us as part of its financial statements, but at the time that we had the Committee hearing we had not been through that information in that detail.

Q113 **Barry Gardiner:** Was it just unfortunate timing?

David Black: The key question from an Ofwat perspective is: do we have the controls to protect customers' interests against dividends being paid to support the holding company debt? The answer is that we have now brought those controls in. That is the point that I was making to you.

Q114 **Barry Gardiner:** You know very well—and we have just heard it, as you have, you have been watching it, from the chairman, from the acting chief executives—that if you do exercise those controls, the shit really does hit the river.

David Black: That is a question for Kemble Water.

Q115 **Barry Gardiner:** No, it is not. It is a question for you because you have an obligation to the bill payer. Ultimately, it is the bill payer who is going to be the one who suffers here. It is the customer, isn't it?

Iain Coucher: Can I say a few words? I am not sure if this is going to address your point. We were satisfied, when we spoke about the injection of equity, much-needed equity into Thames in the summer; it needed those funds to continue to support its business. We saw equity coming in and we gave you an assurance that that was happening.

We have controls—subject to the point that I know you are going to raise immediately after this—about whether funds can be released from the operating company to pay dividends. We will only allow dividends to be paid if it is in the best interest of consumers and it meets other obligations. You can get money in, and we look after consumers' interests by only allowing dividends to be repaid to support their businesses as and when the business can afford to do it. That is the assurance that we can give you.

Q116 **Barry Gardiner:** Mr Coucher, they have got you be the short and curlies, haven't they?

Iain Coucher: No.

Q117 **Barry Gardiner:** They have absolutely got you because you know that you are in a Catch-22 situation. If you do what your job is, to protect the environmental quality, to make sure that you protect the bill payer, and you impose those fines on them for dispersing that £37.5 million, the result of that, that 10% that you can levy against it, the fine that you can levy against it, that sends a direct message to its shareholders, "Don't put any more money into this company, it's going down the pan". That is why you are impotent in this, isn't it?

Iain Coucher: No, I do not accept that characterisation; no, I don't.

Q118 **Barry Gardiner:** Why is it that the chairman did? Why is it that the chairman was very clear that what you can do is a threat to the holding company and, therefore, a threat to the whole operation?

Iain Coucher: Because the way that it works is that they have to demonstrate to us that the payment of dividends—because the whole construct, whether it is debts and equity payments, relies on institution investors putting up billions of pounds to fund the business going forward so we need to allow dividend streams to go to companies. We will do so as long as we are satisfied that the company can afford to make those payments and that it is in the best interest of customers. That is the protection that we have. We have to allow dividends otherwise you will not get money in the first place.

Q119 **Barry Gardiner:** That is right, you have to allow it. You have no option because you know that in this situation if you put the screws on them, if you come back and say, "Hang on, you haven't met your environmental targets. You haven't met your key performance indicators. The people of Camberwell are not terribly happy with you either", what is going to happen is that you are going to choke off the investment that this company needs if it is able to turn itself around.

David Black: I do not think that that is correct, because you also heard the chair of Thames saying that it has £190 million due at Kemble in March/April next year and it is going to extend.

Q120 **Barry Gardiner:** It is going to extend. How long can it go on doing that?

David Black: That is a question for Kemble Water.

Barry Gardiner: It is a risk that you will have to take.

David Black: Sure, and we deal with the risks that companies take; it is privatisation. It has always been clear that the company might fall into special administration. We have had parent companies of water companies fail before—Enron owned Wessex Water back in 2000 and that transferred into other hands without any issue from a customer perspective.

You are absolutely right that parent companies may fail, and parent companies have failed in the past. We have yet to see a water company itself, the appointed business, fail but that remains a possibility. We have a protection regime for that. We are not saying that it is an ideal position to be in as a regulator, but if we have to take steps that does lead to the failure of the parent company, we are prepared to do so.

I understand the point that the chair of Thames Water and the chair of Kemble are making. That is their concern. What we will do as a regulator is regulate in the best interests of customers.

Q121 **Barry Gardiner:** There are two best interests of customers, aren't there? One is that here is a continuing water company to go on supplying it with water and sewage—

David Black: That will happen regardless of the regulator.

Barry Gardiner: —and the other is that it gets a decent service in doing so.

David Black: In terms of the continued service that is provided for, as you say, by the special administration regime. That backstop is built into the legislation, and it is for all water companies so that is there.

Q122 **Barry Gardiner:** Slightly at a tangent here, you will have heard the conversation that I had with Mr Cochran about the £560 million, the special clauses that were put in 2018 and 2019 into those four notes. Is it your understanding—as he said to this Committee—that those clauses were ineffective and would not entail the repayment of those funds?

David Black: I am sorry, I am not aware of those clauses and how they work, so I would have to come back to you.

Q123 **Barry Gardiner:** Given that you are saying that you have contingency plans in place and that this would relate to £560 million, given that contingency, can I ask you to make that investigation and to write back to this Committee as to whether you believe that Mr Cochran is correct in saying, "It wouldn't make any difference. We just drafted them badly"?

David Black: Yes, we can look into that.

Q124 **Barry Gardiner:** You agree that, in taking the £50 million injection, Thames Water was placed in a better financial position in terms of its liquidity. Do you also agree that it implied a new financial burden on Thames Water because ultimately the only place that that debt in the holding company could be repaid from was from bill payers in Thames Water?

David Black: No, I would not accept that as a characterisation.

Q125 **Barry Gardiner:** What characterisation would you give it?

David Black: As Thames Water has explained, it is equity in terms of equity injection into Thames Water Limited. That is where bill payers' interests are. As I say, we have introduced the new powers that we have taken, in terms of the control of dividend payment from Thames Water, that allow us to protect customers if Thames were to make payments out to support that debt. However, you have also heard it explain that it is not going to try to fund that from Thames Water customers.

Q126 **Barry Gardiner:** It has treated that in what it said. It said that that can be rolled up and paid up at a later date, hasn't it?

David Black: That is what it has said, yes.

Q127 **Barry Gardiner:** That would suggest that it is not debt but equity. It is straddling two horses in that one and we will see, when it writes to us, about the tax treatment of that note. However, you would agree that the only place that the holding company can go to get the money to pay off the debt that it has—if it cannot raise any more from shareholders—is Thames Water?

David Black: I agree that it has made that investment, with the view that ultimately it will turn around Thames Water and that there will be returns from that. Either it can sell the business, or it can ultimately obtain returns on the business over time. Every investor invests in a water company with that same purpose, so that is not novel.

Q128 **Dr Neil Hudson:** We have covered a little bit of this, but I will fire through it. You are currently investigating Thames Water over a £37.5 million dividend paid to shareholders in October. Can you explain what your concerns are, and what will determine the size of the fine you issue if it is found to be in breach of its licensing conditions?

David Black: Where we are at with the dividend payment is that Thames has informed us that it has paid the dividend. It has raised concerns for us. It supplied information to us to justify the payment. We were not satisfied with that explanation, so we have now written to it under formal powers, asking a number of questions. It is shortly due to respond to us. We will consider its answers and then decide whether we wish to open and enforcement case or whether we are taking other forms of action.

Q129 **Dr Neil Hudson:** In follow up to Barry's questions, it has now been announced that the cap on fines is going to be unlimited if water companies breach their environmental guidelines. Given your responsibility for securing the long-term resilience of these companies—touching on what we have talked about—how do you balance that in terms of imposing a large fine and the long-term viability of these companies? We have touched on this, but this is going to have to be a judgment call moving forward, isn't it?

David Black: Just to be clear, we do not have limited powers to fine companies. That is a power that the Government have given the Environment Agency. We have power to impose large fines, with up to 10% of a company's relevant turnover.

Q130 **Dr Neil Hudson:** Your regulatory role would be involved in the assessment of what is going on. You work very clearly with the EA on lots of these issues, don't you?

David Black: Yes, but the EA's decision about fining will be for the EA. Similarly, in this case of the dividends, or we have disclosed that we have other enforcement action against Thames Water, we will reach a view about what we think is the appropriate fine on that basis and on the basis of the issues in front of us. We have set out our guidance in terms of how we set fines and we do not consider the financial resilience of the company as part of that. We will set something that we think is proportionate to the issues involved.

Q131 **Dr Neil Hudson:** How confident are you that your new powers to investigate dividend payments will have a positive effect and impact on the water industry?

David Black: This has been quite contentious from an investor perspective. There was considerable resistance to Ofwat introducing these powers, and investors are rightly concerned that this will constrain the flow of dividends from water companies. However, where there is common ground, as both investors and Ofwat would agree, dividends should be linked to performance.

Our view, and it is a view that we have had for some time, is that dividend payments should be linked to the performance for customers and the environment. Companies that perform well we would expect to pay dividends. These are capital-intensive businesses and investors invest in these companies with the expectation of a dividend. The payment of a dividend in itself is a problem, we think, where the issue arises where companies are paying dividends and where the performance does not justify that.

What is more, what we are trying to do is to get a change in the way that companies—the ultimate decision maker in this is company boards and we want them to be able to explain clearly to the public why they are paying the dividend, how that relates to their performance. We think that that will help the reputation of the sector. Companies ought to be able to explain to their customers their sources of financing and their dividend payments. If they have not acted responsibly, we have the ability to step into that.

Q132 **Dr Neil Hudson:** In your earlier answer you talked about the delineation between your responsibilities and the Environment Agency. You saw our previous line of questioning with Thames Water on some of the environmental issues going on with potentially Thames. There is an ongoing investigation that I am sure you will not be able to comment on, but previous breaches as well.

Obviously, you are the regulator, and the Environment Agency is the enforcer monitoring that side of things. However, you must work very closely together on that. As the regulator, do you have concerns about the court case that I described in the previous panel, where the judge had said that there was an attempt to mislead the enforcer, the Environment Agency?

We also have recent investigations by BBC "Panorama" about United Utilities and what has gone on in the north-west of England, including Lake Windermere, where potentially that water company has wrongly downgraded dozens of pollution incidents so that the Environment Agency did not have it on its radar and come in and investigate. I am sure that you are going to say that a lot of that is the Environment Agency's bag, but as the regulator you must be concerned about the performance of water companies. When we have this background and culture of water companies doing some of these practices, do you have concerns about that?

David Black: There are two issues that you raise. One is about companies' environmental performance and the other is about their reporting on environmental performance. To deal with the first, we have been very open that we have six live major enforcement cases against wastewater companies. That relates to their functions in terms of their safe discharge and treatment of sewage. We have live major cases against companies, so we certainly have questions about their performance and their compliance with the law.

The Environment Agency has parallel investigations with all wastewater companies. It is fair to say that, as regulators, we and the Environment Agency are concerned, and our enforcement teams work closely together in that regard.

In terms of the reporting of data, it is very important that companies report accurately on their performance. The Environment Agency has a regime of self-monitoring with a check and challenge on companies, and there are some questions for the Environment Agency as to how effectively that is working and what changes might need to be made to those arrangements.

Where we find evidence that companies are misreporting, we take action. Our major case against Southern Water back in 2019 was to do with misreporting as well as the discharge of sewage when it ought not to have been. We do impose extremely high punishments on companies if they are found to be misrepresenting their position.

Looking to the future we also see the ability of technology to help in this space. There are more and more cases where better monitoring equipment is being rolled out into treatment works. We are also now monitoring all storm overflows. Therefore, there is much better data and that will enable better detection and monitoring of company behaviour.

Q133 **Chair:** You obviously have intense scrutiny of the dividends that may be paid by water companies and control those excesses. Do you ever look at some of the interest rates that might be paid? We were talking about a very large loan at 8%. That is quite a high interest rate for a company that does not have much competition in the water business or the sewage business, which should be rock solid. Have you concerns that some of the loans made from connected parties—that is people in the company anyway—are not being done for as good a value as they might be?

David Black: Generally we would not have a concern with that. The loan that they were talking about was related to Kemble rather than to Thames. However, Thames has raised money in the public markets in a competitive process and it has paid around 8.25% on that. We think that that reflects the current interest rates and the level of creditworthiness of the company. Across the board we observe that interest rates have increased.

We ensure that when we set the financing cost allowances for companies, customers are getting good value. We can look at a range of market benchmarks. For example, we look at all investment-grade debt and look at the cost of that debt when we set cost allowances. We do not just pass through what companies pay. We look at what the efficient costs of debt are, and we set an allowance to companies that reflects our view about that. That may be less than what they are paying as well.

The twofold answer to your question is: first, I do not have particular concerns about what I have heard about the level of interest that is being paid but we do protect customers' interests by making sure that they pay the efficient costs of financing, not just what the company may have paid in that case.

Q134 **Chair:** Thames was very clear to make clear that all the information about what goes on in Kemble, the various bits of Kemble, are made available to you. Are you satisfied that you do not need more powers—Iain is smiling there—to scrutinise what is going on? Does it just tell you what it wants you to know, or do you think that it would be helpful for you as a regulator to be able to look at some of these holding companies in more detail?

David Black: We do have powers to gather information. The concern is twofold. First, is there enough transparency around these financial structures? These are public utilities, so we think that it is absolutely right that their financing should be transparent and should be available for people to access. We also note that it is complex and difficult to understand. Therefore, we think that companies have a responsibility to be able to explain that to customers and all stakeholders as well as to us as a regulator. We think that transparency around that information is vital.

Q135 **Barry Gardiner:** Kemble is just a shell company that is a vehicle for accruing debt that, if it were accrued in Thames Water, you would be jumping all over it. How can you say that you only look at the regulated company and you do not have a view on what goes on above? Of course, you must have a view on what goes on above. This is the way that they get around you. Yet you are sitting there as if, "We've just got to do our job. Parliament has set us these limits to look at".

David Black: I do not think that you are characterising our position correctly, with respect, Mr Gardiner. Clearly, we have powers to regulate the appointed companies. That is the focus of our regulation. You are absolutely right that we need to look further than that, and we do. Our concern is to make sure that these structures do not result in decisions by the board of the appointed company to pay out payments when it ought not to. That is why we have brought the new provisions in. When companies are entering into these arrangements, if they are entering these arrangements, we make our position very clear so that both debt and equity investors in these companies know what the rules are.

You are right that these arrangements are complex and difficult to understand and there are questions about the value that is being driven from them. You are correct that they may pose risks to the business, which is why we have set the regulatory arrangements that we have in place. We agree that there are issues there; it is just in terms of how you regulate it.

The question that I would put back is that, yes, you could start regulating Kemble, but what if the owners in Kemble set another holding company up above it? You can carry on with that game. The question is: is customer money in Thames Water being protected? That is what our focus is. If we think that we need more powers in that space, we will make those changes. However, at this point in time we would like to operate and to bring into effect the new regime that has now been passed on to us.

Q136 **Barry Gardiner:** On the point of agreement, do you agree that Kemble is simply a vehicle to accrue debt into the group that it can then transmit as equity to the holding company?

David Black: Kemble is the investment vehicle for the collective owners of Thames. There are a number of owners—I think eight—of Thames. It is their investment vehicle, and it has accrued debt, yes, but there is also equity in that business.

Iain Coucher: Could I add one thing? I do not want you to leave here thinking that we do not care about it. We absolutely do care about it. We observe what is going on. We raise questions. We challenge. To David's point, we want to be assured that we are protecting the interests of customers. There are aspects of this that do sometimes trouble us, so key for us is transparency and openness more than necessarily controls.

However, as David also said, if we felt like there are avenues that we needed to close off because of those structures, we would seek additional power to do so. However, at this point in time you are right that we do observe it. It is sometimes made a little bit more complicated for those owning companies that have other businesses wrapped in there as well, but for Kemble it is a stack. However, as Sir Adrian said before, these stack things are not uncommon in shared infrastructure companies, but we challenge those.

Chair: Thanks Barry. Did you spot we have a good cop, bad cop going on between me and Barry? I will let you decide which one is which.

Q137 **Cat Smith:** You say that you are interested in protecting customers, but certainly Thames Water customers are absolutely raging about this proposal to increase their bills by 40%. The business plan has been submitted to you requesting that 40% increase in bills. Given everything that you know and everything that we have heard today, do you think that that is acceptable? Is it acceptable for a company like Thames Water—with its financial arrangements as murky as they are—to be asking for this?

David Black: Like all other companies, Thames has submitted business plans. All companies have proposed bill increases, all of them at quite a significant level. We are talking about levels of potentially £170 per customer over a five-year period. What has driven the bill increases, though, is not the financing of the company; it is the need to increase investment, particularly to protect the environment and to improve service.

You are absolutely right that we will be scrutinising and challenging Thames's plan. We will be examining whether it is efficient, looking at its ability to deliver the performance that customers expect and looking to set appropriate allowances for both costs and returns to ensure that customers are paying no more than they need to.

That amount of money might be more than last period, and all pointers are that it will be. However, customers will be paying for the efficient cost of service. Society quite rightly has decided that we need to see improvements in the environmental performance of companies. That will cost money and that is regardless of how it is funded.

This is talking about real investments in sewage treatment works, building new water reservoirs and replacing water mains if that is what is required. The question is: are customers getting value for money? There is a second question about the affordability of that and how companies help customers who are struggling to pay. Again, that is part of the challenge that we will be running over these plans.

Q138 **Cat Smith:** I would be interested to know if you think that Thames Water customers are getting value for money. I want to pick you up on the fact that many of the 15 million Thames customers are being squeezed in all directions—rents, mortgages going up, energy bills going up and then the idea that water rates are also going up. The reality is that people are struggling to feed their families, they are struggling to keep a roof over their heads, and we are seeing increasing homelessness. In a cost of living crisis, how can it be justifiable to see water rates for Thames Water customers increasing by up to 40%? Surely it is not.

David Black: I certainly agree that customers are facing real cost of living challenges. We strongly agree with that point, and we have been examining the support that companies provide for their customers. We have been particularly looking at their fair payment terms and looking at what they can do to help customers.

At the same time, the requirements are set in terms of improving the environment. There are a number of statutory environmental plans. The forecast investment in the collective water industry national environment programme is moving from about £5 billion in the current programme to £25 billion.

If there is to be that increase in scale in environmental investment, ultimately those costs will be recovered from customers. They may be paid for upfront by investors, in terms of they are protected from paying for upfront capital costs, but ultimately, if we want better service, there is a price to be paid. The question about the balance for that is something that we are carefully considering.

Equally, there are special administrations about how companies help those customers who heed to pay. Companies have social tariffs at the moment that are proving support of hundreds of thousands of customers. There is a question of whether more needs to be done and how that help can be provided. Then there are questions about how companies help or deal with customers who are struggling to pay their bills and the assistance that they offer to those customers.

We think that companies need to go much further in making that support known to customers. People need to know that help is available. If anyone is struggling to pay their bill, please speak to their water company about it. They are all able to help their customers.

Q139 **Cat Smith:** It sounds to me like it is a case of going to the customers with a begging bowl now, during a cost of living crisis, to try to fix problems that could have been fixed while the sun was shining, so to speak, a few years ago, when a lot of these water companies were creaming off quite a lot of profits.

It has been reported that the investment that has been detailed in the business plan is contingent on you accepting that increase. Do you recognise the risk that that poses? Does it put you under pressure to agree to Thames Water's demand? To quote my colleague Mr Gardiner, has Thames Water got you by the short and curlies?

David Black: All companies submit business plans to us. They set out what they would like. They may have views about the preferred returns they would like to see. They will have views about what they think the efficient costs are and about the service targets that they think they can meet. We consider those plans, but we also consider customer views. For example, we have been going through a process of independently chaired customer sessions. I have sat in on a number of sessions with water company customers to hear their views about company plans as well. That is part of our determination process.

We will be looking at all of these questions to reach a view and we will publish our draft decisions in June next year. There will be opportunities for the public to consult and engage on that, and then we will move to a final decision later in the year. The companies themselves have the ability to refer these decisions to the Competition and Markets Authority if they do not like our decisions. That happened at the last price review as well.

We will do our best to reach our views about what efficient costs are, what efficient returns look like, and we will set those returns to deliver services to customers. However, it is very clear from the environmental plans that a substantial increase in investment is required, which will unfortunately have an impact on customer bills.

Cat Smith: The customers are always left picking up the tab, aren't they?

Q140 **Chair:** We have not talked about business users. I live in the Yorkshire water area, but I buy my water from a Scottish company. Are you content that we are getting a bit more competition in the water market and is that working? Is that something that water companies like Thames are resisting or will we have a bit more of a market in water in the same way that we have in energy and other utilities?

David Black: Yes, you are right. The business retail market—that is the retail service for business customers for water—has been open to competition since 2017. It is reasonable to say that water companies are not resisting competition. A number of companies that are incumbents have exited from the business, including Thames Water. None the less, we think that results from the competitive market process have been mixed to date.

We certainly see some benefits for competition, particularly for larger customers and customers with branches across the country, but for smaller business customers we have seen very little competition yet in that space and we still have price controls in that space to protect those customers' interests.

We have also not seen a great deal of innovation in areas like water efficiency where we would hope to do so. We are working with retailers and wholesalers to see what we can do to improve outcomes in that market. That is something that remains under consideration.

Q141 **Ian Byrne:** I want to read out something within the brief. "Kemble Water Holdings loaned this £500 million to Kemble Water Eurobond who purchased £480 million of shares in Kemble Water Finance and also settled monies owed to Kemble Water Finance, bringing the total sums received by Kemble Water Finance to £500 million. Kemble Water Finance purchased £500 million of shares in Thames Water Limited and Thames Water Limited purchased £500 million of shares in Thames Water Utilities Holdings. This is how the funds were received". You are categorically saying that was equity.

Nick Hood, a corporate restructuring adviser at Opus Business Advisory Group, categorically said that was a loan shown in the accounts. Kate Bayliss was a little bit stronger, a water expert at the University of

London. She said that it is absolutely "outrageous that both Thames Water and Ofwat led us to believe that the company was getting £500 million of new equity investment when it was in fact just a loan".

Are you completely confident in your facts and where you are at the moment with all these extremely dubious practices? Because that is what it looks like. You have the confidence of the public who are hinged on your ability to ensure that they are getting value for money. What we have heard this afternoon has been terrifying because this is not just Thames Water, this is the entire industry.

David Black: We have traversed the question in terms of it is equity—

Ian Byrne: Are you happy that it is equity?

David Black: It is a debt or a debt-type instrument at the holding company level, so we are happy with that characterisation. In terms of the rest of the sector's financing, it would be wrong to describe Thames as representative of the sector. We have clearly identified it as an outlier as in it has the highest level of gearing in the sector.

Q142 **Ian Byrne:** It was said in the last evidence session that it was very much the model.

David Black: It was referring to structures, but its level of gearing is higher than other companies and its operational performance is poorer, so it has a greater challenge. There are other companies. It is certainly true to say that it is not unique in its position. We have identified three other companies where we have concerns about their financial resilience. There are a number of different structures in the sector. They range from listed companies, we have a not-for-dividend company in Wales, and so there are a range of structures in the sector.

Q143 **Ian Byrne:** I will talk about that in a minute. Generally, the worry is that Ofwat is about as useless as a chocolate fireguard in the face of these huge companies and the complexity of how they are structured. The people who are going to be paying the penalty here are the people who pay the bills and also—as we have heard from Mr Gardiner—the redundancies that are coming down the line; we have people being made redundant. It is extremely worrying. In a perfect world what do you need to get these under control, to change that culture, to change the entire model, because it is obviously failing?

David Black: You characterise a range of issues. We would agree that the sector needs to improve its performance and we also agree that the finances of the sector are not in the shape that they ought to be, so companies like Thames—and we have talked about issues at Southern Water in the past as well—need to address those issues. We think that putting the public interest first needs to become much clearer in the way that companies are acting. We think that they have not met public expectations and that is very clear.

None the less, companies are in different positions. We see Thames with a set of issues, and we do see other companies that have been able to turn themselves around. We see companies that have been able to improve their performance. There are issues in companies that are run in very different ways. For example, I have been in front of Select Committees recently in terms of performance of Dŵr Cymru Welsh Water.

You cannot draw a simple line to say that we have highly geared private equity owned companies that are causing these problems. What we need to see is a much stronger focus on the public interest at the heart of these companies. We need to see them modernise.

Q144 **Ian Byrne:** A change of culture?

David Black: Yes.

Q145 **Ian Byrne:** Can Ofwat drive that?

David Black: We can be part of that, and we are changing the way that we regulate. We are taking a much more proactive role. We are putting much more pressure on companies that are performing poorly and we are intervening in the financing of the companies, as we have just explained.

Q146 **Ian Byrne:** Surely you are at the forefront of this, because if you do not do it, who will?

David Black: I agree that we have a key role to play, along with the Environment Agency.

Q147 **Ian Byrne:** An absolutely fundamental role to play. You do not think that they will do it themselves, looking at the past history of what we have seen over the last 25 or 30 years.

I want to touch on what assessment you have made of the financial viability of Kemble Water. We spoke in the last evidence session about if Kemble goes the impact of its failure on Thames Water and what plans are in place to deal with that eventuality. You have touched on the SAR; that is nationalisation, isn't it? Is this being considered and prepared for by Ofwat?

David Black: We think that it is prudent to prepare for any company in terms of privatisation. The SAR, the special administration regime, was set up as a way to ensure that the service keeps being provided to customers even if a water company was to fail. Fortunately, in the 30 years since privatisation, we have not had to use that provision, but we have had situations where parent companies have failed. That has happened.

Q148 **Ian Byrne:** This could mean the water company failing.

David Black: If it was Kemble Water that would be the holding company.

Q149 **Ian Byrne:** If that fails, Thames Water would be intact. It will not go under with it?

David Black: it will be a question for Thames Water in terms of finding new investors. That would be the challenge for Thames Water, and I would not underestimate that challenge. That is significant.

Q150 **Ian Byrne:** Therefore, we are preparing ourselves in case the model does fail.

David Black: It is absolutely prudent that we—

Ian Byrne: Iain is nodding away.

David Black: We will be seeking to be ready. It is not just a question for Ofwat, though, because there is a Government role in this. Formally we do not have powers to put a company into special administration. That power sits with the Secretary of State. We can advise the Secretary of State.

Ian Byrne: Of his available options.

David Black: As I said, that is a decision for the Secretary of State. That power is there, and it is a backstop provision.

You say it is nationalisation. I want to be clear that what happens is a special administrator is appointed. That administrator runs the business and then seeks to sell it to a new owner. It is not quite the same.

Q151 **Ian Byrne:** Who does the administrator answer to?

David Black: As I say, the administrator is appointed by the Secretary of State, but they are looking to sell that business to a further party. In that sense it does not look like nationalisation, but you can obviously describe it as you prefer.

Q152 **Ian Byrne:** I want to touch on what I touched on before on the capitalisation of interests by Thames. What is your opinion on that capitalisation interest and how it looks on the accounts? Does Ofwat have a view on the utilisation of that process?

David Black: Our view is more about the broader financial resilience of Thames. We are very clear, and we produce a report every year where we set out our views about the financial resilience of Thames. We think that it is not where it ought to be, and that action needs to be taken. That is a view that is shared by the company itself.

Q153 **Ian Byrne:** Can the capitalisation process inflate the profits?

David Black: I have not looked in detail at the ranges that you are referring to. It is more about saying that the finances of Thames has a—

Q154 **Ian Byrne:** It looks like £140 million in the last two years. Do you need to be looking at these things and seeing it from a balance sheet point of view?

David Black: We do examine the finances of Thames Water, as I say, and we do produce a view on that every year, and we disclose that view.

Q155 **Ian Byrne:** How confident are you that Kemble Water and its shareholders, any shareholders, have the best interests of Thames Water and its customers at heart? Do you have confidence in that?

David Black: That is part of the reason why we are here as a regulator. Hopefully its model is to serve customers' interests well. That will increase its returns and therefore allow it to profit from that. That is the way that we design our regulatory regime so that good performance gets rewarded with better returns and poor performance gets recognised with poor returns.

As Thames noted in the previous session, the ultimate shareholders of the company have not seen any dividends for six years. Returns for these companies have been negative to very low numbers. Returns for the sector as a whole are around 3% for the last three years.

Q156 **Chair:** They have had 8% on the money that they have lent, though, haven't they, which is not a bad rate of return?

Barry Gardiner: Not yet, because it is deferrable.

David Black: They have not realised those returns as yet. I am talking about returns to equity holders that are around 3% in the current period to date. It is important to keep that perspective in mind. There is a lot of finance required for the sector. The capital base is worth close to £100 billion now.

Q157 **Ian Byrne:** To be fair, Macquarie did very well out of it, didn't it?

David Black: Macquarie did do well out of it, yes.

Q158 **Chair:** To be clear, if a water company did fail, it would be the shareholders who would be carrying the can, not the UK taxpayer, is that correct?

David Black: The special administration regime is designed to protect the interests of customers. That brings in a special administrator who is appointed to run the company and to sell that business. There would be a question for how that business would be financed in the period that it was in special administration. It is difficult to speculate about what might be required in any particular instance in the water sector.

Q159 **Chair:** However, a company could be quite an attractive proposition for a new investor, given that the debt had been written off.

David Black: Indeed. There is a £20 billion business here in Thames Water. It is a question of turning around the operational performance and addressing the finances of the company.

Q160 **Chair:** One final point. Do you have much discussion about how to deal with greywater? We often take for granted the quality of drinking water in this country, but we use most of it to flush our toilets. Obviously from a water company perspective they do not want people to harvest their own water free and then flush the toilets and get free sewage treatment as well. Is it something that we should be doing more in terms of improving the environmental performance of the sector, to take more of the water from our baths and washing machines and roofs and use that rather than build more reservoirs?

David Black: Certainly increased use of greywater is an option. If we can make better use of water—water is precious, it is scarce, particularly in the east of England and the south-east of England.

Q161 **Chair:** Not at the moment it isn't.

David Black: Unfortunately not. Yes, we need to make better use of water. Water companies themselves are not standing in the way of reuse of greywater. It is about making the means available to customers to be able to do that. Everything is plumbed and configured in a way that often makes that quite difficult, but it is an area that for new homes needs greater consideration and it is a way of saving water.

Chair: I was going to say that was the last one, but Barry wants to come in.

Q162 **Barry Gardiner:** Would you agree that the way in which Macquarie extracted money from the company is the reason the company is now in the situation it is, to a large extent? Can you remind us of who was in your position as the head of Ofwat when Macquarie was doing that?

David Black: First, on Macquarie, it is very easy to blame Macquarie and say that it caused the problems at Thames. It is true to say that Macquarie earned very high dividends out of Thames.

Q163 **Barry Gardiner:** Remind us in terms of billions?

Chair: It was £891 million in 1999, which seems quite a lot of money to me.

Barry Gardiner: In 1999 alone.

David Black: That would have been before Macquarie owned Thames Water. It bought Thames Water in 2007, if I have that right.

Q164 **Barry Gardiner:** It was billions, and it structured the company in such a way.

David Black: I am not disputing that. I am saying that Macquarie exited Thames Water in 2017. It is 2023, so I am not sure that we can just blame everything that is going on in Thames Water on the decisions made by Macquarie.

Q165 **Barry Gardiner:** The legacy that it left was a poor one. Was it not the current interim CEO at Thames Water who was previously in your position as chief executive of Ofwat?

David Black: Yes, she was chief executive of Ofwat. I would have to check the dates, but it was something like 2013 to 2017, yes, and Macquarie owned Thames from about 2007 to about 2016. Therefore, for part of that period but certainly for the early part of the period she was not.

Q166 **Barry Gardiner:** It is strange that somebody who allowed that to happen, as the chief executive of Ofwat, then went on to become the chief executive of Thames Water itself. I have one question for you. Do you have any future plans, when you leave Ofwat, to go off and become the chief executive of a regulated water company?

David Black: No, is the short answer.

Barry Gardiner: Not at this stage.

David Black: It was very unusual in the situation. Cathryn was interim co-chief executive. She was appointed at Thames as a regulation director.

Q167 **Chair:** There is quite a list of senior Ofwat people who have ended up in nice jobs in water companies.

David Black: I would dispute that. One or two people a year have left Ofwat over a decade who have worked in water companies. Any suggestion that there are a lot of people leaving Ofwat to work in water companies is not borne out by the facts.

Chair: We will draw stumps there. Thank you very much indeed for coming in and giving us the benefit of your experience.