Water companies' profits and investment

The £116 billions of investment that water companies have invested in water and sewerage services in the past 25 years have led to a wide range of benefits for the UK, including having the best quality drinking water in the world and rivers and beaches that are now cleaner than ever before.

To achieve all this, water companies have to maintain and replace water and sewerage assets and infrastructure with massive ongoing investment. To put this scale of investment in context, water companies invest around £5 billion per year – this is about half the turnover of the industry, a far higher proportion than any other sector.

If all investment came directly from customers' bills, water bills would a third higher than they are now and would also fluctuate more year on year.

Instead, water companies seek funding from financial investors, to smooth the cost of investing in the future of our water and sewerage services over time.

But financial investors do not have to put their money into the water sector, so to persuade them to provide funding to companies, the companies need to provide them with a reasonable rate of return, to provide interest on debt and dividends to shareholders.

Because of this, the headline figures that are often reported for profits in the water sector only tell part of the story. It is these profits that provide the return to investors who are financing the massive ongoing investment in the future of our water and sewerage services.

In England and Wales, water companies' prices are set by Ofwat, the independent economic regulator, and this includes assessing what returns investors require for them to continue to invest in the sector. The stable and predictable framework for independent economic regulation of the water industry over the past 25 years has given investors confidence that they can provide funding on a long-term basis, at rates that keep bills affordable.

Ofwat last set price limits for water companies in 2009, and companies' post-tax returns are currently in line with limits set by the regulator, at on average around 5%.

Efficient services

As well as improvements in their services, water customers want value for money. New investments, whether they are mains, sewers, treatment works or monitoring systems, must provide years of trouble-free service. So long-term investment finance is essential and companies regularly obtain loans that are repaid over 30 or 40 years.

Water bills have risen in the past due to the scale of the work required and the need to recover from many years of underinvestment while water and sewerage services in England and Wales were in the public sector.

If these investment programmes had not been necessary, customers' bills would have fallen substantially due to the efficiency gains made by companies, to meet and then beat tough regulatory efficiency targets. These efficiency gains mean that – according to Ofwat – water bills are on average over £120 less than they would have been.

Profits and bills

Companies that win investors' confidence can obtain funds at competitive rates of interest.

A strong financial performance, including making steady profits, helps keep water bills down. This is because the large amount of capital invested in the companies over the years means that returns to investors account for a substantial share of company revenue – and if investors are confident about the long-term prospects for water companies, they will be happy to receive stable and predictable returns over the long term.

Investors also press companies' management teams to beat regulatory targets for getting more efficient, doing more for less and generating higher profits. Companies and investors can keep the benefits of this in the short term, but customers also benefit when Ofwat resets prices at the next price review – so extra profits today from companies outperforming targets result in lower bills for customers in the future.

Investment, profits and return on capital

The main advantage of the way investment is financed and regulated in the water sector is that benefits come more quickly and costs are lower than if companies used a 'pay-as-you-go' system, with investment being funded directly from customers' bills in the year it was needed.

The costs can be spread over a longer term, as it would be unrealistic and unfair to ask today's customers to foot the whole bill.

The investors who make this possible do so by buying water company bonds or shares through the debt or equity (share) markets. Often these are fund managers whose duty is to maximise returns on the savings and pensions of millions who live in the UK. Water companies are attractive because as long as they are efficient and successful, they make steady, reasonable-level profits and fill an important place in investment portfolios.

The scale of capital investment in the water sector has brought a big increase in the accumulated value of the assets companies own and manage on behalf of the public. Companies must reward this investment by paying dividends from their profits.

Because the investment in water companies is unusually large – much larger as a proportion of turnover than sectors like oil or pharmaceuticals, the profits needed to provide a return to investors are correspondingly large, but the actual return paid to investors is modest in percentage terms – only around 5% on average.

For further information, please contact Neil Dhot, Water UK Head of Corporate Affairs, at ndhot@water.org.uk or on 020 7344 1852.