

It's time we took water nationalisation seriously: it...

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There is much discussion on the subject of the nationalisation of our water companies right now, with a lot of what is being said by Labour and commentators being close to nonsense. This thread lays out why nationalisation is the right option now, is affordable, and so is right.....

First, I should lay out my credentials for saying what follows. I am a professor of accounting practice at Sheffield University Management School. More importantly, I have been a chartered accountant for forty years and I have bought and sold a lot of companies.

This matters because a lot of what is being said right now about the affordability of various options when it comes to our water companies and other utilities is based on political rhetoric and not very much at all on how nationalisation works and how it can be paid for.

The other necessary preamble to this thread is to note the thread I wrote last week. In this, I explained that the English water and sewage companies do, as a whole, look to be operating on the basis of exceptional financial assumptions that threaten their viability.

These water companies are monopolies. They make strong operating profit margins that have over twenty years averaged 38 pence in every pound paid to them. But, and this is the critical point, they have spent almost all that on their funding.

20p in every pound paid to them by us, the water consumer, has gone on interest charges, and another 15p has gone on dividends. The remaining 3p has gone on tax. There has never been profit left over to invest in the new equipment the industry needs.

The scale of the new investment that is required is massive. The government says it's £56 billion. The House of Lords says it is £260bn. Either way, the water companies can only raise this by charging more, borrowing more or getting the shareholders to finally

cough up more.

In fact, whatever happens, the shareholders are going to have to do that right now because these companies are losing money hand over fist at present, and that is going to continue. The loss after tax in 2022 was £2.7 billion. This might well get worse.

The worsening situation of these companies is down to their reckless use of index-linked bonds to finance their borrowing. Index-linked bonds guarantee that people lending to a company will get their money back having allowed for the impact of inflation when it is repaid.

The interest rate these bonds pay is usually quite low but people who buy them don't do so for the interest. They buy them because these bonds guarantee repayment of the original sum lent as adjusted for inflation, meaning that the value of the bond does not fall in real terms.

Let me offer a quick example. Suppose a bond is issued for £1 million with a 1% interest rate, and it is index linked. Assume inflation was nothing for 5 years. In those years the interest was £10,000 a year.

Then, though, inflation hits 10% all of a sudden. Now the cost of repaying the loan goes up by £100,000 in the year that happens. And interest is now paid on £1.1 million, the new repayment sum owing. So that year's interest costs £111,000. That's a massive increase.

If the inflation continues for a second year you can see how this might ruin the profitability of a company. If it moves into a third - as now seems possible in the UK - it could mean the end for a vulnerable company with a lot of these bonds.

UK water companies do have a lot of these bonds. Something like 65% of all their bond borrowing is index-linked. They thought they could afford this because a) inflation was not going to happen, and b) they thought they could pass the cost onto us, the customer.

But inflation has happened. And worse, their bonds seem to be linked to the retail price index, but the water regulator, Ofwat, uses the lower consumer price index. So first, they are bound to have losses and, second, we do not need to pay for all of them.

The result is that these companies might look weaker and weaker as time goes on: some of them, at least, do not have the balance sheets to absorb this scale of losses and still look like viable going concerns.

Why say all this? Because any discussion of nationalisation of the companies has to take into account the facts. And the fact is that the finances of some of these companies do not look good.

Not that you would know this from looking at the stock market performance of those amongst them that are quoted on those exchanges. They are Severn Trent, United Utilities and Pennon Group (South West Water).

These companies appear to be in rude stock market health. Take this example, of Severn Trent:



The price is down 10% in the last three months but still up significantly over time. And the current price is 44 times the earnings of the company, i.e. shareholders think it is worth paying 44 times the profit attributable to each share to buy it. They can only justify that by thinking the profit is going to rise.

United Utilities has a current share price suggesting shareholders value it at more than 30 times earnings. Pennon Group is valued at more than 90 times its earnings. Together these companies have a market value of about £14.9 billion right now.

Together these companies make up 36.1% of the English water industry in my estimation, based on weighted average assets, sales and employees. That implies that the sector as a whole in England is worth about £41bn.

On top of that the sector now has about £55bn in borrowing outstanding. So, that suggests that these companies have total funding that might require compensation if there was to be nationalisation of maybe £90bn or more.

However, I doubt this figure. First, these companies are losing money heavily and are desperate for funds for investment. So if the regulator gets heavy with them (as it should) then the shares in them are not worth anything like the sums stock markets are suggesting.

Second, if it becomes apparent that these companies are in trouble the debts that they owe will fall in market value to something well below the amount on the balance sheet. This is what happens in distressed companies.

So, how much are these companies really worth? It depends on a) how long inflation

lasts, as it is ruining them with excessive loan interest costs right now b) how long it is before the government acts before nationalising them and c) who blinks first.

The last is important. There is no precise science to company valuation (whatever the textbooks say). At the end of the day it comes down to who is the more desperate to do a deal. If the shareholders panic - and they might - then all the cards are with the government. And vice versa.

Either way, by the time anyone gets near to talking nationalisation of these companies their value will have fallen considerably, is my suggestion. Nationalisation is not going to cost £96bn, in my opinion.

But whatever happens, nationalisation need never have a cash cost. Let me repeat that in another way. It is complete nonsense to suggest that so-called taxpayers' money will ever be used to pay for nationalisation of the water companies.

How can I be so sure? Three reasons. First, I have looked at the nationalisation of industries like the railways in 1947. They too were run down, under-capitalised and in dire need of investment. How did the government pay for them? With bonds.

Technically those bonds used to pay for the industry were repaid thirty years later but actually they were simply replaced with replacement bonds, and so cash has never been paid for that nationalisation as yet.

I cannot stress this point enough. Just as most company takeovers are paid for by the issue of new shares in the acquiring company, so too can any nationalisation be paid for with the issue of government bonds, which then in effect stay in issue in perpetuity.

Cash needs play no part in a nationalisation in that case. What is open to debate is what the fair compensation for shareholders and maybe bondholders might be - because this has to be paid and has been in previous nationalisations.

I argue that the English water companies are now environmentally insolvent. They are surviving in business solely on the basis that they are being permitted to pollute and not pick up the cost. That's not a great business model.

If the government through Ofwat forced the real cost of solving this issue onto the water and sewage companies they would be insolvent, in my opinion. I happen to think that is what Ofwat should do. I also think that should be the basis of the negotiation of fair value.

I would also use that basis of valuation to argue for a write down in the value of debts in issue given that I doubt these companies could service many of those issues for much longer. But I stress, these are negotiations to be had.

The outcome of those negotiations might well change the total value of new bonds to

be issued, but not the cash to be paid, of which there will still be none.

So, the only cash cost to be paid is the cost of the interest on the new bonds issued to replace the bonds and share capital now in issue. Let's assume the total compensation package is £60 billion in a couple of years, by which time base interest rates will have fallen a lot.

Let's say the borrowing cost will be 4%. That's a cost of £2.4 billion per annum when the average interest and dividends paid by the companies over the last amount to £3.4bn a year. Even if £90bn compensation was paid (and that would be crazy, in my view) the cost would be £3.6bn.

In other words, this industry can pay for its own nationalisation out of its own cash flow. If it is realistically priced, there would be a significant margin to spare. So in that case to say this can't be afforded because of the cost to taxpayers is nonsense: there is none.

And in that case those politicians saying that this is not an option to consider are simply ignoring two facts. One is that nationalisation does not involve cash. The other is that the money the industry already pays to investors can pay for nationalisation.

So, might we stop the claims that nationalisation is not an option because of the cost of doing it? Nationalisation is not just an option, but at a fair market price it is a totally viable one.

But more than that, given that large-scale state investment in this industry is essential why should it be under the control of anyone but the state? Private ownership and discussions of mutual benefit companies make no sense. Now is the time for the N word to be rolled out.

And one final point, if any government says it could not afford the cost of investment to deliver us safe, pollution-free water after nationalisation then who do they think can? The market certainly could not do so.

So, any politician using this argument is actually saying that they think the state should abandon its duty to provide that most basic commodity, which is clean water. I think that should rule them out of office.

It really is time politicians stopped ducking this issue and started talking about what is possible and necessary. Only nationalisation meets that dual criteria, which is why it must be on the agenda.