Moody's
INVESTORS SERVICE

SECTOR IN-DEPTH
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Regulated Water Utilities – UK

Ofwat tightens the screws further

On 18 July, the Water Services Regulation Authority (Ofwat), the economic regulator for water and sewerage companies in England and Wales, published its draft determination for the five-year regulatory period beginning April 2020 (AMP7). Material differences between the companies and regulator remain and, if not resolved by final determinations in December, will be credit negative for the affected issuers.

- **Further cut in allowed returns will intensify pressure on companies' interest coverage ratios.** Ofwat based its draft determination on an allowed cash return of 2.69%, 21 basis points below the guidance it gave in December 2017. However, this was based on market data from February 2019. Ofwat says a further cut of 37 bps could have been justified based on more recent market data. The full cut of nearly 60 bps would mean cash returns 140 bps lower than in the 2015-20 period. As a result, the adjusted interest coverage of a company financed in line with the regulator's assumption would fall to 1.15x in the next period from 1.3x in the current period.

- **Most companies need to find material cost efficiencies.** There is still a large gap between companies' proposed spending and the regulator's view of efficient costs, most notably for Anglian Water Services Limited (Baa1 negative), Thames Water Utilities Limited (Baa1 negative) and Yorkshire Water Services Limited (Baa2 negative). To the extent that companies cannot reduce their costs to levels assumed by the regulator in the final determination, they will need to find other efficiency savings or suffer reduced cash flows to support their debt.

- **Financial incentives for operational performance skewed to the downside.** The potential range of financial incentives for companies' performance against targets has shifted toward penalties being imposed rather than rewards being paid. Given the additional tightening in performance commitments, we believe companies are unlikely to be able to achieve similar levels of rewards as in the current period.

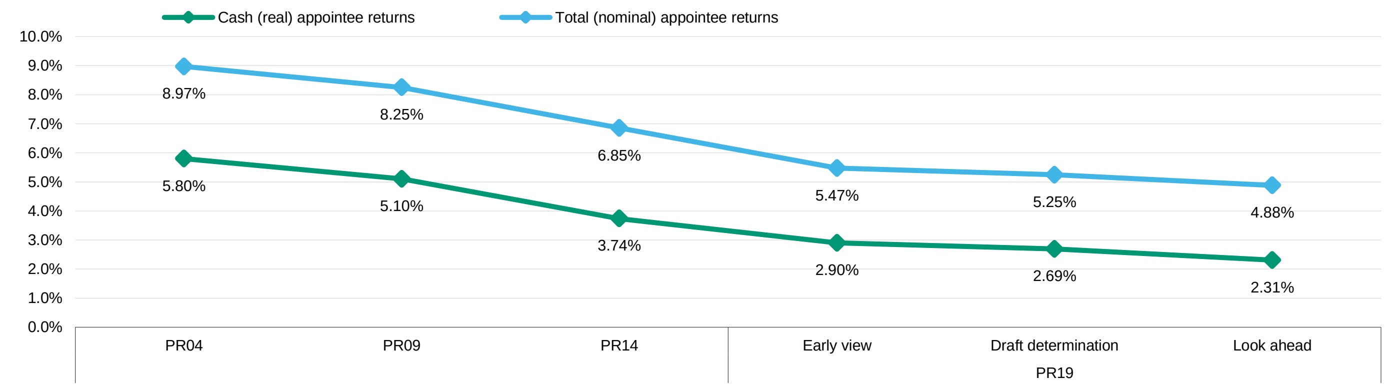
- **Indications of larger cuts in allowed returns lead to rising risk of referrals to the Competition and Markets Authority (CMA).** With Ofwat proposing larger cuts in allowed returns and large gaps between companies' plans and regulatory assumptions, the likelihood of CMA referrals is growing.

Further cut in allowed returns will intensify pressure on companies' interest coverage ratios

Ofwat based its draft determination on an allowed cash return of 2.69% (or 2.58%, excluding the retail margin), 21 bps below the "early view" guidance it gave in December 2017. The cash return on the wholesale business was cut by 22 bps, reflecting a change in the allowed retail margin. However, this figure was based on market data from February 2019. Ofwat noted that large market movements between February and June would support a further reduction of 37 bps. In total, this would translate into a roughly 140 bps cut in cash returns from the 3.74% (or 3.6% excluding the retail margin) allowed in the 2015-20 period (Exhibit 1).

Exhibit 1

Evolution of allowed appointee returns over time



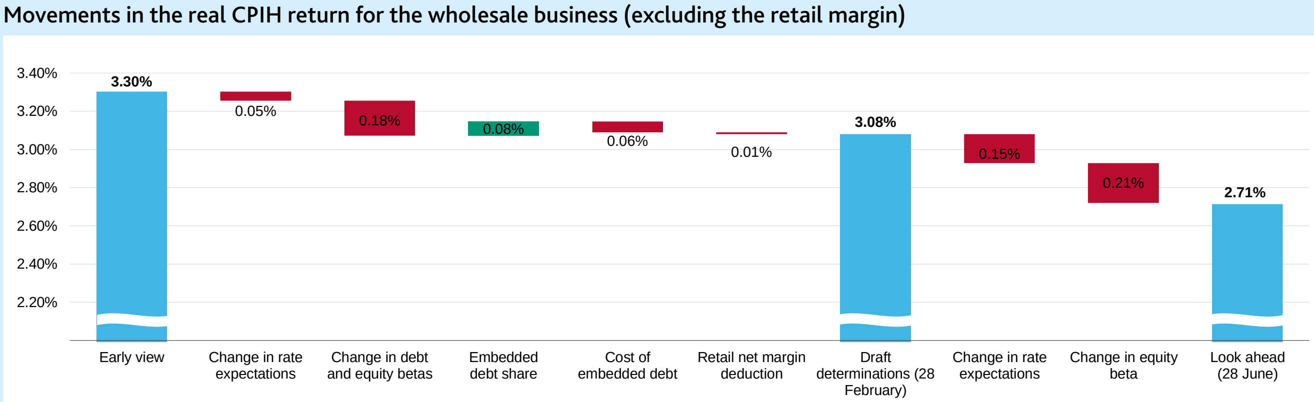
Note: Cash returns for PR19 reflect a 50:50 split of the RPI and CPIH returns at the start of the regulatory period. Actual cash returns will evolve slightly differently across companies depending on their RCV growth.
Source: Ofwat

The WACC – what has changed?

The lower returns reflect the regulator's updated views on the cost of equity, driven by the decline in risk-free rates and Ofwat's assessment of the sector's risk profile in comparison with the market (see Exhibit 2).

Exhibit 2

Movements in the real CPIH return for the wholesale business (excluding the retail margin)



Sources: Ofwat, Moody's Investors Service

Most of the 22 bps cut in the wholesale return came from a fall in Ofwat's estimate of the equity beta, a measure of the undiversifiable risk of investing in a water company. This change was *not* a result of lower observed equity betas for listed UK infrastructure companies, which have actually risen slightly since the early view, but an increase in the debt/capitalisation ratio because their share prices have fallen sharply. Ofwat and its economic advisers believe that because share prices fell without a corresponding movement in the market, equity investors must believe there is less systematic risk associated with investing in water companies and that they therefore require a lower return.

Ofwat also reduced its estimate for the cost of "embedded" debt already issued by the sector. While it has continued to reference the iBoxx A/BBB non-financial corporates index, it has now applied a 25 bps discount rather than the 15 bps in the early view. This reduction was largely offset by assuming that embedded debt will make up a larger share of debt outstanding over the period.

Ofwat has calculated that equity betas declined further between February and June, while interest rates also fell. On the basis of June market data, Ofwat's wholesale allowed return of 2.71% (2.83% including the retail margin) on a CPIH-stripped basis is below the 2.88% set in Ofgem's sector decision for the transmission and gas distribution companies, largely because of the lower equity beta. Ofgem's data was calculated as of March 2019 and will also be updated at final determinations in December 2019 (see Exhibit 3).

Exhibit 3

Lower cost of equity assumption drives the cut in returns

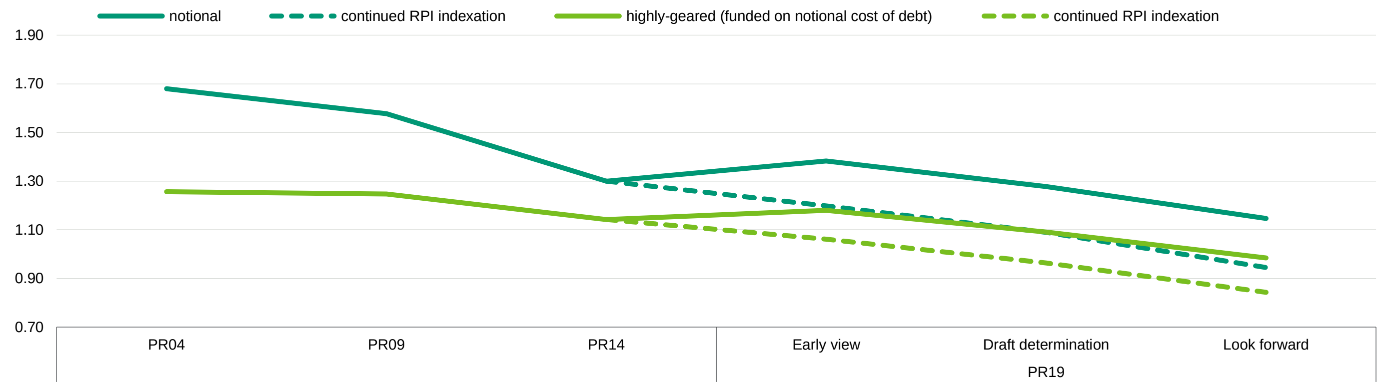
	Early view	Draft determination	Look ahead	Ofgem sector decision[1]
Calculation date	31/03/2017	28/02/2019	28/06/2019	29/03/2019
Gearing	60.0%	60.0%	60.0%	60.0%
Risk-free rate	0.10%	-0.45%	-0.99%	-0.75%
Total market return	6.47%	6.50%	6.50%	6.50%
Observed equity beta of peers[1,2]	0.63	0.64	0.58	0.63
Enterprise value gearing of peers[1,2]	49.3%	54.7%	54.7%	49.8%
Debt beta	0.100	0.125	0.125	0.125
Equity beta of the notional company	0.77	0.71	0.64	0.75
Ofgem adjustments				-0.39%
Allowed cost of equity	**5.03%**	**4.47%**	**3.79%**	**4.32%**
Embedded debt share of total debt	70%	80%	80%	
Cost of new debt	1.37%	1.33%	0.59%	
Cost of embedded debt	2.58%	2.46%	2.46%	
Issuance costs	0.10%	0.10%	0.10%	
Allowed cost of debt	**2.32%**	**2.33%**	**2.18%**	**1.93%**
Appointee allowed return	**3.40%**	**3.19%**	**2.83%**	**2.88%**
Retail net margin deduction	-0.10%	-0.11%	-0.11%	
Wholesale allowed return	**3.30%**	**3.08%**	**2.71%**	**2.88%**
Change from previous		*-0.22%*	*-0.37%*	

[1] Ofwat's peer group consists of Severn Trent and United Utilities. Ofgem's peer group consists of National Grid, Pennon, Severn Trent and United Utilities. [2] Observed equity beta in look-ahead is Moody's estimate consistent with the unlevered beta cited by Ofwat.
Sources: Ofwat, Moody's Investors Service estimates

Across the industry, with an RCV of just over £75 billion, a 22 bps cut in wholesale returns would reduce annual cash flow by around £165 million, while a 60 bps cut would reduce cash flow by around £450 million compared with the regulator's early view (not accounting for inflation and RCV growth over the period).

For a hypothetical "notional" company with 60% gearing, 33% of debt linked to inflation and average borrowing costs in line with the regulator's assumption, the full 60 bps cut would mean the adjusted interest coverage ratio (AICR) would fall to 1.15x in AMP7 from 1.3x in the current period. For a hypothetical highly-leveraged company with 80% gearing and 50% inflation-linked debt, the AICR would fall to 0.99x from 1.14x. This takes into account the change in Ofwat's measure of inflation from the retail prices index (RPI) to a blend of RPI and the consumer prices index including housing costs (CPIH), which softens the reduction in cash returns. As Exhibit 4 shows, the AICR would have fallen significantly further if RPI indexation had been maintained.

Exhibit 4
AICR of the notional company will be significantly weaker, leaving very little financial flexibility

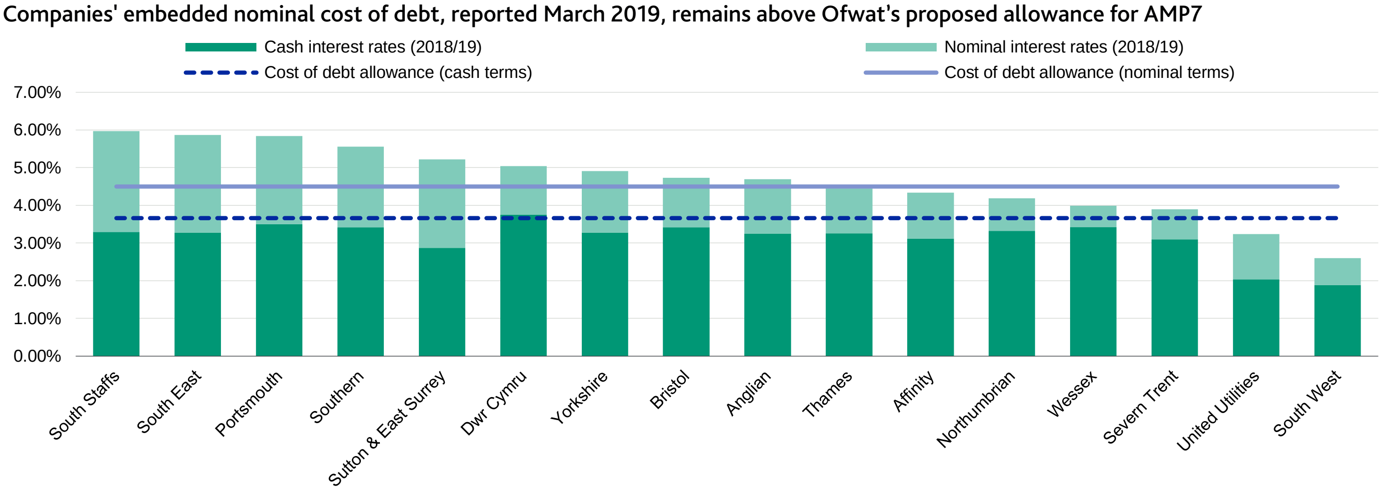


The dotted line indicates where the AICR would be on a like-for-like real RPI return basis. The shift to CPIH indexation for 50% of the March 2020 RCV as well as all new RCV additions will provide additional cash flows in comparison, but only at the expense of lower RCV growth over time. The notional company is being funded at the regulatory cost of capital; for PR19, where the cost of capital is based on a blended RPI-CPIH inflation, the above calculation assumes that the inflation-linked funding is raised in the same RPI-CPIH proportion
Source: Moody's Investors Service

While the partial switch to CPIH from RPI would have more or less offset the cut in allowed return in cash terms based on Ofwat's December 2017 guidance, this will no longer be the case at the updated indication.

As of March 2019, nine companies had a nominal embedded cost of debt above the regulator's proposed allowance (see Exhibit 5). Most of these companies are the smaller water only companies (WoCs), and only Portsmouth Water Limited (Baa1 negative) has been granted a 30 bps uplift on the overall cost of debt allowance. Among the larger water and sewerage companies (WaSCs), Southern Water Services Limited (funded through Southern Water Services (Finance) Limited, Baa2 review for downgrade) and Yorkshire Water will face greatest pressure due to the long tenor of their debt and swaps. Dwr Cymru Cyfyngedig (Welsh Water, A2 negative) is also an outlier, but benefits from low gearing and an ownership structure that does not require any distributions.

Exhibit 5
Companies' embedded nominal cost of debt, reported March 2019, remains above Ofwat's proposed allowance for AMP7

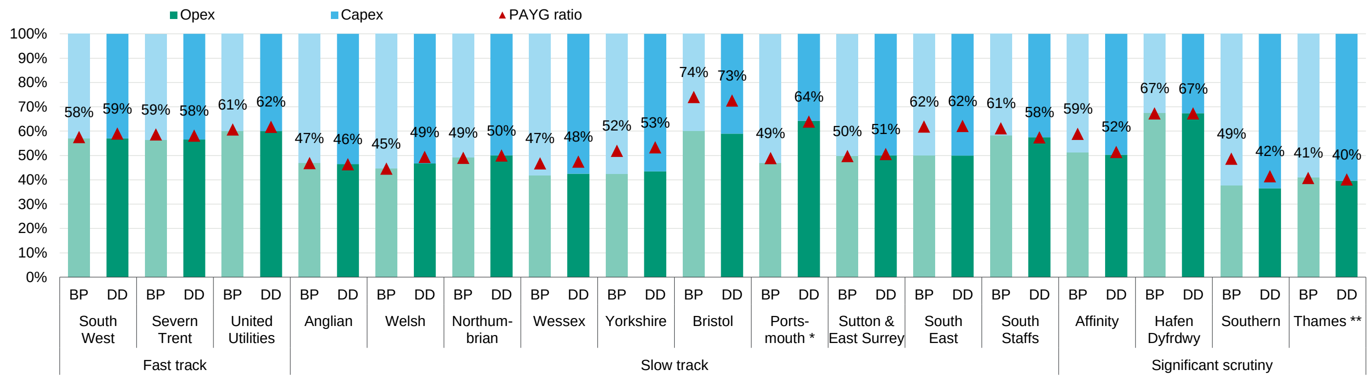


Cost of debt allowance for embedded debt as set out in Ofwat's draft determination for nominal cost of debt and assuming 33% of debt is inflation linked for cash cost of debt allowance, in line with the notional company assumptions.
Sources: Companies' annual performance reports as at March 2019, Ofwat's draft determinations, Moody's Investors Service

To support near-term cash flows, Ofwat offered companies some flexibility to adjust the so-called pay-as-you-go (PAYG) ratio (the portion of total spending remunerated through revenue, also known as fast money because it is received upfront) and RCV run-off rates (or RCV depreciation). However, PAYG ratios in the individual draft determinations imply that most companies will not receive excess fast money above that required for operating expenses (see Exhibit 6).

Exhibit 6

Companies' PAYG ratios in the context of total spending split imply most companies will not receive excess fast money



BP = Business plans (revised after initial assessment in January 2019), DD = Draft Determination. *Portsmouth Water's plan at the BP stage included expenditure for the Havant Thicket reservoir, while the DD excludes it. ** Thames Water excludes Thames Tideway Tunnel, meaning the investment that Thames Water remains responsible for in relation to the tunnel sites.
Source: Ofwat

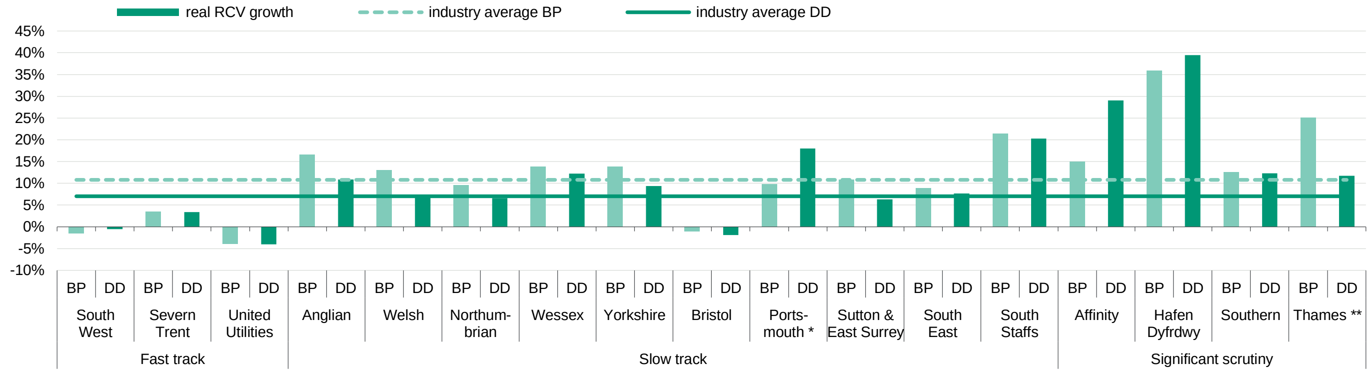
Run-off rates will be slightly higher than in the current period. This reflects the transition to CPIH inflation for the RCV, which requires higher rates to achieve similar ongoing annual cash flows, as well as the shorter asset life of investments during the period.

The regulator views the adjustment of PAYG and run-off rates as economically equivalent to the change in indexation measures, because they involve a trade-off between fast money (received through revenue through the detriment of RCV growth) and slow money (increased RCV growth with lower short-term revenue). However, we believe that there is a key difference: the switch to CPIH is a permanent change that applies to all companies in a similar way, while PAYG and run-off rates are partly within companies' control and can change between periods, distorting comparability between companies and over time. We will continue to remove the regulatory depreciation as well as excess PAYG to calculate company-specific AICR ratios.

In its draft determination, Ofwat also assumed that companies may need to adjust their dividend profile to aid financeability, particularly those with high RCV growth, including Affinity Water Limited (Baa1 negative), Southern Water, Thames Water and Wessex Water Services Limited (A3 negative) (see Exhibit 7). The regulator also reflected additional equity as proposed by Portsmouth Water to support the construction of the Havant Thicket reservoir, which will be covered under a separate 10-year price control.

Exhibit 7

Draft determinations assume average real RCV growth of 7% for the industry over the 2020-25 regulatory period



BP = Business plans (revised after initial assessment in January 2019), DD = Draft Determination. *Portsmouth Water excludes Havant Thicket reservoir. ** Thames Water excludes Thames Tideway Tunnel, meaning the investment that Thames Water remains responsible for in relation to the tunnel sites.

Source: Ofwat

Overall, the lower allowed returns will leave little room for manoeuvre to tackle potential cost overruns or performance penalties, both of which appear more likely in AMP7.

Most companies need to find material cost efficiencies

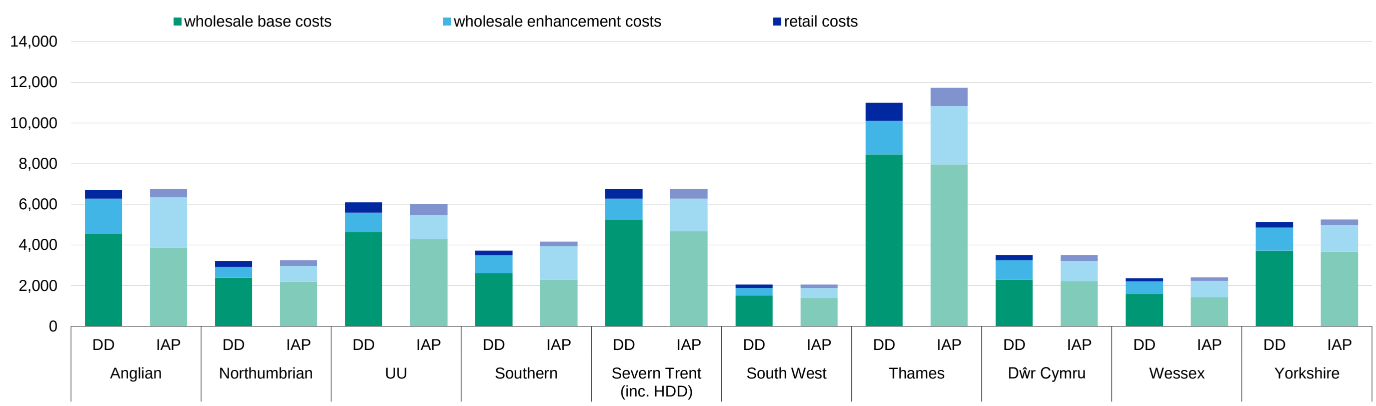
The gap between companies' proposed expenditure and the regulator's view of efficient costs has not improved much since Ofwat's initial assessment of plans (IAP) in January 2019, with companies reducing their overall cost claims by only roughly £1.4 billion or 2.5%. Companies mainly reallocated specific cost items between base and enhancement costs, and tried, but in most cases failed, to convince Ofwat of their claims.

Among the WaSCs, the main reductions were proposed by Thames Water and Southern Water (see Exhibit 8).

Exhibit 8

Proposed costs from WaSCs' business plan submissions for the draft determination and initial assessment indicate reallocation of cost elements, with limited reductions

Amounts in £ millions



Total spending at DD represents comparison against companies' revised business plans following Ofwat's initial assessment, whereas total spending at IAP is as presented in the original business plans.

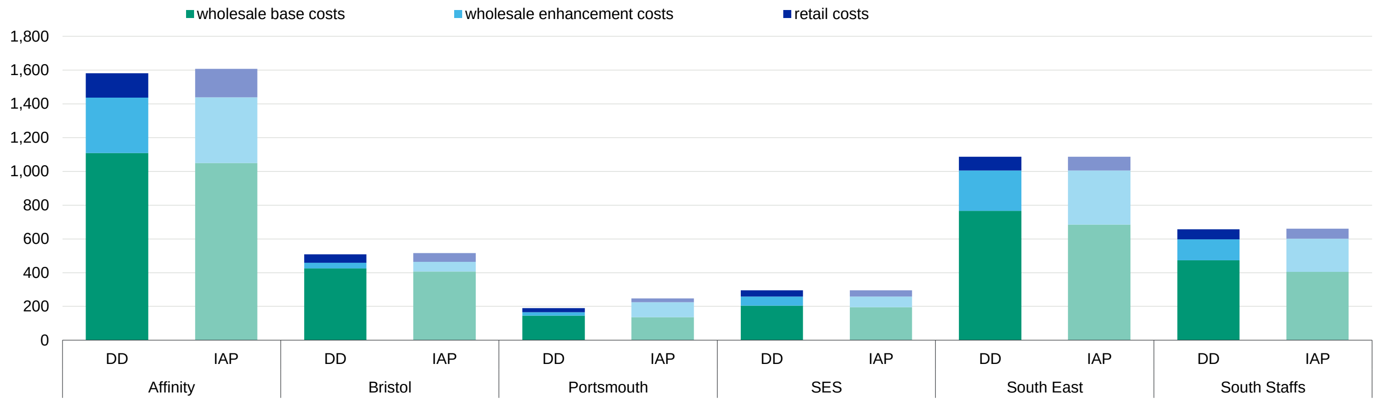
Source: Ofwat

The smaller WoCs submitted largely similar overall total spending claims (see Exhibit 9).

Exhibit 9

Proposed costs from WoCs' business plan submissions for the draft determination and initial assessment indicate primarily a reallocation of cost elements

Amounts in £ millions

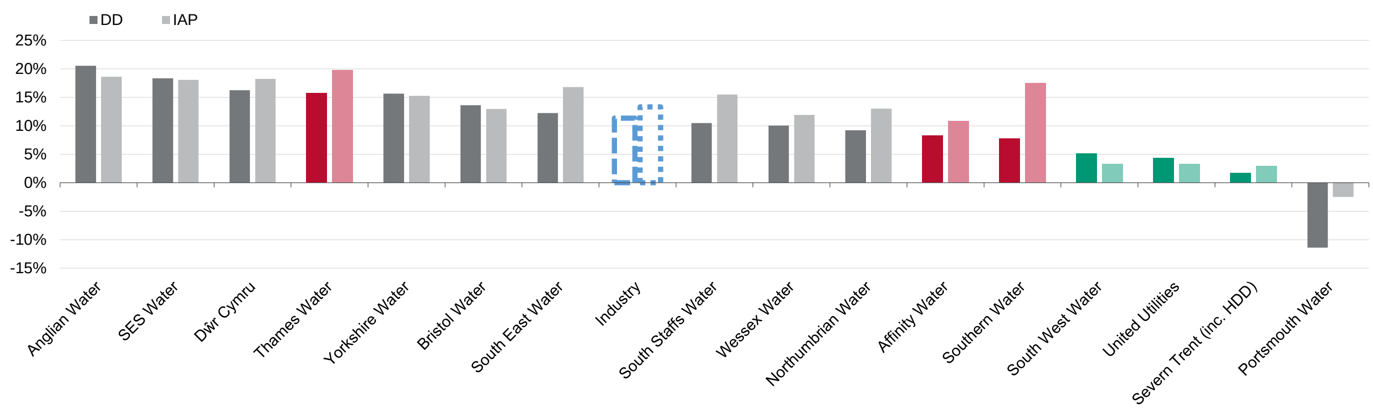


Total spending at DD represents comparison against companies' revised business plans following Ofwat's initial assessment, whereas total spending at IAP is as presented in the original business plans. Portsmouth Water's plan at the IAP stage included expenditure for the Havant Thicket reservoir, while the DD excludes it.
Source: Ofwat

Ofwat expects companies to incur around £48.6 billion of total expenditure in AMP7, which includes operating costs and capital investment across the wholesale and retail price controls, compared with companies' proposals of £54.8 billion, resulting in an overall efficiency challenge of 11%, only slightly lower than 13% at the initial assessment (see Exhibit 10).

Exhibit 10

Companies continue to face a significant total spending efficiency challenge

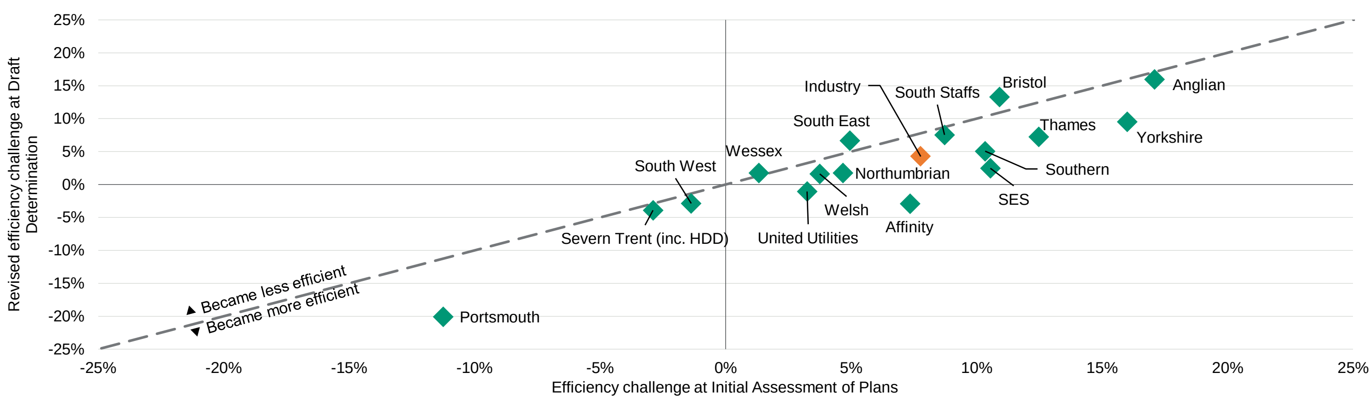


Business plan proposals have been updated following Ofwat's initial assessment; IAP columns represent the original business plan submission, while the DD columns compare against revised plans. Companies shown in green indicate fast-track status, while red denotes significant scrutiny business plans. Hafren Dyfrdwy (HDD) was classified as significant scrutiny, but its spending was considered very efficient; here it is included under fast-tracked Severn Trent Water, which owns Hafren Dyfrdwy. Portsmouth Water's plan at the IAP stage included expenditure for the Havant Thicket reservoir, while the DD excludes it.
Source: Ofwat

Earlier in July, the regulator sent public letters to four companies – Anglian Water, Thames Water, Yorkshire Water and Sutton & East Surrey Water plc (SES Water, Baa1 stable) – indicating that not all of their planned costs will receive funding. SES Water was highlighted for its retail price control only, which is a relatively small part of the overall activities.

Split into the different cost categories, there remains sizeable pressure on wholesale base operating and maintenance costs for individual companies. Ofwat changed its definition of base and enhancement cost between the IAP and draft determination (DD) stages, resulting in a reallocation of certain enhancements to base expenditure. As a result, the sector now faces a 4% base cost efficiency challenge compared with 8% at IAP (see Exhibit 11). However, Anglian Water, Bristol Water plc (Baa1 negative) and Yorkshire Water would still need to reduce their base expenditure by 10% or more to meet the regulator's view of efficient cost. This remains significant, particularly because base spending generally contains less room for scope adjustments, meaning that cost differences here will require companies to reconsider their individual unit costs for providing services. Part of the challenge reflects Ofwat's expectation that the industry as a whole should reduce base expenditure by around 2% compared with historical cost levels.

Exhibit 11
Most companies benefitted from a reallocation of enhancement costs to base expenditure

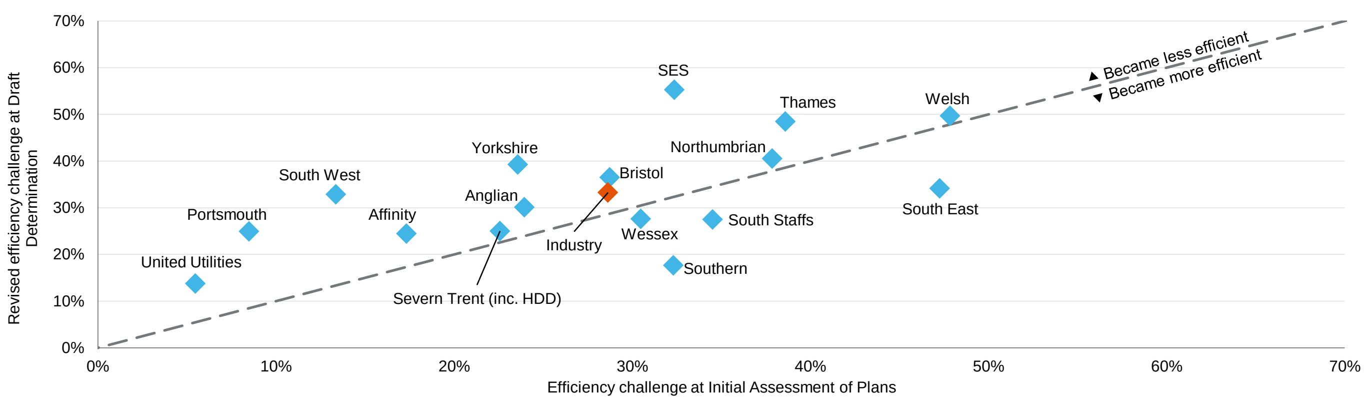


Business plan proposals have been updated following Ofwat's initial assessment; IAP ratios reflect the original business plan submission, while the DD ratios compare against revised plans.
Source: Ofwat

The picture looks worse on enhancement expenditure, which is the main driver of total spending increases compared with the current regulatory period. The industry would have to cut proposed costs by around a third to meet the regulator's efficient cost estimates, although there may be a greater element of scope involved, as companies may decide not to deliver unfunded projects.

Exhibit 12 shows that most companies are in a worse position on enhancement costs compared with the IAP. Although the industry reduced its claims to around £11 billion from £15 billion, Ofwat also reduced its estimate of efficient costs to £7.6 billion from just under £11 billion previously, mostly as a result of reallocating expenditure to base costs. Welsh Water remains a significant outlier but SES Water now faces the greatest efficiency challenge, although Ofwat invited the company to provide additional evidence to support its claims.

Exhibit 12
Cost differential for enhancement expenditure has increased for most companies



Note: Business plan proposals have been updated following Ofwat's initial assessment; IAP ratios reflect the original business plan submission, while the DD ratios compare against revised plans.
Source: Ofwat

On the residential retail cost element, the position remains unchanged, with SES Water and Welsh Water facing the biggest efficiency challenges, both in excess of 20%.

The absolute amounts of the efficiency challenge are also striking, with Anglian Water and Thames Water being asked to cut their overall total spending by over £1.3 billion and £1.5 billion, respectively, while Yorkshire Water has to find savings of ca. £800 million.

Having such significant gaps at this stage for such a large number of companies materially increases the risk of potential cost overruns in the next regulatory period. However, we note that any cost overruns will ultimately be shared with customers according to agreed sharing rates, which in most cases are roughly 50:50, subject to a true-up at the following price review. There may be additional risk for the four companies whose plans had been assessed as requiring significant regulatory scrutiny. In its PR19 final methodology, Ofwat stated that these companies could receive reduced cost-sharing rates, meaning that they could only retain 25% of their cost outperformance but must bear 75% of cost underperformance. The regulator believes Affinity Water and Southern Water will have to make further progress to address regulatory concerns, while Thames Water has substantially more progress to make to avoid reduced sharing rates by the final determination.

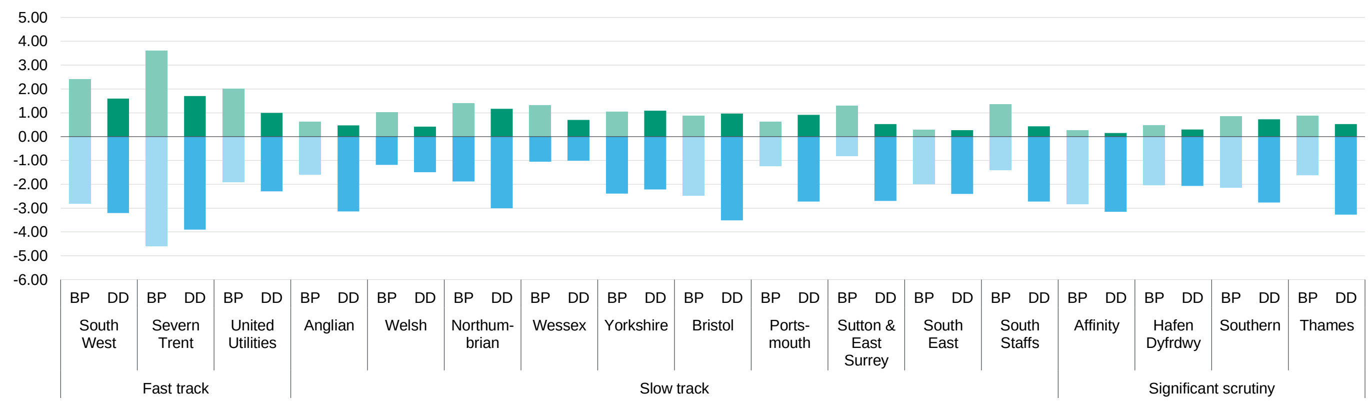
Financial incentives for operational performance significantly skewed to the downside

While the potential range of financial incentives for companies' performance against targets agreed with customers narrowed at the initial assessment stage compared with companies' original business plans, Ofwat's draft determination points to a widening, which may increase cash flow volatility. The risk has shifted toward penalties being imposed rather than rewards being paid (see Exhibit 13).

Exhibit 13

Downside risk on performance commitments increased for most companies since publication of their plans

%

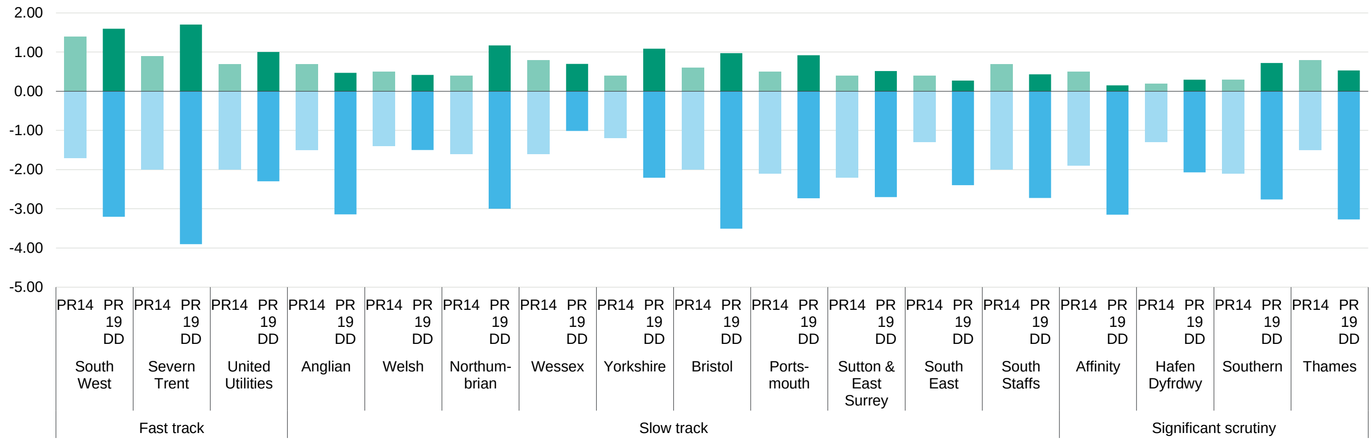


BP = Business plans (revised after initial assessment in January 2019), DD = Draft Determination. Outcome delivery incentives are presented in P10 and P90 intervals, that is the range in which 80% of possible outcomes lie, but reflecting that the risk is not necessarily additive, meaning underperformance in one area need not result in similar underperformance in all areas. Fast-tracked companies have not been adjusted for the additional changes to ODIs implied by Ofwat's analysis of the slow-tracked companies.
Source: Ofwat

Ofwat changed companies' proposed performance commitments and financial incentives to ensure targets are based on stretching service levels equivalent to the performance of the best 25% of companies (which Ofwat refers to as upper-quartile performance) and companies are only rewarded for superior customer service. To avoid disproportionate penalties, Ofwat proposes to introduce a glide path around commitments on supply interruptions to allow companies to improve performance gradually towards upper-quartile levels over the next regulatory period. Please see the appendix for details on the regulator's changes to individual performance commitments at the draft determination stage.

While the current period also included a skew to the downside, the ranges are more pronounced in Ofwat's draft determination for PR19 (see Exhibit 14).

Exhibit 14
PR14 ODI ranges also presented a negative skew but PR19 ranges point to further downward shift
%



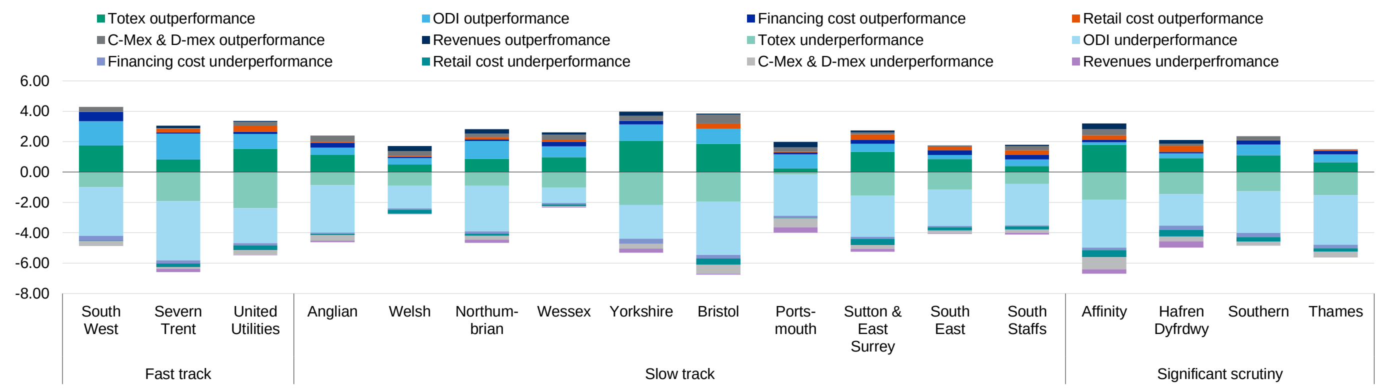
Source: Ofwat

In the current period, companies have managed to generate modest or, in the case of Severn Trent Water Limited (A3 negative) quite substantial performance rewards. However, we believe companies are unlikely to replicate this in the next period given the shift to upper-quartile performance targets.

We note that there may be additional downside risk for the four companies whose plans had been assessed as requiring significant regulatory scrutiny. However, while in its PR19 final methodology Ofwat considered capping ODI outperformance payments, the regulator said in its draft determination that it does not currently intend to cap any of the four significant scrutiny companies.

Considering all aspects of performance, Ofwat provides ranges of companies' individual out- or underperformance potential against the base return on regulatory equity (regulatory equity equals 40% of the RCV under the notional capital structure), as illustrated in Exhibit 15. With an average base return of 4.2% across the sector and average combined downside of -4.9%, a materially underperforming industry could – without any offsetting management action – completely wipe out any equity return.

Exhibit 15
Potential out- and underperformance against the base regulatory return on equity
%



Base RORE differs slightly between companies due to variations around the impact of the retail price control (ranging from -0.2% to 0.5% for WaSCs and -0.2% to 0.9% for WoCs), and the proportion of CPIH-linked returns over the price control period, which depend on the level of RCV growth, i.e. by 2025, the proportion of RCV inflated with CPIH will generally range between 55-75% across all companies. Fast-tracked companies have not been adjusted for the additional intervention on ODIs implied by Ofwat's analysis of the slow-tracked companies.
Source: Ofwat

Indications of larger cuts in allowed returns raise risk of referrals to the Competition and Markets Authority

With Ofwat proposing larger cuts in allowed returns – which will prove especially difficult for companies with expensive long-term debt – and large gaps between companies' plans and regulatory assumptions, the likelihood of referrals to the Competition and Markets Authority (CMA) is growing. If significant differences remain at the final determination stage, companies can choose to reject their final price determinations (see Exhibit 16), which will require Ofwat to refer its decision to the CMA. The CMA will conduct an independent review of the company's business plan and Ofwat's price review process, and its results will be binding for the relevant company. The appeals process is an integral part of the UK regulatory framework, and was used in the 2009 and 2014 price reviews by Bristol Water. A CMA referral typically takes six months to resolve. Any appeal to the CMA will prolong the uncertainty for the relevant company around cash-flow stability and predictability over the coming regulatory period.

Exhibit 16
Summary of next steps

18-Jul-19	Draft Determinations for slow track and significant scrutiny companies, update on WACC
30-Aug-19	Slow track and significant scrutiny companies submit representations on draft determination
11-Dec-19	Final Determinations, final WACC
11-Feb-20	Deadline for CMA Referral
01-Apr-20	New tariffs apply

Source: Ofwat

Appendix — Individual outcome delivery incentive adjustments

Ofwat highlights individual adjustments to companies' common and associated bespoke outcome delivery incentives (ODIs). Most notably, these include:

- **Leakage:** Thames Water has been set a more stretching performance target of 25% leakage reduction (a 20% reduction is in line with an already existing enforcement action because of the companies weak performance on that measure), while Affinity Water and Yorkshire Water had their target reduced to 20%, which Ofwat considers sufficiently stretching and also covered by base costs.
- **Per capita consumption:** Ofwat adjusted levels for nine companies, including a change from reputational to underperformance-only for Welsh Water, and also determined a more stretching target for United Utilities.
- **Water quality compliance:** The performance commitment was changed from reputational to underperformance-only for Thames Water, in line with the rest of the sector; for fast-tracked Severn Trent, the underperformance rate was increased to reflect poor performance.
- **Mains repairs:** All companies that were challenged at the IAP stage had their performance commitments tightened, including a change from reputational to underperformance-only for Anglian Water; Ofwat's assessment would also indicate more challenging performance levels for fast-tracked companies Severn Trent and United Utilities.
- **Sewer collapses:** Wessex Water and Yorkshire Water are highlighted as the outliers and received more challenging targets.
- **Unplanned outages:** Eight companies – Northumbrian Water, Portsmouth Water, South East Water, Southern Water, Severn Trent, Thames Water, United Utilities and Yorkshire Water – are highlighted as relatively poor performers on this measure. Ofwat adjusted forecast performance levels of all of these companies, except Southern Water, which proposes an 81% improvement from current levels, considered adequate by the regulator.
- **External sewer flooding:** Welsh Water and Yorkshire Water were set more stretching performance levels based on the upper quartile percentage improvement proposed by all other companies.
- **Customer contacts:** More stretching targets were set for Anglian Water, Wessex Water, Dŵr Cymru and Yorkshire Water as well as, by implication, United Utilities.
- **Low pressure:** More stretching performance levels were applied for Southern Water and Bristol Water because of the small improvement proposed and for Hafren Dyfrdwy due to their poor comparative performance. United Utilities could also see its targets tightened following Ofwat's analysis of the slow-tracked companies.
- **Treatment works compliance:** For Southern Water, performance incentives have been set as in-period adjustments to revenue rather than RCV, as proposed by the company.

Moody's related publications

Sector Outlook:

» Regulated water utilities - UK: 2019 outlook negative as companies steer through troubled waters, 5 December 2018

Issuer Comments:

» Thames Water, Anglian Water, Yorkshire Water and Sutton & East Surrey Water: Ofwat warns that planned costs will not be funded, 4 July 2019

Sector Reports:

» Regulated electric & gas networks – Great Britain Regulator signals smaller cut to allowed return, but many uncertainties remain, 30 May 2019

» Regulated gas networks - Great Britain: Credit quality likely to weaken in RIIO-GD2 regulatory period, 14 February 2019

» Regulated energy networks - UK: Labour Party details energy network nationalisation policy, 16 May 2019

» Regulated water utilities - UK: Ofwat's initial assessment credit positive for three companies, challenges others, 8 February 2019

» Regulated water utilities - UK: Covenanted financing structures help mitigate growing risks, 9 October 2018

» Regulated water utilities and energy networks - UK: Increasingly complex group structures create diverging opco and holdco credit risk, 9 October 2018

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