

## IAP Response

Ref B2.WSH.RR.A4

## Target Credit Rating

1 April 2019

## WSH.RR.A4 Target Credit Rating

Our PR19 Business Plan targets an actual company credit rating of Baa1/BBB+/BBB+ (Moody's, S&P and Fitch respectively).

In determining that the actual company is financeable we have assessed the projected credit metrics for the 2020-2030 period against the following thresholds:

	Thresholds for Baa1/BBB+/BBB+
Gearing	72% maximum
Adjusted interest cover ratio (Moody's definition)	1.5x minimum
FFO/Net Debt (S&P definition)	9% minimum

The thresholds for gearing and adjusted interest cover ratio are based on Moody's revised ratio guidance for UK water utilities as set out on page 5 of their publication of 22 May 2018 'UK Regulator's proposals undermine the stability and predictability of the regime'.

	A2	A3	Baa1	Baa2
Minimum AICR	2.0	1.7	1.5	1.3
Maximum Net debt to RCV	55%	65%	72%	80%

Source: Moody's Investors Service (May 2018): Regulator's proposals undermine the stability and predictability of the regime, Exhibit 5

Most credit rating reports issued by S&P focus on FFO/Net debt. The table below provides the S&P credit metric bands that are consistent with S&P credit ratings for companies with excellent business risk profile.

S&P financial risk assessment	Modest	Intermediate	Significant	Aggressive	Highly leverage
Rating	AA	A+/A	A-	BBB	BBB-/BB+
FFO/Net debt	23-35	13-23	9-13	6-9	<6

Note: The read across from S&P financial risk assessment to the implied credit rating is based on Standard & Poor's (November 2013), Corporate methodology, Table 3

Source: Standard & Poor's (February 2014), For U.K. water utilities, challenging cost-of-capital guidance may bring rating stress, Table 3

From this table we concluded that the threshold for the FFO/Net debt metric for a BBB+ credit rating is >9%.

We note from reviewing other companies plans that United Utilities have provided an assessment of the impact of the difference in calculation between the credit rating agency and Ofwat versions of the key financial metrics. [United Utilities PR19 Business Plan Chapter 9: Supplementary Document – S7003].

The calculation results in an uplift in the threshold for FFO/Net debt (Ofwat definition) to > 10.0%. The calculation of the uplift in the threshold for AICR (Ofwat definition) is predicated adjusting for the revenue the company has accelerated via an adjustment to the PAYG above

the natural level. We have not proposed brining forward revenue from future periods into AMP7, therefore an adjustment to the AICR threshold for Ofwat’s version of the metric is not required.

Overall threshold position:

	<b>Thresholds for Baa1/BBB+/BBB+</b>
Gearing	72% maximum
Adjusted interest cover ratio (Moody’s definition)	1.5x minimum
Adjusted interest cover ratio (Ofwat’s definition)	1.5x minimum
FFO/Net Debt (S&P definition)	9% minimum
FFO/Net Debt (Ofwat’s definition)	10% minimum

We note that Ofwat intends to review the WACC for the sector when it published draft determinations in July. Any further downward change in WACC would put our ability to deliver financial ratios above the thresholds noted above and cast doubt on whether our target credit rating could be achieved. Any such action which would impact upon the financial resilience of the sector and of the company in particular would not be in the best interest of customers. In the event of any further change to WACC, we would need to consider whether a consequent change was needed to our RCV run-off rate, within the range of values supported by the underlying asset lives in the business (as set out in response to IAP action WSH.RR. A6), in order to preserve the financeability of the company and protect the interest of customers.