MOODY'S RATINGS

SECTOR IN-DEPTH

18 November 2024

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Regulated Water Utilities – UK

Reduced predictability of regulatory environment pressures credit quality

Summary

On 13 November 2024, we took negative rating or outlook actions on most UK water companies, primarily reflecting a deterioration in the sector's business risk profile and the associated tightening of our ratio guidance for a given rating (see Appendix 1 for a list of rating actions and detailed summary of current ratings and outlooks).

As a result of these rating actions, two operating companies now carry ratings below investment grade (see Exhibit 1) and a third one is at risk of losing its investment-grade rating. Overall, 80% of the sector faces downward rating pressure (see Exhibit 2).

Exhibit 1

Two operating companies now have ratings below investment grade

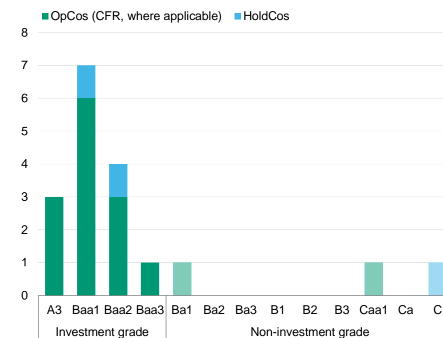
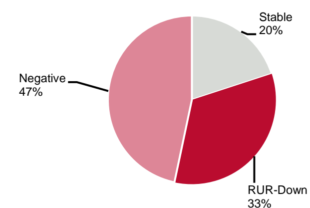


Chart shows corporate family rating (CFR), or senior secured/ unsecured debt ratings for companies without CFR. Rating distribution as of the date of this report.
Source: Moody's Ratings

Exhibit 2

80% of the sector faces downward rating pressure



Outlook distribution as the date of this report.
Source: Moody's Ratings

Sector risk has increased

There has been a material and sustained weakening of credit quality for nearly all companies amid continued public scrutiny and heightened political and regulatory focus. Across the sector, previous decisions, such as prioritising affordability and shareholder distributions, have contributed to underinvestment and exacerbated the sector's exposure to changing weather patterns, population growth and shifting expectations. Regulatory targets have become more demanding and penalties for those that fall short have continued to rise. With widespread investigations ongoing, fines for UK water companies breaching environmental legislation are likely to increase further.

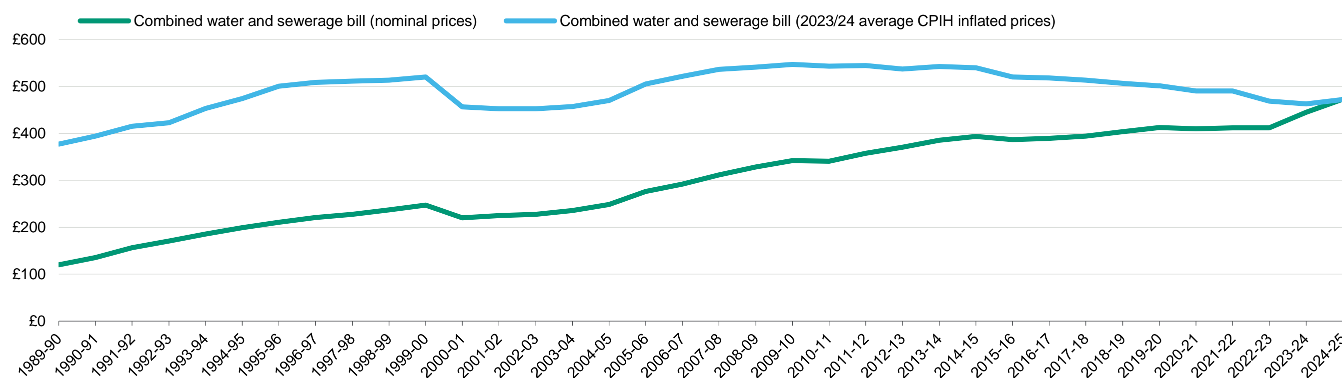
In addition, the perception that the water sector is "broken" has prompted a government-initiated strategic review, which aims to improve the regulatory environment and create a stable backdrop to attract investment. However, the review results in greater short-term uncertainty for the sector until it is completed and any potentially credit positive recommendations are successfully implemented.

Given the above considerations, we have changed our assessment of the stability and predictability of the regulatory environment for the UK water sector under our rating methodology to A from Aa.[1]

We believe that the predictability and supportiveness of the regime has reduced regardless of whether the final determination for the next regulatory period (1 April 2025 to 31 March 2030, known as AMP8), expected on 19 December 2024, ultimately results in a more positive outcome for the sector than the draft determination. This assessment reflects a continuing trend of negative public perception resulting in more regulatory powers, an increased focus on enforcement action, demanding targets, greater penalties for operational underperformance and growing regulatory complexity that, in turn, result in higher cash flow volatility and leaner returns. All of these factors are leading to an environment that is less supportive of the water utilities' operations and, therefore, credit negative.

Rising investment needs to address public concerns over wastewater pollution and offset the effects of population growth and climate change also increase the affordability challenge. The historical evolution of bills indicates that, before considering inflation, bills were declining in real terms for over 15 years (see Exhibit 3). This points to an even sharper increase in bills for customers going forward than would have been the case if bills had been allowed to grow gradually. A more gradual rise in past bills over time could also have allowed for progressively increasing investment to address sectoral challenges much sooner.

Exhibit 3
Average combined water and sewerage bill in England and Wales since privatisation



Nominal prices (green line) inflated by RPI until 2019-20 and by CPIH thereafter, in line with regulatory approach. Real prices (blue line) presented in FY average 2023/24 CPIH prices.
Source: Ofwat, discoverwater.co.uk

The risk that public concern over environmental, social or affordability issues could drive adverse regulatory or political intervention is a key aspect of demographic and societal trends that are assessed under the social risk considerations discussed in our General Principles for Assessing Environmental, Social and Governance Risks cross-sector methodology. The water companies in England face elevated social risk (S4-score). The slightly stronger S3-score for Dwr Cymru Cyfyngedig (Welsh Water, CFR: A3 on review for downgrade) reflects its unique not-for-dividend status and the fact that water strategy sits within the remit of the devolved Welsh government, which partially alleviates this risk.

Ofwat, the economic regulator for water companies in England and Wales, also increasingly focuses on companies' financial policies, driven by a very public and political debate around the sector's legitimacy. The regulator is targeting companies that it perceives to have limited financial flexibility, as evidenced by a proposal to introduce a distribution block when gearing exceeds 70% of net debt to regulatory capital value (RCV). It is also striving to improve operational performance, stating in its latest assessment that "no company

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has made it into our 'leading' category for the second year running and progress against key targets, including pollution and internal sewer flooding, is unacceptably slow."

Continuing the trend from the current period, we expect cash flow volatility to materially increase in AMP8, because of tough cost efficiency and performance targets as well as significantly higher reward and penalty rates.[2] We estimate that the recent draft determinations – if implemented unchanged – would result in operational underperformance for all companies.[3] Since publishing its draft determination, Ofwat received additional performance data from the latest financial year, which will flow into its final assessment of performance incentives and we also understand that the regulator intends to ultimately set a balanced incentive package. In addition, on 15 October 2024, Ofwat announced a consultation to introduce an outturn adjustment mechanism to further alleviate concerns around the potential penalty exposure. The mechanism aims to rebalance the impact of outcome delivery incentives (ODIs), such that the sector median would be zero (see Appendix 2 for further details on the mechanism). Although the mechanism may ultimately create a more balanced distribution of rewards and penalties, it was introduced at a late stage of the process and, in our view, reduces regulatory predictability.

The mechanism further complicates regulation, which already has up to six different price controls and significant true up adjustments (related to, inter alia, actual vs forecast performance, actual vs forecast inflation and actual vs forecast interest rates for new debt raised within the regulatory period). Many of these adjustments aim to ensure adequate cost recovery, which is credit positive. However, the adjustments could either boost or diminish future returns and are difficult to quantify upfront; many adjustments carry across regulatory periods, creating potentially significant distortion to the underlying business case.

Our sector view also considers that, on 23 October 2024, the UK and Welsh governments initiated a strategic review of the UK water sector by appointing an independent commission into the sector and its regulation. The objectives of the commission are to recommend measures to ensure that the regulatory system delivers:

» A clear long-term vision for delivering environmental, public health, customer and economic outcomes;

» A collaborative, strategic, catchment approach to managing water, tackling pollution and restoring nature;

» Better regulation, clarifying requirements for companies to secure better outcomes;

» Empowered regulation to effectively hold companies to account, for example for illegal pollution;

» Stable regulation that attracts investment and supports financial resilience of companies;

» Enhanced ability of the sector to deliver outcomes, while driving innovation;

» Consumer protection and affordability; and

» Resilient infrastructure that anticipates future needs and climate change.

The commission will draw on the expertise of the regulatory, environment, health, engineering, customer, investor and economic sectors and report back to the government in the second quarter of 2025 on "how to tackle inherited systemic issues in the water sector to restore our rivers, lakes and seas to good health, meet the challenges of the future and drive economic growth."

While the review could improve stability and predictability over the longer term, it creates uncertainty until concluded and recommendations are implemented. This uncertainty may act as a deterrent to new capital at a time when it is critically needed, because it may be difficult to establish a clear long-term business case.

The government's review also follows the introduction of the Water (Special Measures) Bill, which includes new powers for the Environment Agency, Drinking Water Inspectorate and Natural Resources Wales, among other things, related to personal liability for water company management, potentially leading to imprisonment, for obstructing investigations. The Bill would also allow the Environment Agency to introduce automatic penalties for certain offences, and includes additional regulatory powers for Ofwat to establish new rules on remuneration and governance, under which it will be able to prohibit executive bonus payments in certain circumstances and introduce requirements relating to consumer involvement in certain company decisions. Ofwat is currently consulting on the design of these new licence obligations on executive remuneration and governance.

Despite these recent developments, we still consider the UK regulatory approach to be among the most transparent globally, with consultations on potential changes to the framework typically well in advance of them being implemented. At each price review, Ofwat publishes detailed regulatory financial models, with company-specific inputs showing the regulatory allowances for the entire period. It also provides annual updates on the regulatory asset base as well as incentive income or penalties.

Ratio guidance has been tightened

To reflect the increased business risk – given our changed view of the stability and predictability of the regulatory environment – we have revised our ratio guidance for the sector. A UK regulated water company would now have to exhibit a slightly lower gearing and a stronger adjusted interest coverage ratio (AICR) to maintain the same credit quality. Exhibit 4 summarises our previous generic guidance for the UK water companies at a given rating level, as well as the updated illustrative metrics in the context of our revised view of the sector's business risk. In the context of an evolving regulatory framework and generally greater uncertainty in outcomes for water companies, guidance for individual companies will likely show greater variance from generic guidance, and we may be more likely to change generic guidance.

Exhibit 4
Moody's generic ratio guidance for the UK water utilities

Rating	Guidance pre-May 2018 (Stability & Predictability = Aaa)		Guidance post-May 2018 until Oct 2024 (Stability & Predictability = Aa)		New guidance from Nov 2024 (Stability & Predictability = A)	
	AICR	Gearing	AICR	Gearing	AICR	Gearing
A2	≥1.8x	≤60%	≥2.0x	≤55%	≥2.1x	≤50%
A3	≥1.6x	≤68%	≥1.7x	≤65%	≥1.8x	≤60%
Baa1	≥1.4x	≤75%	≥1.5x	≤72%	≥1.6x	≤68%
Baa2	≥1.2x	≤85%	≥1.3x	≤80%	≥1.4x	≤75%

Ratio guidance applies to standalone regulated businesses funded on a senior unsecured corporate basis and is consistent with our press releases for UK water utilities during the relevant periods. Actual credit quality may also reflect the consolidated financial strength of a wider group, or the benefits of structural enhancements. Because of their smaller size and the associated risks in relation to cash flow stability, we would expect very small water-only companies to exhibit a stronger AICR for an equivalent gearing level. We are not providing guidance below a generic Baa2 rating level, because we believe a lower rating is not sustainable in the long term and guidance for any Baa3-rated issuer will likely reflect issuer-specific considerations.
Source: Moody's Ratings

The above ratio guidance applies to standalone regulated businesses funded on a senior unsecured corporate basis. For some companies, we may also reflect the credit-enhancing effect of structural features within their finance documentation. However, with companies having to exhibit stronger credit metrics for a given rating going forward, existing financial covenants will not provide the same level of protection, as metrics could deteriorate more materially before creditors can step in.

In addition, in an environment where companies will have to invest more and potentially incur larger penalties, the amount of cash flow that may be locked up during a trigger event is diminished. While an organised intercreditor approach, additional emergency liquidity reserves and share security can add value, we view this as limited to around half a rating notch.[4] Where companies have further eroded the benefit of financial ratio covenants, for example through the use of derivatives, such that financial problems may be masked and therefore not allow creditors to step in in time, we will continue not to give rating uplift. Please refer to individual companies' press releases for issuer-specific ratio guidance.

For some companies, we have also already made changes to our assessment of another factor – cost and investment recovery (sufficiency and timeliness) – under our rating methodology. We had historically scored this subfactor A for most UK water utilities. However, we recently changed our scores to Baa for Thames Water Utilities Ltd. (CFR, Caa1 negative), Southern Water Services Limited (CFR, Ba1 on review for downgrade, with senior secured debt issued by SW (Finance) I PLC rated Ba1 on review for downgrade) and South East Water Limited (funded through South East Water (Finance) Limited, rated Baa3 on review for downgrade) because their underperformance is likely to prevent them from earning the allowed return for a number of years.

The rising investment needs will also affect the size and complexity of companies' capital programme, another rating methodology factor. We expect the portion of capex to increase relative to the existing asset base over AMP8 compared with AMP7. This will then also lead to lower scores for this subfactor.

Based on the draft determination and companies' representation, we expect that many companies could struggle to meet our revised ratio guidance, which led to our recent rating and outlook actions. In contrast to prior regulatory processes, legal targets continued to change throughout the price review process and this has increased uncertainty on the amount of investment required and associated funding allowances. This also means that our forecast ratios remain highly uncertain at this point. However, final determinations are typically less onerous than draft determinations and we expect some rebalancing. A more supportive final determination would likely bolster credit ratios compared with current estimates. In addition, companies' management and shareholders may take actions, including cost saving measures or higher equity contributions, to further bolster credit quality.

Maintaining investment-grade credit quality

Maintaining an investment-grade credit rating is a requirement under UK water companies' licences, and companies typically should maintain an investment-grade rating from at least two credit rating agencies (unless the regulator permits a company to have only one investment-grade credit rating). Being in breach of this requirement would trigger regulatory enforcement action, which would likely include a remedial plan.

The requirement to maintain an investment-grade credit rating is also embedded in many companies' highly covenanted financing structures and a breach could trigger a technical default.[5] Such technical default would not be considered a default under our definitions, but a subsequent payment acceleration and resulting non-payment would constitute a Moody's default.

A UK water company may risk losing its investment-grade rating if it has a track record of sustained operational or financial underperformance, which is likely to continue, or faces the risk of future prolonged underperformance. Long-term underperformance will hinder the prospect of raising new capital and could adversely affect a company's ability to finance its functions and make the necessary investment to improve its performance. These circumstances, combined with a diminishing liquidity runway, have resulted in Thames Water's ratings ultimately deteriorating into the Caa category.[6] Strong shareholder support and commitment to provide equity funding to address operational underperformance can mitigate some of these risks, but only to the extent that it results in operational improvement over time.

We believe that a speculative grade credit rating would not be sustainable for a UK regulated water utility. It would likely reduce access to and increase the cost of capital, leading to underperformance of regulatory cost of capital allowances, which would, in turn, further weaken financial metrics.

We also consider companies that cannot maintain a sustained forward-looking liquidity runway of at least 12 months as operating a financial policy that is not commensurate with an investment-grade credit quality.

UK water companies have historically had good access to capital markets, even in difficult economic environments such as the coronavirus pandemic. They also typically apply a prudent and forward-looking approach to maintaining liquidity, in many cases covering a rolling 15-18 month period into the future. However, the most recent rating downgrade for Thames Water highlights the risk that companies may not be able to replenish their liquidity in a timely fashion if they face a material weakening in their operational or financial performance, or if shareholder support is lacking.

In assessing forward-looking liquidity, we typically compare a company's estimated sources of cash (including cash flow from operations, cash and short-term marketable securities on balance sheet, and availability under committed arrangements, such as credit facilities from banks) with estimated uses (including capital expenditures and other investments, debt maturities and dividend payments). We typically assess these on a quarterly basis over at least the next 12 months and under a presumption of no market access during this period. For further details, please see our cross-sector rating methodology on General Principles of Liquidity Risk Assessment.

Appendix 1 – Summary of rating actions and current ratings and outlooks

On 13 November 2024, we took the following rating actions:

Rating downgrades

» Southern Water: Moody's Ratings downgrades Southern Water to Ba1, on review for further downgrade

» South East Water: Moody's Ratings downgrades South East Water to Baa3, on review for further downgrade

Ratings placed on review for downgrade

» Affinity Water: Moody's Ratings places Affinity Water's ratings on review for downgrade

» Anglian Water: Moody's Ratings places Anglian Water's A3 ratings on review for downgrade

» Dwr Cymru (Welsh Water): Moody's Ratings places Welsh Water's ratings on review for downgrade

Outlooks maintained at negative or changed to negative from stable

» Northumbrian Water: Moody's Ratings changes outlook to negative on Northumbrian Water, affirms ratings

» South West Water (including SES Water): Moody's Ratings affirms South West Water Baa1 rating with negative outlook; aligns ratings of SES Water

» United Utilities: Moody's Ratings changes outlook to negative on United Utilities; affirms ratings

» Wessex Water: Moody's Ratings changes outlook to negative on Wessex Water, affirms ratings

» Yorkshire Water: Moody's Ratings changes outlook to negative on Yorkshire Water, affirms ratings

Ratings affirmed with stable outlook

» Portsmouth Water: Moody's Ratings affirms Portsmouth Water's Baa2 rating; stable outlook

» Severn Trent: Moody's Ratings affirms Severn Trent's ratings with stable outlook

» South Staffordshire Water: Moody's Ratings affirms South Staffs Water at Baa2; stable outlook

Exhibit 5 summarises the current ratings and outlooks, following the above rating actions and as of the date of this report:

Exhibit 5
Ratings and outlooks as at the date of this report

	Rating Type	Rating	Outlook
Anglian Water			
… Anglian Water Services Ltd	CFR	A3	RUR-Down
… Anglian Water Services Financing plc	Senior Secured (Class A)	A3	RUR-Down
Dwr Cymru/Welsh Water			
… Dwr Cymru Cyfyngedig	CFR	A3	RUR-Down
… Dwr Cymru (Financing) UK Plc	Senior Secured/Subordinated	A3/Baa2	RUR-Down
Northumbrian Water			
… Northumbrian Water Ltd	Senior Unsecured	Baa1	Negative
… Northumbrian Water Finance Plc	Senior Unsecured (Backed)	Baa1	Negative
Severn Trent			
… Severn Trent Plc	Senior Unsecured	Baa2	Stable
… Severn Trent Water Limited	Senior Unsecured	Baa1	Stable
… Severn Trent Utilities Finance Plc	Senior Unsecured (Backed)	Baa1	Stable
South West Water			
… South West Water Limited	Senior Unsecured	Baa1	Negative
… South West Water Finance plc	Senior Unsecured (Backed)	Baa1	Negative
… Sutton & East Surrey Water plc	Senior Secured (Backed/Underlying)	A1/Baa1	Negative
Southern Water			
… Southern Water Services Limited	CFR	Ba1	RUR-Down
… SW (Finance) I PLC	Senior Secured (Class A)	Ba1	RUR-Down
Thames Water			
… Thames Water Utilities Ltd	CFR	Caa1	Negative
… Thames Water Utilities Finance Plc	Senior Secured (Class A)/Subordinated (Class B)	Caa1/C	Negative
… Thames Water (Kemble) Finance PLC	Senior Secured (HoldCo)	C	Stable
United Utilities			
… United Utilities PLC	Senior Unsecured	Baa1	Negative
… United Utilities Water Limited	Senior Unsecured	A3	Negative
… United Utilities Water Finance Plc	Senior Unsecured (Backed)	A3	Negative
Wessex Water			
… Wessex Water Services Finance Plc	Senior Unsecured (Backed)	Baa1	Negative
Yorkshire Water			
… Yorkshire Water Services Finance Limited	Senior Secured (Class A)	Baa2	Negative
… Yorkshire Water Finance plc	Senior Secured (Class A)/Subordinated (Class B)	Baa2/Ba1	Negative
Affinity Water			
… Affinity Water Limited	CFR	Baa1	RUR-Down
… Affinity Water Finance (2004) Plc	Senior Secured (Class A)	A3	RUR-Down
… Affinity Water Finance Plc	Senior Secured (Class A)/Subordinated (Class B)	A3/Baa3	RUR-Down
Portsmouth Water			
… Portsmouth Water Limited	CFR	Baa2	Stable
South East Water			
… South East Water (Finance) Limited	Senior Secured (Backed)	Baa3	RUR-Down
South Staffs Water			
… South Staffordshire Water Plc	Senior Unsecured	Baa2	Stable

Source: Moody's Ratings

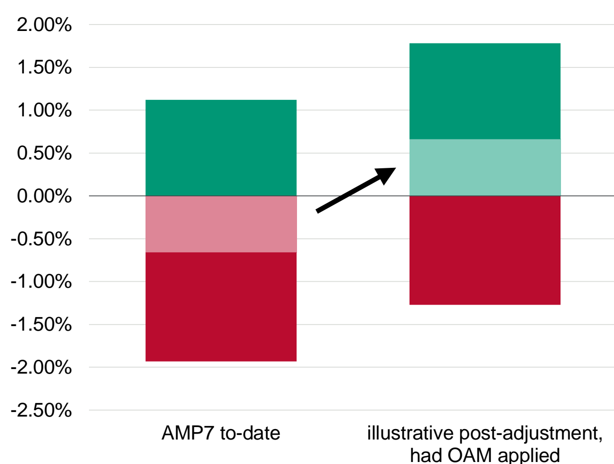
Appendix 2 – Ofwat's outturn adjustment mechanism (OAM)

Ofwat's main aim remains "to calibrate the risk and return package so that an efficient company, with the notional capital structure, has a reasonable prospect of earning the base allowed return." However, the regulator is also consulting on an option to introduce an additional end-of-period adjustment that would rebase to zero the median achieved impact on return on regulatory equity (RORE, based on a notional assumption of equity, which will be 45% in AMP8) from performance against outcome delivery incentives (ODIs), including service measures. This would leave half of the companies with an increase to their equity returns from performance against the ODI package and half with a reduction.

Exhibit 6 illustrates how the mechanism would have worked had it applied already in the current period on the basis of companies' cumulative performance on ODIs, including service measures, over the first four years, while Exhibit 7 indicates the potential improvement of companies estimated mid-point penalties based on the draft determinations for AMP8. The approach would be symmetrical, meaning that if the sector overall underperformed (as shown below) there would be an uplift. However, if the sector outperformed, companies would see a downward adjustment.

Exhibit 6

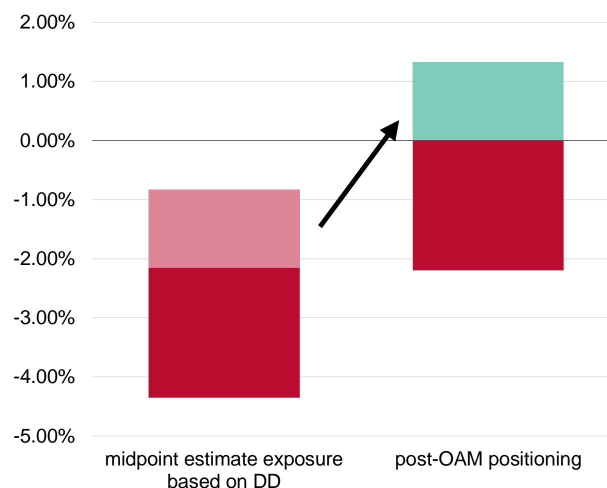
Illustrative improvement of performance impact on RORE based on companies AMP7 performance to date, if OAM would have applied



Combined RORE impact from performance against ODIs and service measures
Source: Moody's Ratings on companies and regulatory data

Exhibit 7

Illustrative improvement of performance impact on RORE based on companies midpoint estimated performance under draft determinations



Combined RORE impact from performance against ODIs and service measures
Source: Moody's Ratings on companies and regulatory data

The regulator recognises that this mechanism, if implemented, would increase uncertainty because the ultimate reward would not be known until the end of the period and depend not just on an individual company's performance but that of the rest of the sector.

In our view it could also result in unintended consequences. Companies' incentives to weigh spending against the potential ODI rewards/penalties may become skewed. For example, a cash-strapped company may decide to underspend allowances and risk incurring penalties, if it believes that there is a high likelihood that these can reduce through the recalibration adjustment. On the other hand, companies performing at the extremes may not benefit as much, if the median remains around zero. The mechanism would also reduce overall rewards available, should the sector median outperform the base equity return. In this case, companies that had achieved small performance rewards may suddenly face a penalty. It would effectively mean that half of all companies would always receive a reduction in their allowed equity return from performance against ODIs, which may not be a sustainable nor low risk proposition.

There may also be a question on whether Ofwat may ultimately be able to follow through with the relevant end-of-period true-up. If the sector severely underperforms and generates sizeable penalties, it may not be publicly and politically acceptable to ultimately provide the sector with a sizeable reward.

Ofwat's consultation does not specify whether the true up will be paid through revenue or RCV. A sizeable adjustment, either positive or negative, could have a significant impact on customer bills if it were to flow through revenue. Therefore, sizeable true-up amounts will likely have to be applied to the RCV, which will mean that the cash flow benefit is very much delayed over a long period of time. This would not reduce the cash flow pressure on companies that have to face the initial penalties.

Endnotes

1 This report does not provide a summary of the methodology. For a full explanation of the methodology, including detailed factor definitions, please see Rating Methodology: Regulated Water Utilities.

2 See 'Regulated Water Utilities - UK: Ofwat's draft determination increases sector risk', 14 August 2024.

3 See 'Regulated Water Utilities - UK: Outlook remains negative on tough price review', 14 October, 2024.

4 This is in addition to any benefit that we apply to the regulatory ring-fence embedded in companies' licences.

5 The investment-grade requirement could be linked to the most senior class of debt in issuance under a structure with several classes or the overall corporate credit quality. An event of default may be triggered if the relevant target rating was below investment-grade by any two credit rating agencies. In some cases, an event of default may only apply if it also results in a material adverse effect. A material adverse effect would typically refer to any event or circumstance that has a material adverse influence on the financial condition of the obligors or their ability to perform under the finance agreements or their licence, or on the enforceability/validity of the rights of the secured creditors.

6 Please see our rating actions on Thames Water from 24 July 2024 and 25 September 2024.

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