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CREDIT OPINION
10 March 2023

Update

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**RATINGS**

**Portsmouth Water Limited**

| | |
|---|---|
| Domicile | United Kingdom |
| Long Term Rating | Baa2 |
| Type | LT Corporate Family Ratings |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Portsmouth Water Limited

## Update following rating downgrade to Baa2

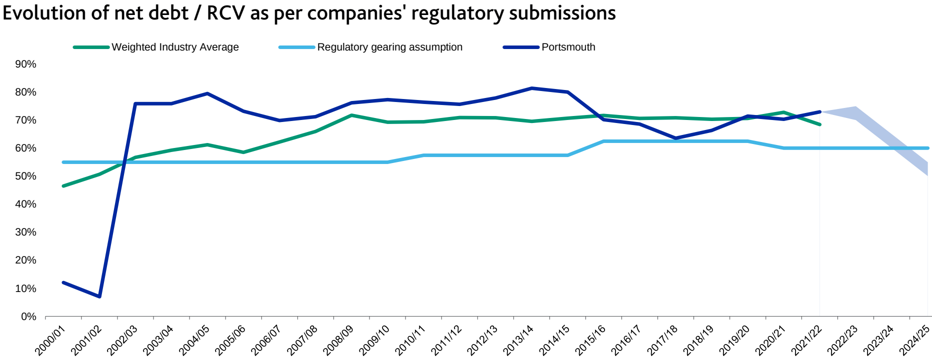
## Summary


Portsmouth Water Limited's (Portsmouth Water, Baa2 stable) credit quality is supported by (1) the company's low business risk profile as a monopoly provider of water services under a well-established and transparent regulatory framework; (2) its solid and cost-efficient performance; and (3) creditor protections embedded within its debt documentation, including cash lock-up provisions. Committed equity injections of £150 million across 2023 and 2024, in support of the company's very large investment programme, will bolster Portsmouth Water's financial profile so that it is leveraged around the regulatory assumption of 60% (measured as net debt to regulatory capital value [RCV]) over the remainder of the current regulatory period to March 2025.

At the same time, Portsmouth Water's credit quality is constrained by (1) the company's relatively small size, which leaves it more exposed to cost shocks than larger peers; (2) its long-dated and relatively expensive funding, compared to regulatory allowances, which acts as a drag on interest coverage metrics; (3) a financing structure which allows maintenance of financial leverage at much higher levels than exhibited currently, albeit also subject to lock-up triggers; and (4) a very large investment programme, primarily driven by the construction of the Havant Thicket Winter Storage Reservoir (HTWSR) which carries execution risk that is partly but not fully mitigated by the aforementioned equity injections and regulatory protections around costs sharing.


Exhibit 1

**Committed equity injections will support deleveraging towards regulatory assumptions**
**Evolution of net debt / RCV as per companies' regulatory submissions**




(1) Regulatory gearing as reported, and not reflective of Moody's standard adjustments. Portsmouth Water's regulatory gearing includes £25 million drawn under subordinated intercompany loans, which are excluded for the purpose of the company's covenant calculation as well as Moody's gearing ratio, resulting in Moody's adjusted net debt/RCV closer to 61% at March 2022.
(2) Moody's projections include the shadow RCV associated with the HTWSR project.
*Source: Companies performance reports, Ofwat, Moody's estimates for forward view*

Portsmouth Water's Baa2 corporate family rating (CFR) reflects a level of credit enhancement embedded in the terms and conditions of the finance documentation.

## Credit strengths

» Monopoly provider of water services under a well-established and transparent regulatory framework

» Most cost-efficient company in the sector based on regulator's assessment

» Modest gearing, as reflected in our expectation that net debt to RCV will be at or below regulatory gearing assumptions (60%) over the remainder of the current regulatory period (to March 2025), reflecting material equity commitments from owners

» Lenders benefit from credit enhancing features, such as cash lock-ups, liquidity reserves, intercreditor and security arrangements

## Credit challenges

» Relatively expensive embedded debt, compared to regulatory assumptions, acts as a drag on interest coverage metrics

» Pressure on interest coverage metrics accentuated by sizeable financing requirements for HTWSR occurring after a material rise in interest rates in 2022, and deferral of returns for this project in the current regulatory period (true-up in next period)

» Execution risk associated with the construction of HTWSR, the largest part of the company's investment programme, although additional equity contributions and regulatory protections around cost sharing moderate risk

## Rating outlook

The rating outlook is stable, reflecting our expectation that with the aforementioned equity commitments Portsmouth Water will be geared, as measured by net debt to shadow RCV (including HTWSR's RCV), at or slightly below the regulatory assumption of 60% and maintain an adjusted interest coverage ratio (AICR) at least in line with minimum guidance for the Baa2 rating (1.3x).

## Factors that could lead to an upgrade

Given our expectation of weak interest coverage metrics over the remainder of the current regulatory period. upward rating pressure is not currently anticipated. However, upward rating pressure could arise upon (1) successful completion of the three key years of the construction phase with no significant cost overruns or delays; and (2) the company exhibiting an AICR sustainably above 1.5x.

## Factors that could lead to a downgrade

The rating could come under downward pressure if (1) the outstanding HTWSR actual construction works did not progress as currently envisaged, or construction delays or cost overruns increase liquidity needs, unless mitigated appropriately; or (2) Portsmouth Water was likely to exhibit gearing, measured as net debt to shadow RCV (including HTWSR's RCV), significantly above 70% during the years of peak construction spend, or an AICR persistently below 1.3x, although significant gearing headroom may allow the company to sustain an AICR slightly below this level.

## Key indicators

Exhibit 2
**Key credit metrics for Portsmouth Water Limited**

| | Mar-18 | Mar-19 | Mar-20 | Mar-21 | Mar-22 | 12-18 months forward view |
|---|---|---|---|---|---|---|
| Adjusted Interest Coverage Ratio | 1.5x | 1.9x | 1.3x | 1.3x | 1.3x | 1.1x-1.3x |
| Net Debt / Regulated Asset Base | 63.0% | 65.8% | 72.4% | 54.5% | 60.9% | 50%-60% |
| FFO / Net Debt | 10.7% | 10.0% | 7.4% | 9.5% | 8.4% | 4%-6% |
| RCF / Net Debt | 9.3% | 7.8% | 5.0% | 9.1% | 3.9% | 2%-4% |

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. For definitions of Moody's most common ratio terms please see the accompanying User's Guide. Forward-looking views represent Moody's estimates and not the view of the issuer.
*Source: Moody's Financial Metrics TM*

## Profile

Portsmouth Water Limited is the smallest of the six water only companies in England and Wales by RCV and has the lowest average customer bills of all the water service providers in the sector. The company supplies around 324,000 homes and businesses in an area of 868 square kilometres in Hampshire and West Sussex. It serves Gosport, Fareham, Portsmouth, Havant, Chichester and Bognor Regis, as well as some surrounding rural areas.

In the year to March 2022, Portsmouth Water had an RCV of £190 million, reported revenues of around £42.7 million and operating profit of £8.5 million.

Since March 2018, Portsmouth Water has been wholly owned by funds managed by Ancala Partners LLP (Ancala), an independent infrastructure investment manager.

## Detailed credit considerations

### Transparent regulatory regime, but returns have fallen

The UK water sector benefits from a transparent, stable and predictable regulatory regime, which is based on clearly defined risk allocation principles and their consistent application in setting water tariffs by an independent regulatory body, the Water Services Regulation Authority (Ofwat).

Ofwat has, to date, reset price limits every five years and the current regulatory period (AMP7) began in April 2020 and runs until March 2025.

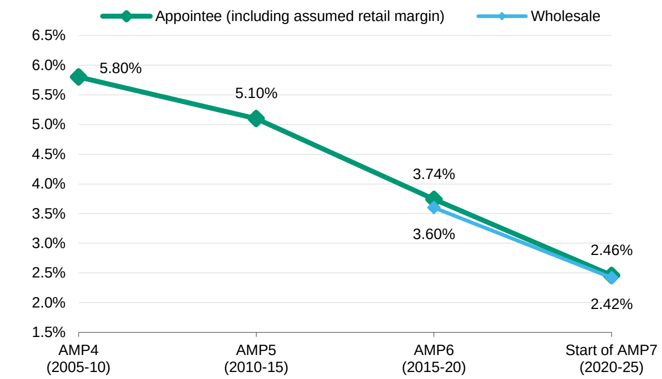
The determination included a significant cut in allowed cash returns for the sector to ca. 2.42% for the wholesale activities at the start of the new period, which incorporates the regulator's decision to only link half of the existing regulatory assets as at March 2020 to the Retail Prices Index (RPI), with the remainder and all new additions linked to the Consumer Prices Index adjusted for housing costs (CPIH). As the share of regulatory assets linked to CPIH grows over time, we estimate that most companies will have an average allowed cash return of around 2.5% over AMP7. For comparison and on a like-for-like RPI-stripped basis, allowed returns will fall by close to 50% to 1.92% (1.96% including retail margin) in AMP7 from 3.6% (3.74% including the retail margin) in AMP6 (April 2015 - March 2020).

We note that Portsmouth Water's allowed return includes a small company adjustment, which for the five year regulatory period to March 2020 (AMP6) amounted to 15 basis points overall and for AMP7 adds 33 basis points to the cost of debt allowance only (equivalent to c. 20 basis points on the overall allowed return).

Exhibit 3

**Significantly lower allowed returns since April 2020, despite lower inflation index**

**Real (cash) allowed returns**

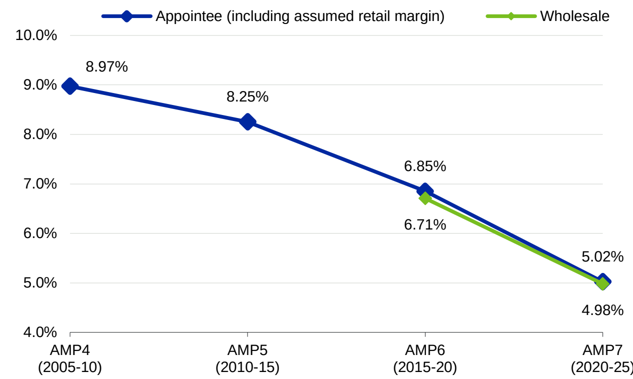



(1) Since PR14, Ofwat has separated retail activities from the wholesale services.
(2) Figures exclude company-specific adjustments, worth 15 basis points overall for Portsmouth Water in AMP6 and c. 20 basis points in AMP7
*Source: Ofwat*

Exhibit 4

**Unprecedented cut in nominal allowed returns**

**Nominal (total) returns including forecast inflation of RCV**




Assuming ex ante expectation of 3% RPI inflation and 2% CPIH inflation.
*Source: Ofwat*

For Portsmouth Water (as well as its slightly larger peer South Staffordshire Water Plc, Baa2 stable), Ofwat included a company-specific adjustment of 35 basis points on the cost allowance for embedded debt and 25 basis points for new debt, equivalent to roughly 33 basis points on the overall cost of debt allowance. This means that Portsmouth Water's allowed wholesale WACC is 2.61% at the start of the period compared with the 2.42% for the sector as a whole. Considering the RCV growth assumed by the final determination and associated new assets added over the period linked to CPIH indexation, we estimate average allowed cash returns for Portsmouth Water around 2.75% over AMP7.

Portsmouth Water's investment in HTWSR includes a CPIH-based return that is in line with the industry's WACC (2.92% real, vanilla), i.e. not including the small company premium applied to Portsmouth Water's core business. The HTWSR return will be subject to a re-opener at the five-year mark as part of its separate ten-year price control.

**Cash allowed returns likely to be higher in the next regulatory period (April 2025 - March 2030)**

On 13 December 2022, Ofwat published its final methodology for the next regulatory period (see Moody's comment 'Regulated Water Utilities – United Kingdom: PR24 methodology increases risk for weak performers' for further details). Its current early view appointee return is 3.29% (CPIH-deflated), based on a September 2022 cut off, and the regulator said that using October 2022 data (when market uncertainty was at its peak) would have led to an allowed appointee return of 3.53%. This is higher than the 2.96% return allowed in the current regulatory period (or 3.20% for companies that appealed their determination) on equivalent terms. Cash returns will increase because of a full switch to CPIH from the RPI-CPIH-blend currently in place.

We expect higher cash allowed returns to improve companies' interest cover ratios despite rising borrowing costs, particularly those with higher embedded cost of debt and infrequent market access, including the smaller WoCs. The WoCs may further benefit from an additional small company adjustment of 30 basis points to the cost of embedded debt, which would translate into an overall 14 basis point uplift to the allowed return. This is slightly lower than the 20 basis points received by Portsmouth Water and South Staffs Water during the current period. WoCs requesting this adjustment will have to provide evidence of higher funding costs on the basis of the notional capital structure as well as customer support for such a company-specific uplift. However, they will no longer need to prove that the uplift creates a “positive cost-benefit”, as required in the last two price reviews.

## Track record on cost-efficiency positions Portsmouth Water well to meet demands of challenging determination

Ofwat's regulatory determination for AMP7 sets challenging operational performance assumptions and targets, reflected in (1) annual assumed cost efficiency gains of 1.1% per annum (higher than that assumed in prior controls, or indeed for energy networks in Great

Britain in the current RIIO-2 controls) applied to a more demanding cost efficiency benchmark than in prior controls (upper quartile as opposed to sector average); and (2) calibrating the outcome delivery incentives (ODI) mechanism so that only the top quartile performers can achieve a reward. This increases the risk that the sector as a whole could earn operational returns below regulatory assumptions, putting a further strain on companies' cash flows. However, we believe that Portsmouth Water is well placed to meet these demands due to its strong starting position on cost-efficiency, which we expect that the company will maintain.

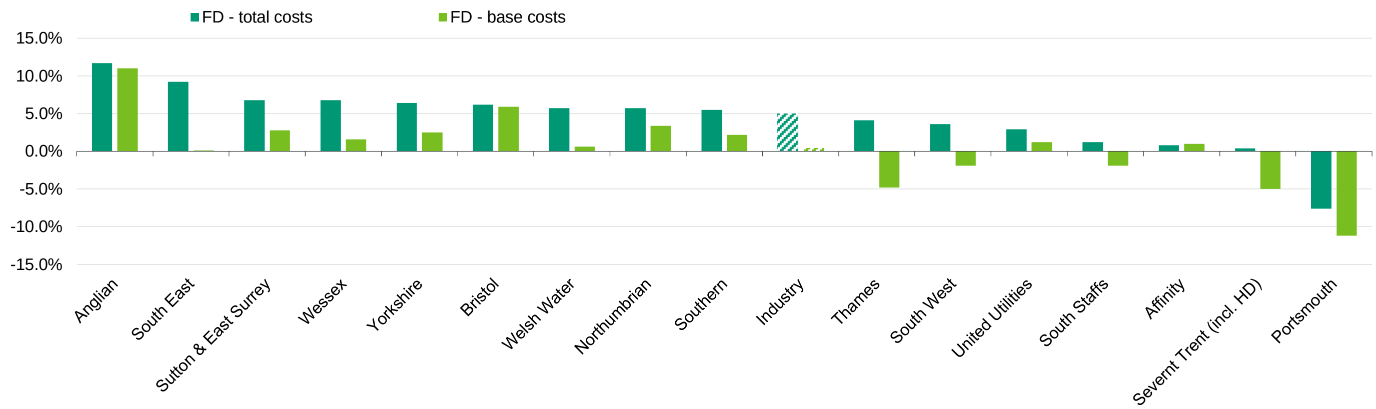
**Frontier status on cost efficiency reaffirmed by Ofwat for the current price control period**

In its final determination for AMP7, Ofwat reaffirmed Portsmouth Water's status as the most cost efficient company, from a total expenditure (totex) perspective, on mains water services. Portsmouth Water's overall controllable cost (totex) allowances for AMP7 are roughly 8% above its request, the largest excess allowance in the industry, which is indicative of its cost efficiency (see exhibit 5 below). The company is particularly strong in respect of base operating and maintenance costs, where allowances are 15% higher than it requested in its business plan (or around 11% when household retail costs are included). We expect that Portsmouth Water will overall outperform its regulatory cost allowances, despite pressure on certain cost items, including chemicals and powers costs, because the company's relative exposure to these is smaller than for most of its peers.

Exhibit 5

**Portsmouth Water received a totex allowance material in excess of its request**

**Cost efficiency challenge at final determination (FD)**

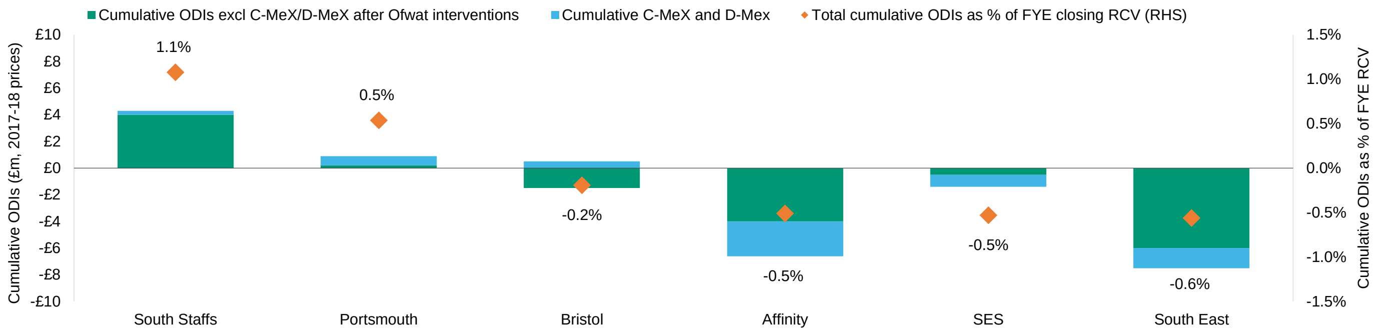



FD efficiency challenge compares FD allowance against companies' response to draft determination (DD) from August 2019. Comparison of base cost efficiencies may be affected by re-classification from base to enhancement expenditure (and vice versa) between DD and FD.
*Source: Ofwat*

Portsmouth Water is also performing solidly on outcome delivery incentives, especially customer service, which will provide a slight boost to operating cash flows over the remainder of the current regulatory period. Ofwat confirmed that Portsmouth Water accumulated net ODI rewards of £0.9 million over the first two years of AMP7, of which £0.5 million will be received in financial year ending March 2023 (FY2023) and £0.4 million in FY2024. Meeting regulatory targets on per capita consumption (PCC) continues to be the most challenging performance commitment for Portsmouth Water (the company earnt a penalty of £0.3 million in FY2022). We note that Ofwat has deferred its assessment of PCC performance to the end of the current period

Exhibit 6

**Portsmouth is one of the two water-only companies to earn net rewards on ODI-Fs in the first two years of AMP7**




Comparison for water-only companies; for the sector as a whole, Severn Trent is now in the strongest position with 1.4% (based on deferral of some rewards into future years), followed by South Staff. The weakest performer for the sector as a whole is Southern Water with cumulative net penalties of 1.5% of RCV. Data represents Ofwat determination of ODI performance and cash impact in t+2.

*Source: Moody's Investors Service based on regulatory data*

The benefit of this strong operational performance on operational cash flows is partially offset by sizeable negative legacy adjustments pertaining to the prior price control (net ODI penalties and an over-recovery on developer contributions). These total £8 million over the current regulatory period, although may be reduced via a true-up in the next price control because the company reached an agreement with Ofwat to moderate the magnitude of the return of developer contribution income.

## Construction of the Havant Thicket Reservoir, the largest single investment project in the company's history, creates execution risks

Portsmouth Water benefits from having a modest water resource surplus within its service area and has been working with neighbouring Southern Water Services Limited (funded through SW (Finance) I PLC, Baa3 stable) to increase water transfers into the latter's more water-stressed region. To facilitate increased bulk supply, Portsmouth Water will build the Havant Thicket Winter Storage Reservoir (HTWSR) which will provide up to 21Ml/d of additional water to supply Portsmouth Water's customers and free up other sources to be traded with Southern Water.

As part of its regulatory determination for AMP7, Ofwat introduced a separate 10-year price control for the reservoir. The unique regulatory arrangements, discussed in the Appendix in more details, reflect that Portsmouth Water will be remunerated through a separately negotiated agreement with Southern Water, and it will be ultimately Southern Water's customers that pay for the construction and operation of the planned reservoir. The regulatory protections around cost sharing play a key role in moderating executing risk of the project.

### Cost adjustment mechanism allows significant upward revision in regulatory cost allowances and provides regulatory protections around cost sharing

Given the early stage of the project in December 2019 and the resulting uncertainty of projects costs, Ofwat provided a cost adjustment mechanism (CAM) which allowed regulatory totex allowances, initially set at £123.6 million in 2017/18 prices (£135.3 million in November 2021 prices), to be updated for the best view of efficient costs. Ahead of the mid-period determination (there is scope for a mid-period review in 2024), the company submitted in October 2022, under the CAM process, an updated total project cost estimate of £370.4 million (in November 2021 prices), almost double its March 2022 RCV. Portsmouth Water attributed the increased costs to (1) planning conditions; (2) development of the design; (3) higher risk pricing; and (4) procurement processes resulting in higher construction costs than previously expected.

On 30 January 2023, Ofwat published its final decision and set an updated regulatory cost allowance for HTWSR of £339 million (in November 2021 prices), 8.5% lower than the company's October 2022 submission but slightly higher (by £4.4 million) than its draft decision. However, we believe that execution risk associated with the construction of HTWSR is significantly reduced by (1) totex allowances being updated for changes in steel, concrete and diesel prices over and above those priced in the main reservoir works contract, which is worth around half of the overall cost allowance; and (2) the mains reservoir works contract being signed in February 2023, after the trial embankment study was completed and key findings known.

**Material further equity injections will bolster Portsmouth Water's financial profile**

The final cost of the HTWSR project will lead to an increase of c. £183 million (in 2017/18 prices) to Portsmouth Water's RCV at the end of AMP7 in March 2025, in addition to £60 million already included as part of the final determination. The drag on interest coverage metrics from the deferral of returns on HTWSR in this regulatory period, which will be trued-up in the next period when Ofwat recognises the return on higher totex, is accentuated by the sharp rise in funding costs in 2022.

However, the impact on Portsmouth Water's financial profile is moderated by the announcement from the company's owners (Ancala)[1] that they will commit further equity to support the financing of the new reservoir. Ancala will provide £120 million of equity in 2023, £60 million of which we understand has already been contracted and will be received in mid-April, with a further £30 million in 2024, reflecting that the peak years of construction spend are 2023-25. We believe that with these equity injections, which are in addition to the £20 million Ancala have already provided, Portsmouth Water will meet minimum interest coverage guidance over the remainder of the current regulatory period until March 2025 whilst being geared at or slightly below regulatory assumptions.

### Interest coverage metrics sensitive to out-turn financing cost and regulatory cost of debt allowances for HTWSR

Portsmouth Water's principal source of funding to-date is a legacy RPI-linked loan maturing in 2032 which carries a 3.625% cash coupon and will have an estimated accreted notional of c. £130 million at March 2023. Consequently, as allowed returns have fallen in recent price controls, Portsmouth Water's base return (regulatory return / cash interest expense) and, in turn, its interest coverage metrics have been depressed.

Given the sizeable financing requirements associated with HTWSR, the evolution of Portsmouth Water's average interest costs will be dependent on the out-turn financing costs. We understand that the aforementioned committed equity injection pledged in February 2023 was upsized from £120 million to £150 million to allow the company to maintain an adjusted interest coverage ratio in line with minimum guidance for the current Baa2 rating (1.3x) despite the material higher funding costs on new debt now anticipated. The evolution of Portsmouth Water's interest coverage metrics in the next regulatory period are highly sensitive to the allowed return provided for HTWSR - we understand that Ofwat have committed to setting a specific allowed return (in the current regulatory period Ofwat set the same return on the project as for the industry as a whole, i.e. without including Portsmouth Water's small company premium).

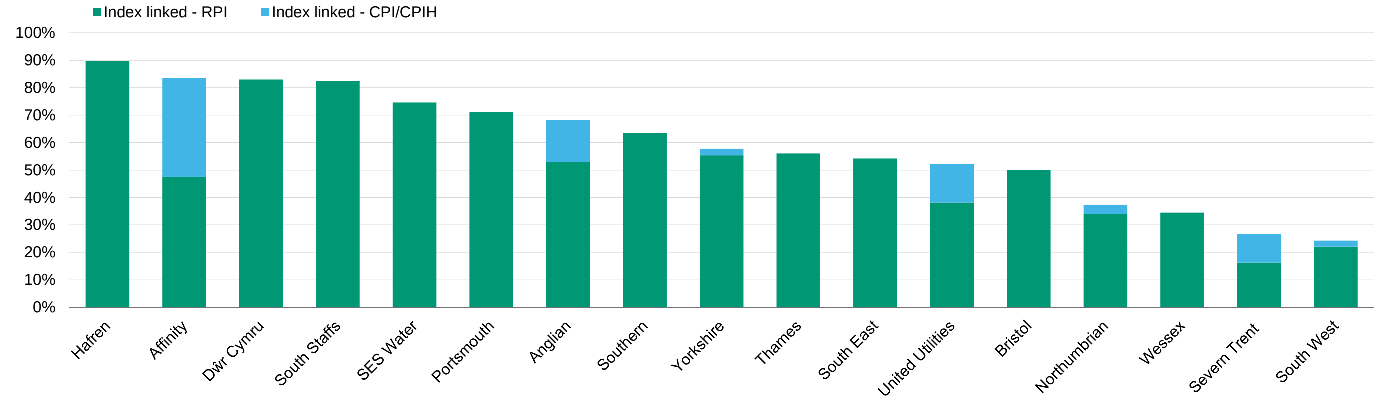
### Macroeconomic conditions will cause sizeable regulatory timing differences

The significant increase in inflation, in part due to the steep rise in wholesale gas and power prices as well as interest rates seen in 2022 will cause sizeable regulatory timing differences, impacting Portsmouth Water's reported credit metrics.

Like other UK regulated utilities, Portsmouth Water's allowed revenues incorporate adjustment for inflationary pressures. However, this occurs with a lag - for example, customer bills in the 2022-23 regulatory year reflect inflation as at November 2021 but companies will have experienced an increase in their cost base between November 2021 and March 2023. The resulting revenue shortfall will depress operating cash flows in the current year, although this will be recovered over time. Because the regulatory framework does not fully reflect out-turn inflation for all baskets of costs and instead uses general measures rather than specific indices (which means that some cost categories have risen well above the general rate of inflation, e.g. unhedged power costs and chemicals, which represent together a material portion of the sector's opex), the sector will not recover this shortfall in full.

High inflation should support deleveraging, as measured by net debt to regulated assets, for water companies operating in real returns frameworks as the asset base is indexed to inflation. However, the benefit to Portsmouth Water is very limited because of (1) the high proportion of its debt that is inflation-linked, over 70% at March 2022 and all RPI-linked; and (2) only around 40% of the sector's RCV is indexed to RPI; the rest is indexed to the structurally lower CPIH measure. In addition, the proxy used by Ofwat for RPI (CPIH plus 1% [the so-called 'wedge']) in the current regulatory applies to the calculation of allowed returns during the period. Although 1% was a reasonable long-term assumption for the wedge, recent market volatility widened the RPI-CPIH gap to around 4.6% in January 2023 (though there will be a true-up adjustment for the difference between the actual and assumed RPI-CPIH wedge at the next price review).

Exhibit 7
**Portsmouth has an above average share of inflation-linked debt which is all RPI-linked**
**Proportion of debt at March 2022 that is inflation linked, Including index-linked swaps**




*Source: Ofwat's data tables, monitoring financial resilience reporting 2021/22*

As allowed returns, intended to cover companies' cost of debt and equity capital, are fixed during the five-year regulatory period (although with an adjustment to reflect indexation of new debt at the end of the period), changes in interest rates will affect interest coverage metrics – especially for companies with large and lumpy funding needs. Water companies will receive some compensation for rising interest rates at the next price review, because the cost of new debt assumed to be raised within the current period had been linked to the average A/BBB IBoxx indices. The regulator assumes that companies refinance on average around 20% of their existing debt over a regulatory period. We currently estimate the cumulative adjustment to be equivalent to roughly 30 basis points of the March 2025 RCV (in 2017/18 prices) for most companies, and just over 50 basis points for those that appealed to the Competition and Markets Authority (CMA). However, infrequent refinancing or sizeable RCV growth may result in an overall funding requirement that differs from the regulatory assumptions. In addition, while floating rate exposure tends to be limited, companies with a larger proportion of floating rate debt are more exposed to rising rates.

## Structural considerations

Portsmouth Water's Baa2 CFR consolidates the legal and financial obligations of Portsmouth Water Limited, Portsmouth Water Holdings Limited and Brockhampton Holdings Limited, the two immediate holding companies of Portsmouth Water. The rights and obligations of these companies and their creditors are set out in the Security Trust and Intercreditor Deed.

In 2022 and 2023, Portsmouth Water has made changes to its financing structure. These have resulted in (1) a reduction in the gearing level that would trigger a distribution block to 80% net debt to RCV (previously 86%); (2) replacing the sinking fund with additional liquidity and lock-up requirements to reduce refinancing risk; and (3) amending the covenant levels to take account of the shadow RCV for HTWSR and allowing equity injections to be made. We view the changes to the financing structure as broadly credit neutral and the structure continues to provide a level of credit enhancement equivalent to around one rating notch, which is incorporated into the Baa2 CFR.

Aside from the gearing lock-up level, a distribution block would also be triggered if the interest coverage ratio were to fall below 1.4x.[2]

Other key features of the covenant and security package include (1) liquidity facilities (and/or cash reserves) equal to six months of debt service; and (2) a first-ranking fixed charge over the shares in the company, plus first-ranking and floating charges over all the assets, rights and undertakings of Portsmouth Water Limited. We recognise that the benefit of the security is limited due to the regulated and essential nature of the services provided by Portsmouth Water as governed by its license and the Water Industry Act 1991.

## ESG considerations

### Portsmouth Water's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 8
**ESG Credit Impact Score**

**CIS-3**
**Moderately Negative**

NEGATIVE IMPACT POSITIVE IMPACT

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.

*Source: Moody's Investors Service*

The ESG Credit Impact Score for Portsmouth Water Limited is moderately negative (**CIS-3**), reflecting moderate social as well as low environmental and governance risks. The overall credit impact score also recognises mitigating factors, in particular the regulated nature of water companies' activities and their investment requirements, including a forward-looking allowance for efficient cost. However, as investment needs continue to grow to tackle climate change and population growth, the resulting increase in regulated assets and their remuneration will have to continue to be supported by the regulatory tariff framework in order to avoid negative credit implications in the future.

Exhibit 9
**ESG Issuer Profile Scores**

| ENVIRONMENTAL | SOCIAL | GOVERNANCE |
|---|---|---|
| **E-2** | **S-3** | **G-2** |
| Neutral-to-Low | Moderately Negative | Neutral-to-Low |

*Source: Moody's Investors Service*

#### Environmental

Portsmouth Water's low environmental risk (**E-2** issuer profile score) reflects the company's currently low risk exposure to physical climate risks, including climate change-related drought or flooding incidents and water management. According to an analysis by the UK government's Environment Agency (EA), the southeast of England, which includes the service area of Portsmouth Water, will require additional supply of 1,765 million litres a day by 2050, more than a third of current overall annual distribution input at just over 5,000 million litres per day, to offset additional challenges from population growth and climate change as well as increase drought resilience. However, Portsmouth Water's specific service area is in overall surplus, and the company is currently investing into a new storage reservoir to allow it to provide additional water bulk supply to a neighbouring company. Over the 2020-25 regulatory period, Portsmouth Water has been allowed to spend roughly £13 million (in 2017/18 prices) on its core activities for improvements in the context of the water infrastructure national environmental programme as well as to increase resilience through improved supply and demand management, in particular higher meter penetration. As mentioned, the company is also investing in a new reservoir, which is subject to a 10-year price control, with an overall cost assumption of £310 million (in 2017/18 prices).

#### Social

Portsmouth Water's social risk is moderately negative (**S-3**), reflecting the risk, common to all regulated utilities, that public concern over environmental, social or affordability issues could lead to adverse regulatory or political intervention. While water companies and regulators have sought to address criticism over operational performance, bills and dividend payments, the opposition UK Labour Party has argued for nationalisation. The risks associated with societal trends and responsible production are balanced by neutral effects from human capital and customer relationships, with Portsmouth Water being one of the best performers in the sector.

### Governance

Governance risks are low (**G-2**). While concentrated ownership, as is the case for Portsmouth Water, reduces board independence and can affect governance negatively, regulatory requirements ensure that independent directors represent the largest single group on the board. In addition, the company's licence prescribes maintenance of a minimum credit profile and financial covenants in its debt structure restrict distributions if minimum financial parameters are not maintained. The company remains modestly geared, with committed additional equity injections in 2023 and 2024 expected to support a balanced financial profile despite large investment needs. Creditor protections embedded in the company's financing structure balance against the risk of additional holding company debt within the wider group structure.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

## Liquidity analysis

We assess Portsmouth Water as having adequate liquidity over the next 12 months, reflecting as positives (1) the stable and predictable cash flows generated by its regulated activities; (2) cash and cash equivalents of £21.5 million as at 30 September 2022; (3) committed equity injections of £150 million; and (4) no long-term debt maturities before March 2025 (a term loan raised to support HTWSR). These benefits are tempered by the sizeable financing requirements associated with the construction of the HTWSR, although the company is at advanced stages of securing the required funding.

Long-term refinancing risk is mitigated by a combination of a liquidity and debt maturity concentration test. The liquidity test will result in a cash lock-up, if available cash and undrawn facilities amount to less than projected debt maturities (principal and inflation accretion) over the next 12 months, while the maturity concentration test will lock up cash if, over the next rolling four years, net debt maturing exceeds 45% of RCV (at the end of that period).

## Rating methodology and scorecard factors

Moody's assessment of Portsmouth Water's credit quality is based on the rating methodology for Regulated Water Utilities, published in June 2018. The scorecard-indicated outcome over the next 12-18 months is Ba1 reflecting the scale of the company's planned investments on HTWSR and that returns are deferred to the next period, depressing cash-flow based metrics. However, the Baa2 rating reflects that execution risk is significantly reduced by regulatory protections around cost sharing and additional equity contributions.

Exhibit 10

**Rating Methodology Scorecard**

**Portsmouth Water Limited**

| Regulated Water Utilities Industry Scorecard [1][2] | Current FY 3/31/2022 | | Moody's 12-18 Month Forward View As of February 2023 [3] | |
|---|---|---|---|---|
| **Factor 1 : Business Profile(50%)** | **Measure** | **Score** | **Measure** | **Score** |
| a) Stability and Predictability of Regulatory Environment | Aa | Aa | Aa | Aa |
| b) Asset Ownership Model | Aa | Aa | Aa | Aa |
| c) Cost and Investment Recovery (Sufficiency & Timeliness) | A | A | A | A |
| d) Revenue Risk | Aa | Aa | Aa | Aa |
| e) Scale and Complexity of Capital Programme & Asset Condition Risk | Ba | Ba | Caa | Caa |
| **Factor 2 : Financial Policy (10%)** | | | | |
| a) Financial Policy | Ba | Ba | Baa | Baa |
| **Factor 3 : Leverage and Coverage (40%)** | | | | |
| a) Adjusted Interest Coverage Ratio (3 Year Avg) | 1.3x | Ba | 1.1x - 1.3x | Ba |
| b) Net Debt / Regulated Asset Base (3 Year Avg) | 62.2% | Baa | 50% - 60% | Baa |
| c) FFO / Net Debt (3 Year Avg) | 8.4% | Ba | 4% - 6% | B |
| d) RCF / Net Debt (3 Year Avg) | 5.8% | Ba | 2% - 4% | B |
| **Rating:** | | | | |
| Scorecard-Indicated Outcome Before Notch Lift | | Baa3 | | Ba2 |
| Notch Lift | | 1.5 | | 1.5 |
| a) Scorecard-Indicated Outcome | | Baa1 | | Ba1 |
| b) Actual Rating Assigned | | | | Baa2 |

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) As of 3/31/2022. (3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

*Source: Moody's Financial Metrics ™*

## Ratings

Exhibit 11

| Category | Moody's Rating |
|---|---|
| **PORTSMOUTH WATER LIMITED** | |
| Outlook | Stable |
| Corporate Family Rating | Baa2 |

*Source: Moody's Investors Service*

## Appendix – Havant Thicket Winter Storage Reservoir

The Havant Thicket Winter Storage Reservoir (HTWSR) project is expected to take around ten years to complete and is intended to boost resilience in a severe drought scenario by supporting additional bulk transfer capacities from Portsmouth Water (which owns the site) to Southern Water. The project and bulk supply contract will allow Portsmouth Water to benefit from a regulatory incentive, the water trading incentive, where cost savings compared with other supply solutions are shared between the entity supplying the water and the one using it.

Ofwat decided to treat HTWSR under a separate price control lasting ten years, reflecting a development, construction and commissioning period of around ten years for the reservoir and the company has also entered into an 80-year bulk supply agreement with neighbouring Southern Water. In line with the general approach to bulk supplies, the regulator includes no revenue allowance as such, because the costs are deemed to be captured by the contract with Southern Water.

While the remuneration of the costs for the construction and operation of the reservoir will, ultimately, be subject to commercial terms agreed between the two parties, Ofwat did set out assumptions for the core revenue building blocks to aid transparency around the investment. These regulatory building blocks have effectively formed the basis for the capacity charge agreed between the parties under the bulk supply contract:

» **Pay as you go (PAYG)** – This reflects the allocation of efficient totex allowance to costs that are recovered from revenue in the 2020-30 period. The proportion of totex not recovered from PAYG is added to the HTWSR RCV to be recovered over a longer period of time. For the duration of the revenue control 100% of total expenditure will be added to the HTWSR RCV (i.e. pay-as-you-go rates are set at 0%).

» **Allowed return on capital** – This will be calculated based on Ofwat's assessment of the cost of capital multiplied by the average HTWSR RCV for each year. In the draft determination, Ofwat provided an indication for its view on efficient cost of capital, including the assumption that, because Havant Thicket is a new asset to be built after the start of the new regulatory period, there is no embedded debt to consider and the new RCV will be inflated by CPIH only. At the final determination, Ofwat updated its view around the cost of capital for HTWSR to reflect the same return as the industry as a whole, but without including Portsmouth Water's small company premium. The wholesale CPIH return for this project would therefore be 2.92%, compared with a cash return for Portsmouth Water's other wholesale activities of 2.61% at the start of the period (which is a 50:50 blended RPI-CPIH return and includes the small company premium on the cost of debt allowance; Portsmouth Water's wholesale return for the core business would be 3.11% on fully CPIH-deflated terms).

» **RCV run-off** – This reflects the amount of HTWSR RCV that is amortised in the period of the price control. In the final determination for HTWSR, Ofwat assumed depreciation of the RCV on a straight-line basis to an end-date that is 80 years after the assumed start date for the bulk supply agreement of 1 April 2020.

» **Non-price control income** – This reflects income from charges excluded from the price controls and includes bulk supply revenues from Southern Water but can also contain other services. Ofwat deducted the forecast income from the allowed revenue, which included associated costs of the same amount.

Ofwat effectively set the allowed revenues for the HTWSR price control to zero, recognising that Portsmouth Water's customer are not funding the development of the reservoir through their bills.

Portsmouth Water will be subject to a bespoke performance commitment and associated financial penalties if dry commissioning is not achieved by 30 September 2026 and wet commissioning by 30 June 2029. These deadlines can be adjusted for delays outside of management's control, in particular associated with (1) planning conditions or refusal of consent; (2) delays in entering the bulk supply agreement by 1 April 2020; (3) environmental protection requirements; and (4) restricted access to land. However, Ofwat will require "compelling evidence that events were beyond Portsmouth Water's reasonable control and that management took reasonable actions to mitigate the effects to delivery of the Havant Thicket reservoir".

The bulk supply agreement between Portsmouth Water and Southern Water was executed on 29 January 2021, but contingent on a number of additional conditions being fulfilled by 31 March 2021. These conditions precedent, which were met in time, included the enactment of certain licence amendments, which will require both parties to comply in all material respects with the Bulk Supply Agreement and allow Ofwat to intervene if there is a failure to comply, additional funding to support the investment and agreements between the parties around the capacity charge as well as a memorandum of understanding around the potential introduction of a direct pipeline between HTWSR and Southern Water's service area at a later stage. The licence changes and associated regulatory principles also aim to limit Portsmouth Water's exposure to counterparty risk in the event of any future potential default by Southern Water.

## Appendix 2

Exhibit 12

### Selected peer comparison

**Portsmouth Water Limited**

| | Portsmouth Water Limited Baa2 Stable | | | South Staffordhsire Water Plc Baa2 Stable | | | Sutton & East Surrey Water plc Baa2 Stable | | |
|---|---|---|---|---|---|---|---|---|---|
| (in GBP million) | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 |
| Revenue | 43 | 42 | 43 | 130 | 130 | 140 | 70 | 66 | 63 |
| EBITDA | 14 | 14 | 14 | 56 | 52 | 56 | 31 | 21 | 20 |
| Regulated Asset Base (RAB) | 152 | 168 | 189 | 388 | 403 | 450 | 262 | 270 | 298 |
| Total Debt | 131 | 120 | 141 | 272 | 263 | 293 | 201 | 213 | 235 |
| Net Debt | 110 | 92 | 115 | 246 | 258 | 243 | 175 | 187 | 211 |
| (FFO + Interest Expense) / Interest Expense | 2.1x | 2.4x | 2.0x | 4.7x | 4.4x | 3.4x | 3.4x | 2.9x | 2.1x |
| FFO / Net Debt | 7.4% | 9.5% | 8.4% | 22.5% | 15.9% | 19.4% | 13.7% | 8.1% | 6.6% |
| RCF / Net Debt | 5.0% | 9.1% | 3.9% | 20.0% | 14.2% | 15.6% | 9.9% | 5.5% | 5.0% |
| Net Debt / Regulated Asset Base | 72.4% | 54.5% | 60.9% | 63.3% | 64.1% | 54.0% | 66.9% | 69.3% | 70.7% |
| Adjusted Interest Coverage Ratio | 1.3x | 1.3x | 1.3x | 3.3x | 2.1x | 2.5x | 1.8x | 0.0x | -0.4x |

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months. RUR* = Ratings under Review, where UPG = for upgrade and DNG = for downgrade.
*Source: Moody's Financial Metrics™*

Exhibit 13

### Moody's adjusted net debt breakdown

**Portsmouth Water Limited**

| (in GBP million) | FYE Mar-18 | FYE Mar-19 | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 |
|---|---|---|---|---|---|
| **As Reported Total Debt** | 107 | 117 | 131 | 145 | 166 |
| Leases | 0 | 0 | 0 | 0 | 0 |
| Hybrid Securities | 0 | 0 | 0 | (25) | (25) |
| **Moody's Adjusted Total Debt** | 107 | 117 | 131 | 120 | 141 |
| Cash & Cash Equivalents | (16) | (18) | (21) | (28) | (26) |
| **Moody's Adjusted Net Debt** | 91 | 99 | 110 | 92 | 115 |

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM =Last Twelve Months.
*Source: Moody's Financial Metrics™*

Exhibit 14

### Moody's adjusted Funds from Operations (FFO) breakdown

**Portsmouth Water Limited**

| (in GBP million) | FYE Mar-18 | FYE Mar-19 | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 |
|---|---|---|---|---|---|
| **As Reported Funds from Operations (FFO)** | 10 | 11 | 11 | 13 | 14 |
| Alignment FFO | (4) | (3) | (4) | (2) | (5) |
| Unusual Items - Cash Flow | 3 | 2 | 2 | 0 | 0 |
| Cash Flow Presentation | 0 | 0 | (3) | (3) | (4) |
| Non-Standard Adjustments | 1 | (1) | 2 | 1 | 4 |
| **Moody's Adjusted Funds from Operations (FFO)** | 10 | 10 | 8 | 9 | 10 |

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM =Last Twelve Months.
*Source: Moody's Financial Metrics™*

Exhibit 15

**Selected historical financial data, Moody's adjusted**

**Portsmouth Water Limited**

| (in GBP million) | FYE Mar-18 | FYE Mar-19 | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 |
|---|---|---|---|---|---|
| **INCOME STATEMENT** | | | | | |
| Revenue | 40 | 42 | 43 | 42 | 43 |
| EBITDA | 14 | 14 | 14 | 14 | 14 |
| EBITDA margin % | 35.1% | 32.7% | 32.9% | 33.4% | 33.8% |
| EBIT | 8 | 8 | 8 | 8 | 8 |
| EBIT margin % | 19.2% | 18.8% | 18.7% | 18.5% | 19.8% |
| Interest Expense | 8 | 7 | 7 | 6 | 9 |
| Net income | 0 | 0 | (21) | 1 | (3) |
| **BALANCE SHEET** | | | | | |
| Net Property Plant and Equipment | 127 | 136 | 150 | 161 | 172 |
| Total Assets | 239 | 249 | 255 | 278 | 282 |
| Total Debt | 107 | 117 | 131 | 120 | 141 |
| Cash & Cash Equivalents | 16 | 18 | 21 | 28 | 26 |
| Net Debt | 91 | 99 | 110 | 92 | 115 |
| Total Liabilities | 161 | 173 | 191 | 187 | 209 |
| **CASH FLOW** | | | | | |
| Funds from Operations (FFO) | 10 | 10 | 8 | 9 | 10 |
| Cash Flow From Operations (CFO) | 13 | (1) | 1 | 4 | 7 |
| Dividends | 1 | 2 | 3 | 0 | 5 |
| Retained Cash Flow (RCF) | 8 | 8 | 5 | 8 | 5 |
| Capital Expenditures | (7) | (13) | (15) | (18) | (17) |
| Free Cash Flow (FCF) | 5 | (16) | (17) | (14) | (16) |
| **INTEREST COVERAGE** | | | | | |
| (FFO + Interest Expense) / Interest Expense | 2.3x | 2.3x | 2.1x | 2.4x | 2.0x |
| Adjusted Interest Coverage Ratio | 1.5x | 1.9x | 1.3x | 1.3x | 1.3x |
| **LEVERAGE** | | | | | |
| Regulated Asset Base (RAB) | 144 | 150 | 152 | 168 | 189 |
| Net Debt / Regulated Asset Base | 63.0% | 65.8% | 72.4% | 54.5% | 60.9% |
| FFO / Net Debt | 10.7% | 10.0% | 7.4% | 9.5% | 8.4% |
| RCF / Net Debt | 9.3% | 7.8% | 5.0% | 9.1% | 3.9% |

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM =Last Twelve Months.
*Source: Moody's Financial Metrics™*

## Endnotes

1 https://ancala.com/wp-content/uploads/2023/02/PW-Release_Havant-Thicket-Reservoir_2023_final.pdf

2 The definition of this ratio differs from Moody's definition. Under the financing documentation, the interest cover ratio (ICR) reflects net cash flow, defined as operating cash flow, before interest cost plus interest income less taxes, plus any borrowings to support capital investments less all capital spending in the year, divided by interest paid.

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