SECTOR IN-DEPTH
14 August 2024

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Regulated Water Utilities – UK

Ofwat's draft determination increases sector risk

Summary

On 11 July 2024, the UK Water Services Regulation Authority, or Ofwat, published its draft determination, or DD, imposing tough cost and performance targets on the water companies operating in England and Wales for the five-year period starting 1 April 2025, or AMP8. The DD responds to public and political concerns over water companies' performance and service levels, particularly concerning wastewater treatment. However, the draft also increases the risk that sector returns may not be enough to attract the equity funding the companies need to support increasing investment. If the draft is adopted unchanged we could lower our view of the regulatory framework's stability, predictability and supportiveness.

» **Risk of cost overruns or future underperformance has increased.** Cost allowances in the draft determination are 16% lower than companies proposed. There are better sharing rates for cost overruns, particularly on enhancement expenditure, but initial allowances may be below companies' needs and require upfront funding, while subsequent adjustments would be delayed into the next five-year period. Ofwat has also cut resilience expenditure, which will expose companies to higher long-term risk. Because investment needs will continue to grow for at least the next 25 years, loading spending into future periods will also increase future customers' costs.

» **Companies at increased risk of incurring penalties.** Ofwat has set more demanding operational performance targets and strengthened incentive rates. Based on the draft determination and if companies perform in line with their business plan assumptions, we estimate that most companies are likely to incur net penalties over the next five years, in aggregate amounting to around £2 billion across the sector.

» **Allowed returns may not be enough to attract equity support for large investment needs**. Equity returns are below those proposed for UK energy networks, implying that water companies may be lower risk. However, water companies may struggle to achieve allowed returns, if the DD is adopted as it stands.

» **Final determinations likely to include some changes, but higher business risk means we could revise our view of regulation**. We expect regulators to respond to additional evidence companies present, with final determinations typically less onerous than drafts. However, the DD increases the sector's business risk, a credit negative. A change in our view of the stability and supportiveness of the regime or companies' ability to recover costs and earn a fair return could lead us to adjust our ratio guidance.

Risk of cost overruns or future underperformance has increased

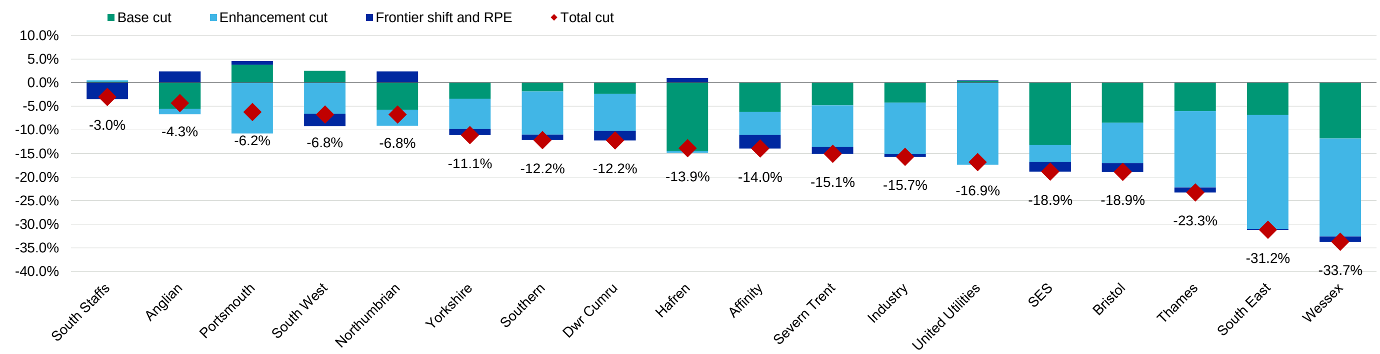
Ofwat's DD proposes what amounts to sectorwide cuts of 16% in total expenditure (totex) allowances for the UK water industry. Totex allowances before any adjustments are £91 billion, but reduce to £88 billion after adjustments for assumed efficiency gains of 1% a year and costs subject to inflation protection.[1] The proposed cut is wider than the 11% and 5% in the 2019 price review (PR19) draft and final determinations, respectively, although this may reflect a proportionally larger enhancement programme.

As Exhibit 1 shows, the combined base and enhancement totex cut for the 2024 price review (PR24) is highest for Wessex Water Services Limited (funded through Wessex Water Services Finance Plc, Baa1 stable), South East Water Limited (funded through South East Water (Finance) Limited, Baa2 under review for downgrade) and Thames Water Utilities Ltd. (Ba2 negative). These three companies had requested some of the largest increase in base costs compared with current levels as well as sizeable enhancement cost increases.

Exhibit 1

Combined cuts highest for Wessex Water, South East Water and Thames Water

Overall PR24 DD totex cuts



Totex cut is calculated as the cost difference between the draft determination and company's plan, divided by company's plan costs.
Source: Ofwat's draft determinations

Base cost gap larger than last price review, but enhanced inflation protection

Ofwat's draft proposes base total expenditure of £56 billion. This is 7% below business plan submissions, but 14% higher than PR19 allowances. This compares with a base cost shortfall of around 4% in the PR19 draft and less than 1% at PR19 final determination.

According to Ofwat, the shortfall reduces to 2% when energy costs and business rates are excluded, which will benefit from ex-post adjustments to reflect real price effects (RPE) and stronger sharing rates. However, the initial funding for these costs may underestimate companies' exposure. For example, funding for business rates is around £1.1 billion or 27% below companies' requests. Improved sharing rates mean companies can recover 90% of any increase, but they will still need to fund costs upfront over the AMP8 period, with reconciliations, or true-ups, delayed until the start of AMP9.

Ofwat estimates that RPE protection will now cover around 55% of companies' costs compared with 30% in the 2019 price review. This is because energy and plant and equipment costs, included in base and enhancement totex respectively, will be adjusted by specified inflation indices in an ex-post reconciliation, in addition to wages, which were covered during PR19.

PR24 base totex sharing rates for costs other than business rates and RPE adjustment — which is the overspend that companies remain exposed to, or the underspend they have to share with customers — are broadly 50%. Companies that Ofwat views as lacking ambition or having inadequate business plans face exposure to 55%-60% of over or underspend. Compared with PR19, sharing rates will improve for South East Water, Southern Water Services Limited (funded through SW (Finance) I PLC, Baa3 under review for downgrade) and Thames Water. Ofwat proposes applying a 40% sharing rate for the final year of the current period for these three companies, allowing them to recover 40% of any overspend during the 2024-25 financial year from their customers. The proposal aims to discourage companies from delaying investment to benefit from more favourable future sharing rates.

Sizeable enhancement gap, but better sharing for overspend

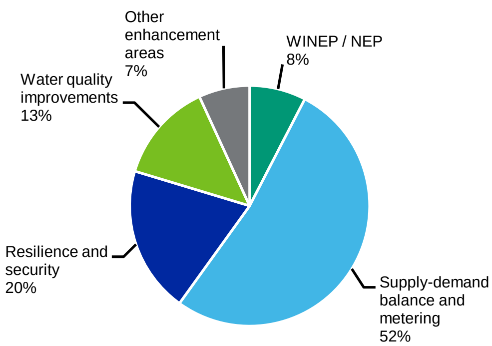
Ofwat's draft enhancement totex allowances of £35 billion are around 25% below companies' updated business plan proposals. In comparison, the PR19 enhancement cost shortfall was 33% and 23% at DD and FD, respectively, but there was also a separate allowance for strategic water resources.

Enhancement allowances are split one third water and two thirds wastewater. Around half the £11.5 billion water enhancement totex allowances are linked to improving water resources through supply and demand management (Exhibit 2), while most wastewater enhancement is linked to environmental obligations, including £9.5 billion for storm overflows (Exhibit 3).

Exhibit 2

Around half the water enhancement spending targets improving the supply-demand balance

Water enhancement (£11.5 billion)

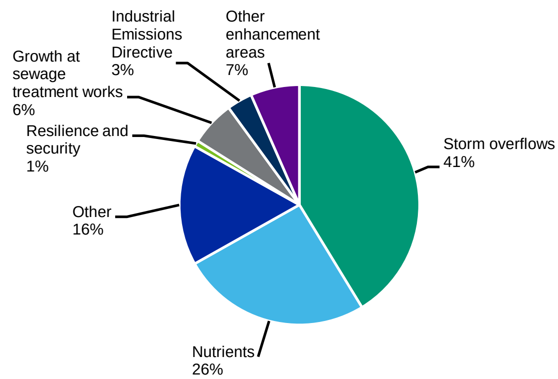


Source: Ofwat's draft determinations

Exhibit 3

Most wastewater enhancement focuses on environmental obligations

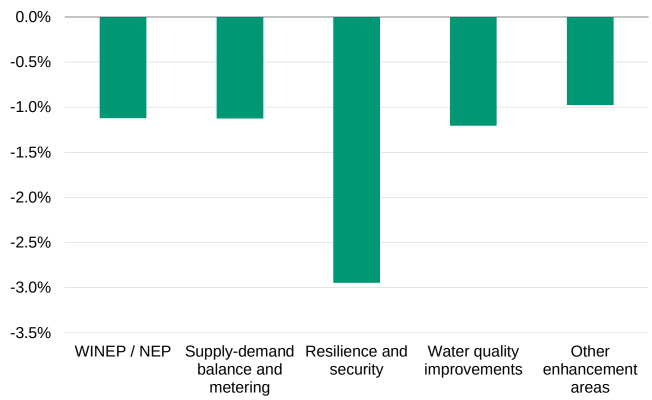
Wastewater enhancement (£23 billion)



Source: Ofwat's draft determinations

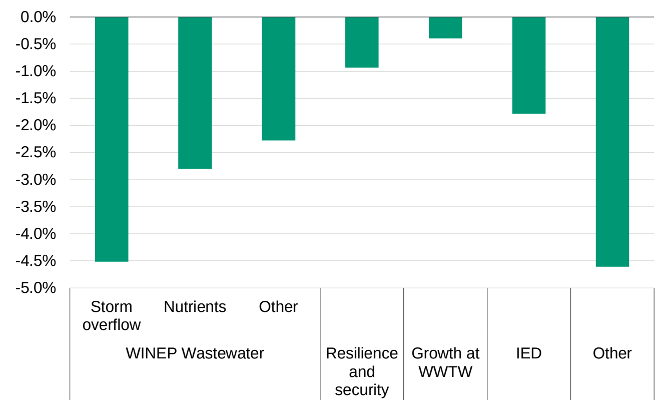
Cuts in allowances were most pronounced in wastewater, particularly in environmental areas such as storm overflows and accounted for around 70% of the total enhancement shortfall (Exhibits 4 and 5). These cuts were mostly driven by cost comparison across companies and with historical levels, where, according to Ofwat, companies did not provide enough evidence for the higher costs they requested. The regulator also reduced the funding companies requested for resilience and security, with larger reductions on water than wastewater, including for cyber, which it viewed as already funded through base allowances or not yet needed. While savings in resilience spending will benefit customers in the short term, they will increase longer term operational risk, [particularly because of growing investment needs, which are likely to exceed £270 billion over the next 25 years.]

Exhibit 4
Water enhancement cuts focused on resilience



Shortfall calculated as a percentage of overall water and wastewater enhancement totex request.
Source: Ofwat's draft determinations

Exhibit 5
Wastewater enhancement cuts are heavily weighted towards the environmental programme



Shortfall calculated as a percentage of overall water and wastewater enhancement totex request.
Source: Ofwat's draft determinations

Ofwat also included additional protection against cost overruns on enhancement expenditure, with companies bearing only 40% of any overspend or retaining 40% of any underspend. For three specific areas of greater uncertainty, primarily related to strategic resources, large complex projects and the industrial emissions directive, Ofwat has applied an even lower rate of 25%. [2] Ofwat considers 21 projects worth £4.5 billion, or around 13% of total enhancement allowances, as of greater uncertainty. Ten of these would be subject to enhanced engagement and 25% cost sharing. Costs submitted for these projects' totalled £1.8 billion, but allowances were reduced to £1.2 billion after benchmarking. Another 11 may fall under a more structured gated assessment, where water companies must submit detailed plans for proposed investments in stages or "gates."

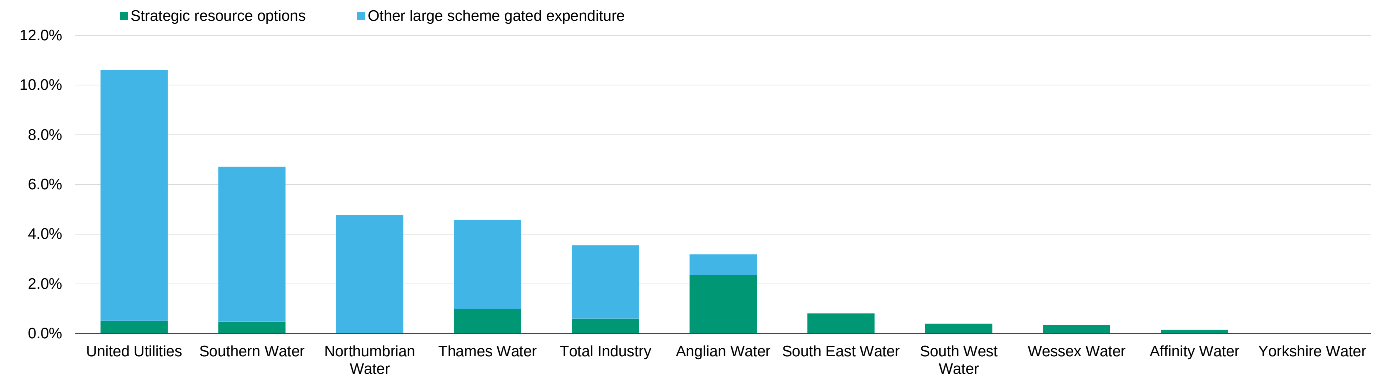
Water companies also proposed 26 schemes for competitive tender, either through direct procurement for customers (DPC) or under the specified infrastructure provider regulations (SIPR), which is the Tideway model. Ofwat considered 21 suitable, including 17 strategic resource options, assessed under the regulators' alliance for progressing infrastructure development, or RAPID. Allowances for their development total £1.2 billion in 2022-23 prices over AMP8. Of this, £686 million baseline funding will carry a 40% sharing rate for over or underspend, while £527 million contingent funding carries a 25% sharing rate.

Despite some de-risking for exposure to cost overruns, Ofwat also introduced new price control deliverables, or PCDs. PCDs will include incentives related to nondelivery and delays. Around 85% and 92% of water and wastewater enhancement expenditure, respectively, will be subject to PCDs or a gated approval process. The latter will provide funds only if certain steps are achieved at several points or gates over the regulatory period. As a result, companies will have to prefund some of these contingent gated allowances during the AMP7 period. The true-up adjustment to reflect these investments in the regulatory capital value, or RCV, and revenue will only apply at the start of the next period, although Ofwat may consider in-period adjustments if required to support financeability on a notional basis. United Utilities Water Limited (A3 stable), Southern Water, Northumbrian Water Ltd. (Baa1 stable) and Thames Water have the largest proportionate exposure to these gated investments and their in-period financial ratios may be weaker as a result (Exhibit 6).

Exhibit 6

United Utilities, Southern Water, Northumbrian Water and Thames Water have largest proportional exposure to gated investments

Proportion of gated allowances in relation to overall DD allowed totex, post-frontier shift and RPE adjustments (includes strategic resources)



Source: Ofwat's draft determinations

Ofwat also proposes introducing a delayed delivery cash flow mechanism (DDCM). Where companies underspend their enhancement allowance in years two and three, they will have to return a proportion of the underspend to customers in years four and five.[3] If a company subsequently accelerates its spending, this would be reflected in an end-of-period uplift. However, this mismatch of cash flow timing could weaken liquidity precisely when companies are catching up on their investment. It is also unclear how Ofwat will treat delays outside management control such as planning applications.

Ofwat also made smaller adjustments to regulatory run-off rates, or the depreciation of the RCV, for a number of companies. This slightly reduces their near-term cash flow but also results in a slower decline in RCV. While this is neutral in the context of our key interest cover ratio, it reduces companies' near term available cash flow.[4]

Companies at increased risk of incurring penalties

Ofwat has set 24 common performance commitments, which apply to all companies and eight potential bespoke commitments which would apply to individual companies.[5] The regulator said the DD performance targets are “stretching but achievable.” It expects companies to improve performance above the industry median but below the upper quartile on the basis of the levels proposed in companies' plans, a slight relaxation from PR19. Compared with PR19, Ofwat applied stronger outcome delivery incentive (ODI) rates for commitments linked to environmental, asset health and customer service performance. If companies underperform these, they will face proportionally higher penalties than in the current period (Exhibit 7).

Exhibit 7

Standard penalty rates have stepped up significantly

Common ODIs that continue into AMP8 and account for a large portion of the estimated sector penalties

Performance commitment	Contribution to estimated sector penalties	AMP8 performance target requirement compared with AMP7	Step up in standard penalty rate compared with AMP7
Total pollution incidents	20.8%	industry-wide (excl Hafren) reduction by 29%	average 3.5x of AMP7 rate, but up to more than 5x for some
Internal sewer flooding	11.9%	industry-wide (excl Hafren) reduction by 19%	average more than 1.5x of AMP7 rate, but up to more than 2.5x for some
Leakage	6.9%	average reduction over AMP8 by 16%	average 3x of AMP7 rate, but up to almost 5x for some
Per capita consumption	6.2%	average reduction over AMP8 by 4%	average 2.5x of AMP7 rate, but up to almost 4x for some
Repairs to burst mains	6.0%	average reduction over AMP8 by 7%	average increase 14% but up to almost 2x of AMP7 rate for some
Discharge permit compliance	4.5%	unchanged from AMP7 at 100%	average more than 6x of AMP7 rate but up to almost 12x for some
Water supply interruptions	4.0%	industry-wide reduction by 13%	average increase 8% but up to almost 2x of AMP7 rate for some
Compliance risk index	2.7%	unchanged from AMP7 at 0 (deadband applies)	average increase 24% but up to almost 2x of AMP7 rate for some
Total contribution to estimated AMP8 sector penalties	63.0%		

This shows the main ODIs where we estimate future penalties. Reward rates tend to be symmetrical for AMP8, but that was not the case for all ODIs during AMP7.
Source: Ofwat's draft determinations, companies' business plans and Moody's Ratings

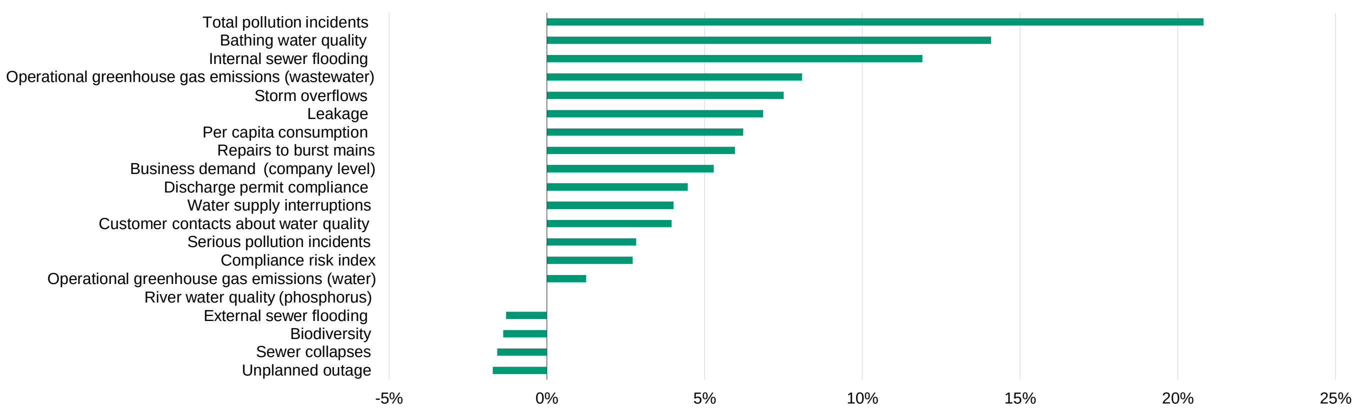
Ofwat has put caps and collars around newer commitments, where future performance is less certain. There is an aggregate sharing mechanism, whereby an incentive impact of more than plus or minus three percentage points on return on regulatory equity (RORE, assessed on the basis of the notional capital structure, with regulatory equity assumed to be 45% of RCV over AMP8) is shared 50% with customers and a RORE impact of more than five percentage points is shared 90%. The aggregate sharing mechanism also applies to customer, developer and business service measures.

Ofwat has designed incentives to be broadly symmetrical. However, we estimate that, on average, the sector will face net penalties of around £400 million a year or £2 billion in aggregate over AMP8 on common ODIs if companies perform in line with their business plans.[6] Estimated penalties are heavily weighted towards environmental outcomes (Exhibit 8).

Exhibit 8

Penalties are heavily weighted to environmental outcomes

Relative contribution of common performance commitments to estimated aggregate sector penalties



This excludes external sewer flooding performance for Thames Water as there are significant inconsistencies between reported performance and target level, which if unchanged could add in excess of £1 billion penalties over the period. Ofwat also stated that some ODIs, including bathing water quality, are affected by a "misalignment" between companies expectation of performance and the level of stretch being set. Additional evidence that companies provide may lead to reduced penalty risk. At this point, we have estimated aggregate bathing water quality penalties of around £280 million for the sector over AMP8.
Source: Ofwat's draft determinations, companies' business plans and Moody's Ratings

Annual penalties of £400 million would be equivalent to an annual reduction in RORE of around 80 basis points (bps), or 36 bps on the allowed return. Only three companies — South Staffordshire Water Plc, Baa2 stable, Sutton and East Surrey Water plc, Baa2 positive and South West Water Limited, Baa1 negative — could achieve relatively negligible net rewards over the period, if they perform in line with their business plan. However, this is contingent on companies being able to achieve their business plan targets despite lower funding allowances. Penalties could exceed £9 billion in aggregate if performance does not improve from current levels, but would be subject to the aggregate sharing mechanism and capped at around £7.5 billion.

Allowed returns may not be enough to attract equity support for large investment needs

Ofwat has allowed a CPIH-deflated appointee return on capital of 3.72%, or 3.66% for wholesale activities (Exhibit 9). This is 43 bps above its early view, but at the lower end of our plausible range of 3.6%-3.9%. If these are confirmed at final determination, cash returns will increase by around 50% because the regulator will switch to full CPIH indexation for AMP8. Returns will only increase by a third for companies which benefited from the higher return after appealing to the Competition and Markets Authority (CMA).

However, available returns may dampen demand from equity investors, increasing funding costs for the sector's investment needs.

Exhibit 9

Ofwat's allowed returns are lower than those applied by energy regulator Ofgem

Ofwat's weighted average cost of capital (WACC) evolution and comparison with energy networks

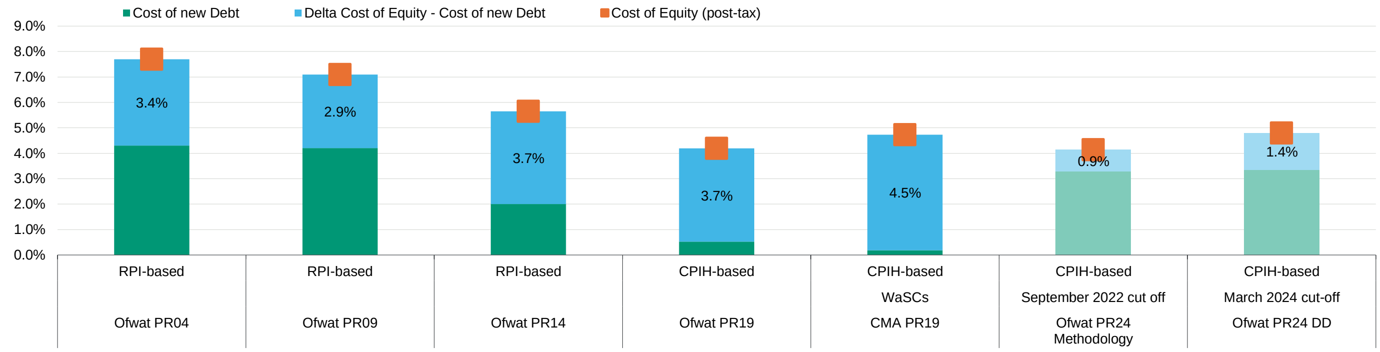
	Ofwat PR19	CMA PR19	Ofwat PR24 Methodology	Ofwat PR24 DD	RIIO-ED2	Ofgem SSMD - GD midpoint	Ofgem SSMD - ET midpoint
		WaSCs	Sep 2022 cut off	March 2024 cut off	Oct 2022 cut off	March 2024 cut off	March 2024 cutoff
	CPIH-based	CPIH-based	CPIH-based	CPIH-based	CPIH-based	CPIH-based	CPIH-based
Notional gearing	**60.0%**	**60.0%**	**55.0%**	**55.0%**	**60.0%**	**60.0%**	**55.0%**
Existing debt	2.42%	2.47%	2.34%	2.46%	2.76%	2.77%	3.13%
New debt	0.53%	0.19%	3.28%	3.36%			
Existing: new debt ratio	80%	83%	83%	74%			
Explicit debt issuance cost	0.10%	0.10%	0.10%	0.15%	0.25%	0.25%	0.25%
Cost of debt (pre-tax)	**2.14%**	**2.18%**	**2.60%**	**2.84%**	**3.01%**	**3.02%**	**3.38%**
Risk-free rate	-1.39%	-1.34%	0.47%	1.43%	1.23%	1.18%	1.18%
Equity risk premium	7.89%	8.15%	5.99%	5.15%	5.27%	5.57%	5.57%
Total market return	6.50%	6.81%	6.46%	6.58%	6.50%	6.75%	6.75%
Equity beta	0.71	0.71	0.61	0.60	0.76	0.76	0.69
Point estimate above mid-point		0.25%		0.26%			
Cost of equity (post-tax)	**4.19%**	**4.73%**	**4.14%**	**4.80%**	**5.23%**	**5.43%**	**5.00%**
Vanilla WACC (appointee)	**2.96%**	**3.20%**	**3.29%**	**3.72%**	**3.90%**	**3.98%**	**4.11%**
Retail Margin	0.04%	0.08%	0.06%	0.06%	n/a	n/a	n/a
Wholesale WACC	**2.92%**	**3.12%**	**3.23%**	**3.66%**	**n/a**	**n/a**	**n/a**
Wholesale WACC Differential CPIH - Ofwat PR19			0.30%	0.74%			
Wholesale WACC Differential CPIH - CMA PR19			0.10%	0.54%			

Portsmouth Water Limited (Baa2 stable) and South Staffs Water receive a 35 bps uplift to their cost of debt allowance, equivalent to 19 bps on the WACC. Havant Thicket, which follows a separate price control, receives a 3.63% cost of debt allowance, resulting in a wholesale return for the project of 4.1%.

Source: Ofwat's draft determinations, Ofgem's RIIO-2 final determinations for electricity distribution (ED) and RIIO-3 sector specific methodology decision (SSMD) for gas distribution (GD) and electricity transmission (ET)

Based on the proposed parameters, the cost of equity allowance provides a slightly better buffer to the cost of new debt allowance than the early view estimate. However it still indicates a rather low equity premium to attract new funding in a higher interest rate environment (Exhibit 10). Many companies are also currently funding above the proposed cost of new debt allowances, but we expect Ofwat to take latest market evidence into account for the final determinations.

Exhibit 10
Implied equity premium by comparing allowances for cost of equity and cost of new debt



Sources: Ofwat and Moody's Ratings

The proposed cost of equity is also below the 5.23% original estimate for the current electricity distribution price control (known as RIIO-ED2) which on the basis of a 60% gearing (net debt to regulated asset base) assumption provided an allowed return estimate of around 3.9%, plus 3 bps for infrequent issuers. The cost of debt and risk-free rates for the cost of equity calculation are indexed for energy networks and we currently estimate average equity returns to be around 5.5% over ED2, with allowed returns around 4.1%. In its sector-specific methodology consultation for gas distribution and electricity and gas transmission, the regulator Ofgem indicated an early view of the cost of equity at 60% gearing of 4.57%-6.35% with an implied midpoint of 5.43%, or 5.0% under a 55% gearing assumption.

The lower cost of equity allowance for water companies implies that the overall risk should be lower in the water sector. However, the water companies in England and Wales face heightened public and political attention, and tougher performance incentives may prevent them from achieving the allowed returns. By contrast, energy networks tend to achieve a small benefit from operational outperformance.

In addition to the base return, water companies with high quality and ambitious plans will receive a 30 bps uplift to the cost of equity allowance, or 13.5 bps additional return (Exhibit 11). Companies with inadequate plans could face a similar penalty.[7] For the four companies which Ofwat said had inadequate or unambitious plans, it raised concerns about conditional board statements around their financeability. These companies submitted plans with a higher return assumption than Ofwat's early view or adjustments to the risk-return balance. They also indicated that they would only be able to raise new funding to support their investments, if these conditions were met.

Exhibit 11
Business plan incentive

	Reward/ penalty in bps on CoE	Equivalent reward/ penalty in bps on WACC	Companies
Outstanding	30	13.5	Severn Trent, South West
Standard (no intervention)	5	2.25	Anglian, Hafren, Northumbrian, United Utilites, Yorkshire, Affinity, Portsmouth, SES
Standard (intervention)	0	0	Dwr Cymru, South Staffs
Lacking ambition	-15	-6.75	South East
Inadequate	-30	-13.5	Southern, Thames, Wessex

Source: Ofwat's draft determinations

Companies can submit additional evidence by the end of August and Ofwat could adjust penalties in response. However, Ofwat also said that Thames Water and Wessex Water, for example, should accept its "approach to the draft determination allowed return or provide compelling evidence for an alternative approach." This may create an unintentional incentive for companies to provide overoptimistic or unrealistic forecasts to avoid further regulatory penalties.

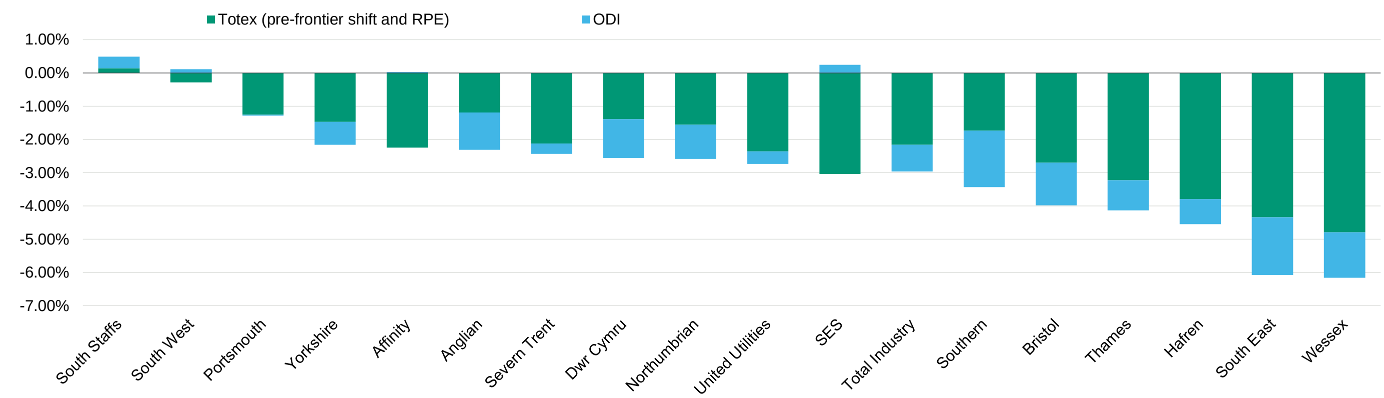
Overall, Ofwat's DD presents significant challenges for companies, particularly in the context of enhancement cuts and the much larger penalty exposure. All companies would face a reduced RORE based on operational performance in line with their business plan assumptions, including spending the disallowed totex amounts. The average annual sector RORE would be reduced by almost three percentage points. This is an overly conservative assumptions, but even half that exposure means a significant adjustment in the context of only 4.8% proposed base equity return.

Based on our simplified analysis in Exhibit 12, only South Staffs Water could achieve a small RORE benefit from operational performance. However, the analysis is based on totex allowances before frontier shift and RPE adjustments. After considering these, we believe no company would be able to earn the allowed return if the DD is confirmed and companies perform in line with their business plans.

Exhibit 12

Only one company could achieve an uplift to equity returns from operational performance

Estimated RORE impact (post-sharing) if companies spend and perform in line with business plan



Considers operational performance only. ODI impact reflects common ODIs only (excluding service measures and also external sewer flooding for Thames Water, which has some inconsistencies). Total expenditure impact is calculated by applying 10% exposure in relation to the business rates cost gap and base cost sharing rates to the remaining base totex gap as well as 40% exposure to enhancement overspend. All totex gaps are calculated pre-frontier shift and RPE adjustments. Aggregate sharing mechanisms are reflected for any totex impact in excess of +/-2 percentage points of RORE.

Source: Ofwat draft determinations, companies' business plans and Moody's Ratings

Final determinations likely to include some changes, but higher business risk means we could revise our view of regulation

Regulatory and political pressure is unlikely to abate, but final determinations, or FDs, are typically less onerous than drafts as regulators respond to companies' additional evidence. So we expect some changes at the final conclusion of the regulatory process, including FDs from Ofwat, currently expected in December 2024. In the event of appeals to the CMA the process could extend well into 2025. However, the draft determinations create a less supportive framework for the water companies and constrain their ability to earn the allowed return. The regulatory regime's stability and supportiveness, as well as companies' ability to earn a fair return, are key factors under our rating methodology for regulated water utilities.

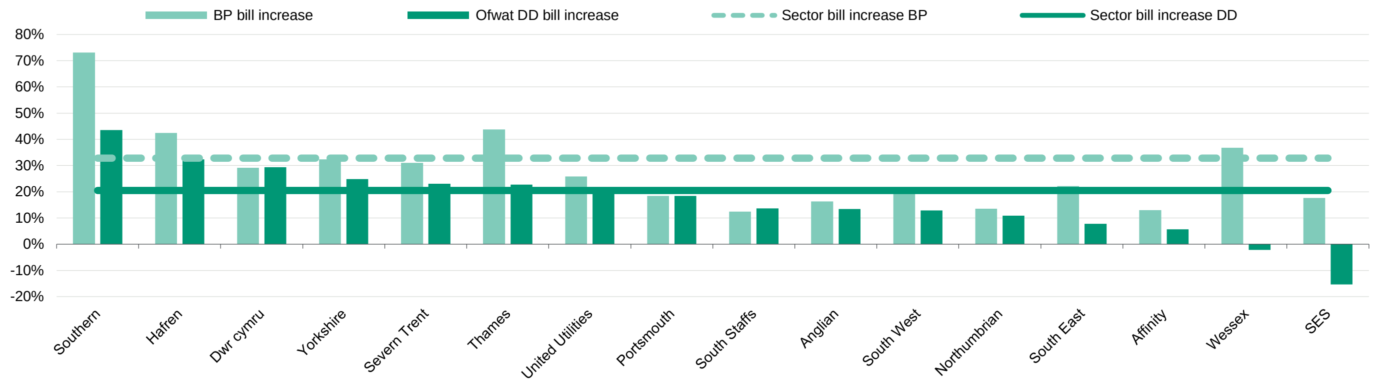
If the draft framework is confirmed at FD, business risk would increase for the sector and we would consider revising our score for either or both of these factors when assessing companies' credit quality. Against this background, companies would need to strengthen their credit ratios to maintain their current credit quality (see Appendix for further details).

Public perception of the sector remains negative, with low and falling public confidence that companies adequately treat wastewater. Even if not always justified, this perception makes it harder to convince consumers to accept the bill increases needed to support better outcomes. It also raises pressure on the UK and Welsh governments and Ofwat to set more demanding performance targets. However, lower funding and higher penalties in the DD risk perpetuating sector underperformance.

The government is also looking to enhance regulatory oversight on dividends, executive bonuses and ensuring that unspent allowances are returned to customers. A new Water (Special Measures) Bill would allow Ofwat to impose automatic and severe fines and may increase compensation for customers if companies do not meet service standards, further increasing cash flow volatility.

Affordability is also a key concern for Ofwat.[8] Under the DD, average sector bills for combined water and wastewater services would rise by around 21% compared with the more than 30% companies have proposed, before accounting for inflation. This ranges from a slight bill reduction for Wessex Water customers to an increase of up to 44% for Southern Water (Exhibit 13).

Exhibit 13
Ofwat's totex adjustments results in lower average real bill increases over the period



Source: Ofwat's draft determinations

Separate review of structural features and their level of credit enhancement

In the context of ongoing sector developments as well as regulatory pressure to de-gear, the DD proposals could also affect our view of the extent of benefit to creditors that structural features of existing financings provide. Where we have incorporated a benefit, this has historically uplifted credit quality by around 1-1.5 notches.

Lower returns, higher operational leverage and much larger investment commitments have reduced issuers' ability to lock up material amounts of cash in a trigger event. This means that the benefit of a distribution block is lower than when these structures were originally put in place. Financial ratio triggers are also not always working as intended and a number of companies already no longer achieve significant rating uplift.

Where companies' exhibit sizeable headroom against trigger ratio levels, the benefit is again reduced. With Ofwat considering a licence gearing cap of 70%, this may become a more relevant measure for companies' capital structure restrictions in future than existing financial covenants, which in many cases allow gearing of more than 80%. The remaining features, including additional liquidity and share pledge security, may still be beneficial but to a much lesser extent.

Ofwat believes that gearing above 70% is too high to protect long-term financial stability.[9] To ensure companies reduce leverage, the regulator is considering three options. The first two are to either signal that 70% gearing is the upper limit for considering distribution as part of its dividend guidance (which is subject to a licence condition); or tighten the ring-fencing licence conditions that restrict distributions where gearing exceeds 70%. This could be for all companies or just those with weaker finances. These two options would be broadly credit positive, because they provide an effective cap on operating company leverage. However, a relatively tight licence lock-up may constrain companies' ability to raise new equity.

Ofwat's third option states that "any distributions paid beyond a gearing threshold of 70% could be considered as an extraction of value, which would be met with an equivalent downward adjustment to the RCV, implemented at a subsequent price review." To allow companies to adjust to this change, it may only be introduced from PR29. Reducing the RCV would effectively reduce a company's future cash flow generation capacity and clearly be credit negative. We would also consider this in our assessment of the stability and predictability of the regulatory regime.

Appendix – Rating methodology factor scores

We will review UK water companies' factor and subfactor scores under our rating methodology for regulated water utilities, including scores for the stability and predictability of the regulatory environment, cost and investment recovery (sufficiency and timeliness) and uplift for structural considerations.[10] In this appendix, we provide some illustrative examples of how changes in factor scores can affect scorecard-indicated outcomes.[11]

Stability and predictability of the regulatory environment

In May 2018, we amended the score of this subfactor for UK water utilities to Aa from Aaa, when we concluded that the introduction of a high gearing penalty was in response to public and political pressure that – together with introducing more cash flow volatility – would undermine the track record of stable and predictable regulation. In this illustrative example, we show the effect of moving the subfactor score to A.

Exhibit 14 shows how our assessment of the UK water regulatory regime compares with regulatory frameworks for regulated water utilities and electric and gas networks across a selection of different jurisdictions.

Exhibit 14

Summary comparison of scores for stability and predictability of regulatory regimes across a selection of different jurisdictions

Aaa	Aa	A	Baa	Ba
		Regulated Water Utilities		
	UK Water (current)	**UK Water (potential future)**	Italy	China
	US (California; New Jersey; Pennsylvania)	US (Massachusetts, New Hampshire)	US (Connecticut)	
			South Korea	
			Spain	
			Brazil	
		Regulated Electric and Gas Networks		
Great Britain (ex OFTOs)	Great Britain (OFTOs)	Belgium - Flanders	Belgium - Wallonia	Kazakhstan
Ireland	Czech Republic	Estonia	Poland	Romania
Norway	Finland	Germany	Slovakia	
US (FERC)	France	Lithuania	Spain	
Australia	Italy	Portugal		
	Netherlands			

Reflects scores as of the date of this report for rated issuers captured under our rating methodologies for Regulated Water Utilities and Regulated Electric and Gas Networks.
Source: Moody's Ratings

Cost and investment recovery (sufficiency and timeliness)

We had historically scored this subfactor A for most UK water utilities. However, we recently changed our scores to Baa for Thames Water, Southern Water and South East Water because their underperformance is likely to prevent them from earning the allowed return for a number of years. On the basis of the DD, we believe most companies would not be able to earn the allowed return. As a result, the ability to earn a fair return may be impaired for the sector. In our illustrative example we indicate how a change from A to Baa for this subfactor affects the scorecard-indicated outcome.

Uplift for structural considerations

For UK water utilities, we currently score 0.5 notches of uplift for the regulatory ring-fencing conditions, embedded in companies' licences. Any further uplift reflects the presence of additional credit-enhancing features, including distribution block, designated liquidity reserves, share security and creditor step-in rights. For a fully-fledged covenant package we currently apply up to 1.5 notches of uplift. In our illustrative example below for a company with a covenanted structure, we also provide an indication of how changing the rating uplift to 1 notch from 1.5 notches affects the scorecard-indicated outcome.

Illustrative impact on scorecard-indicated outcome

In Exhibit 15, we illustrate the impact of a change in these factor and subfactor scores for three generic companies:

» Company A, exhibiting a typical corporate structure and strong metrics

» Company B, exhibiting a typical corporate structure and weaker metrics than Company A

» Company C, which has a highly covenanted and more leveraged financing structure than Company B

Exhibit 15

Illustrative scorecard-indicated outcomes for factor score changes across our hypothetical sample companies

Regulated Water Utilities Industry	Company A - current	Company A - potential post-change	Company B - current	Company B - potential post-change	Company C - current	Company C - potential post-change
Factor 1 : Business Profile(50%)						
a) Stability and Predictability of Regulatory Environment	**Aa**	**A**	**Aa**	**A**	**Aa**	**A**
b) Asset Ownership Model	Aa	Aa	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)	**A**	**Baa**	**A**	**Baa**	**A**	**Baa**
d) Revenue Risk	Aa	Aa	Aa	Aa	Aa	Aa
e) Scale and Complexity of Capital Programme & Asset Condition Risk	Baa	Baa	Baa	Baa	Baa	Baa
Factor 2 : Financial Policy (10%)						
a) Financial Policy	Baa	Baa	Baa	Baa	Ba	Ba
Factor 3 : Leverage and Coverage (40%)						
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.7x Baa	1.7x Baa	1.5x Baa	1.5x Baa	1.3x Ba	1.3x Ba
b) Net Debt / Regulated Asset Base (3 Year Avg)	60.0% Baa	60.0% Baa	70.0% Ba	70.0% Ba	80.0% Ba	80.0% Ba
c) FFO / Net Debt (3 Year Avg)	10.0% Baa	10.0% Baa	9.0% Ba	9.0% Ba	7.0% Ba	7.0% Ba
d) RCF / Net Debt (3 Year Avg)	8.0% Baa	8.0% Baa	7.0% Baa	7.0% Baa	6.0% Baa	6.0% Baa
Rating:						
Scorecard-Indicated Outcome Before Notch Lift	A3	Baa1	Baa2	Baa2	Baa3	Baa3
Notch Lift	0.5	0.5	0.5	0.5	**1.5**	**1.0**
Scorecard-Indicated Outcome	A3	Baa1	Baa1	Baa2	Baa1	Baa2

Source: Moody's Ratings

For all our generic, illustrative examples, the scorecard-indicated outcome would move down by one notch based on the changes to the factor and subfactor scores. To maintain the same scorecard-indicated outcome, other factors or subfactors — for example leverage and coverage metrics — would need to be higher.

However, methodology scorecards are simple reference tools and the scorecard-indicated outcome is not expected to match the actual rating for each company. We believe that, despite our view of increasing business risk, companies can maintain current credit quality if performance allows them to earn or exceed allowed returns, or credit metrics strengthen to align with potentially tighter guidance, or both.

Exhibit 16 summarises our previous guidance for a generic UK water company at a given rating level, and the changes made when we tightened our guidance by broadly half a notch in May 2018, after we revised our view on stability and predictability of the regulatory regime to Aa from Aaa.

Exhibit 16
Moody's ratio guidance for the UK water utilities

Rating	Guidance pre-2018 (Stability & Predictability = Aaa)		Guidance post-2018 (Stability & Predictability = Aa)	
	AICR	Gearing	AICR	Gearing
A2	≥1.8x	≤60%	≥2.0x	≤55%
A3	≥1.6x	≤68%	≥1.7x	≤65%
Baa1	≥1.4x	≤75%	≥1.5x	≤72%
Baa2	≥1.2x	≤85%	≥1.3x	≤80%

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 pre-2018 and post-2018 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 smaller companies, such as the 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 extent of any potential adjustment we make to factor scores or ratio guidance will depend on any change to the risk-return balance at final determination. Ratio guidance for specific issuers will also reflect individual risk factors. As a result it could diverge from the above.

Endnotes

1 In PR19 this "frontier shift" was 1.1%, or 1% for companies which appealed to the Competition and Markets Authority. In their business plans, most companies had applied an annual frontier shift between the midpoint and high end of a 0.3-0.8% range assessed by Economic Insight Ltd.

2 There is also an overarching aggregate sharing mechanism, whereby any out-/ underperformance impact of totex allowances, which results in a +/-2 percentage point change in return on regulatory equity would be shared 50% with customers. Ofwat states that the 2% threshold is broadly equivalent to 15% over-/underspend of allowances at sector level. This sharing mechanism will exclude price control deliverables.

3 Where enhancement expenditure incurred to the end of year two is less that 50% of the allowed amount to year two, or less than 65% to the end of year three, revenue allowances in years four and five would be reduced for 50% of the associated underspent enhancement totex.

4 Our adjusted interest coverage ratio (AICR) deducts regulatory depreciation from funds from operations (FFO).

5 Ofwat's DD provides targets for 20 performance commitments, excluding the measures for customer service or C-Mex, developer service or D-Mex and business retail services or BR-Mex (separate for England and Wales), which are measured on a relative ranking basis. For customer service performance, the benchmarking will now also reflect other sectors, which will likely increase the challenge for weaker performers.

6 This excludes external sewer flooding for Thames Water, where there are inconsistencies between the company's updated reported performance and the DD performance levels set by Ofwat. If unchanged, this ODI alone would add over £200 million of annual penalty and more than £1 billion over the period.

7 Ofwat intends to apply the business plan quality incentive as an adjustment to the RCV rather than revenue, unless companies request otherwise in their representations. The current DD financial models do not yet include these incentives.

8 To help customers struggling to pay, companies plans included social tariff support for 8% of customers on average over 2025-30, doubling from 4% during 2020-25. For 14 companies, shareholders will contribute at least £220 million over the period for social tariffs, hardship funds or other support for customers. If customer-debt matching is included, where a company matches customer debt repayments, the support increases to £510m, a rise of over 50% compared with 2020-25.

9 At PR19, Ofwat had introduced a gearing outperformance sharing mechanism, where companies would have incurred ex-post penalties for gearing above a 74-70% glidepath over AMP7. This was removed by the CMA for companies that had appealed and Ofwat stated in its PR24 DD that it would not apply the PR19 high gearing penalty as this would reduce funds available to companies that could still be used to improve performance levels.

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

11 As described in the methodology, the scorecard-indicated outcome is not expected to match the actual rating for each company. Ratings may reflect consideration of additional factors that are not in the scorecard. For more information, see the "Other considerations" and "Limitations" sections of the methodology.

REPORT NUMBER 1417545