

## RATING ACTION COMMENTARY

# Fitch Affirms UJW's Senior Unsecured at 'A-'; Downgrades UU's Senior Unsecured to 'BBB+'

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Fitch Ratings - London - 12 Feb 2025: Fitch Ratings has affirmed United Utilities Water Limited's (UJW) Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Stable Outlook. Fitch has also affirmed UJW's and United Utilities Water Finance PLC's (UJWF) senior unsecured ratings at 'A-'. Fitch has downgraded United Utilities PLC (UU) IDR to 'BBB' from 'BBB+' and its senior unsecured ratings to 'BBB+' from 'A-'.

The affirmation reflects Fitch's expectation that UJW's financial profile will remain commensurate with its ratings for the price control period ending March 2030 (AMP8). This considers our tightened rating sensitivities, as well as our assumption of net outcome delivery incentive (ODI) rewards and environmental fines. The group's solid operational performance and the low cost of debt embedded in its capital structure relative to the sector's further underpin its rating headroom.

The downgrade of UU reflects our increasing focus on its structural subordination to UJW, despite UU's lower consolidated gearing than at UJW.

## KEY RATING DRIVERS

**Rising Sector Risk:** Ofwat's recent final determination (FD) offers a reasonable outcome for most UK water companies compared to the draft determination and is in line with our expectations. However, we anticipate moderately higher business risk in AMP8 due to increased environmental exposure, public scrutiny, and clawback risk, which is linked to the price control deliverables (PCDs) mechanism. Further uncertainties may arise from the Cunliffe review, the most significant regulatory reform since privatisation.

The sector faces increased risk of fines for operational and environmental underperformance and challenges in rebuilding trust with the public, government, and regulatory bodies. We expect the sector to enhance its assets to accommodate population growth and extreme weather conditions.

**Revised Debt Capacity and Sensitivities:** Fitch has revised the sector's debt capacity for AMP8, leading to a 0.1x increase in cash and nominal post-maintenance interest coverage ratios (PMICRs) for UUW. However, the negative sensitivity for net debt/regulatory capital value (RCV) remains at 67% because UUW is a positive outlier in the sector. In contrast, the gearing sensitivity has tightened by 2% across our utilities portfolio.

The affirmation is supported by solid operational performance and a target gearing of 55%-65% across AMP8 for United Utilities Group PLC (UU Group PLC). We tested the resilience of UUW's rating headroom by including environmental fines in the rating case, and under our cash flow assumptions, the company maintains limited gearing headroom but comfortable coverage headroom.

**Limited Gearing Headroom:** Fitch forecasts UUW's net debt/RCV around 66% by the end of AMP8 (67% expected in financial year to March 2025), leaving limited rating headroom under our negative sensitivity of 67%. UUW plans to fund its investments through bill increases and new debt, with no equity issuance. However, we expect management to undertake mitigation measures to avert breaches of its net debt/RCV negative rating sensitivities.

**Comfortable PMICRs Headroom:** We forecast cash PMICR of 2.3x and nominal PMICR of 2.5x for AMP8, both comfortably above our negative rating sensitivities of 1.7x and 1.9x, respectively. PMICRs benefit from a low cost of debt, which was 4.6% at FYE24 versus a sector average of 5.5%. UUW has around 50% of inflation-linked debt, partly through swaps in FY24, which is broadly aligned with the sector average of 52%. Our ratios also assume an average cost of new debt at 5.3%, below the sector average.

**Neutral Totex Performance:** Net total expenditure (totex) for AMP8 is GBP13.3 billion (real terms, 2022-2023 prices), nearly double the GBP6.8 billion in AMP7, leading to an RCV of GBP21.8 billion by the end of AMP8, up from GBP14.8 billion expected in FY25. Despite a 5% reduction in the company's business plan, we expect UUW to adhere to regulatory cost allowances. This is based on AMP8 investments already in progress and a supply chain ready to handle increased totex. In addition, FD allowances have been set at around 10% higher than the draft determination.

**Increased Enhancement Allowance:** Enhancement expenditure for UUW are about 3x higher in AMP8 (GBP5.7 billion in real terms) than in AMP7. Storm overflows account for nearly 42% of the investments, and 28% are related to river health improvements. About 94% of enhancement expenditure is subject to the PCD mechanism. Under this framework, investments need to achieve Ofwat's benchmarks of allowance and timeline

to mitigate the risk of a clawback. This mechanism ensures that investment funding is ringfenced, with any unspent allowances returned to customers.

**ODI Rewards Expected:** We forecast in-period ODI rewards of GBP80 million related to operational performance in AMP8. Since the cash impact of these penalties materialises with a two-year lag, we are projecting cash ODI rewards of about GBP160 million in AMP8 to include the amount related to the last two years of AMP7. In AMP8, we expect UUW to receive rewards, primarily for improvements in pollution incidents, external sewer flooding, and bathing water quality.

**Regulatory Fines Forecast:** Fitch forecasts about GBP140 million in total fines from the Environment Agency and Ofwat as baseline cash outflows, due to heightened regulatory scrutiny and stricter controls on wastewater networks. We have assumed fines across all companies operating wastewater networks and will adjust this assumption to reflect actual fines or a perceived reduction in risk, accordingly.

**Structural Subordination of UU:** Following its downgrade, UU's senior unsecured debt ratings is now one notch below UUW's. We are placing a greater emphasis on its structural subordination to UUW, despite UU's lower consolidated gearing. The downgrade also reflects the possibility of UU issuing debt during AMP8 to support UUW's financial profile.

## DERIVATION SUMMARY

UUW's is rated at the same level as Severn Trent Water Limited (STWL; IDR BBB+/Stable; senior unsecured A-), given its solid performance and conservative capital structure. STWL's gearing headroom is supported by GBP1 billion equity injection. South West Water Limited (SWW: IDR BBB+/Stable; senior unsecured A-) shares the same ratings as UUW, but we expect its parent company, Pennon Group PLC's rights issue, announced in January 2025 of GBP490 million to support SWW's rating headroom in AMP8.

The senior unsecured rating of UUW and the aforementioned peers benefits from a one-notch uplift from their IDRs, due to their regulated cash flows, which in our view imply above-average creditor recoveries in a default. Wessex Water Services Limited's 'BBB+' senior unsecured rating mainly reflects a weaker financial profile and is thus one notch below UUW's.

## KEY ASSUMPTIONS

- Ofwat's FD financial model used as the principal source of information
- Neutral totex performance

- Net cash ODI rewards of GBP160 million in FY26-FY30
- Fines totalling GBP140 million from the Environmental Agency or Ofwat
- Nominal cost of new debt averaging 5.3%
- CPIH averaging 2.8% (starting at 3.3% in FY26 and decreasing to 2.5% by 2030). RPI averaging 3% (starting at 3.5% in FY26 and trending down to 2.5% by 2030)
- UUW Dividend averaging GBP300 million per year over FY26-FY30
- UU Group PLC group dividend policy increasing in line with CPIH per year over FY26-FY30, supported by UUW's dividend distributions
- No cash tax payments or pension-deficit recovery payments
- No material new debt at UU level

## **RATING SENSITIVITIES**

### **Factors That Could, Individually or Collectively, Lead to Negative Rating**

#### **Action/Downgrade**

- UUW: Adjusted total net debt/RCV above 67%, cash PMICR below 1.7x and nominal PMICR below 1.9x
- Deterioration in operational and environmental performance, resulting in lower ODI rewards or higher fines than Fitch's rating case
- UU: Adjusted total net debt/RCV above 69% or a downgrade of UUW

### **Factors That Could, Individually or Collectively, Lead to Positive Rating**

#### **Action/Upgrade**

- UUW: Adjusted total net debt/RCV below 62%, combined with cash PMICR above 1.8x and nominal PMICR above 2.0x
- UU: An upgrade is unlikely, due to its structural subordination to UUW. However, an upgrade of UUW, combined with UU's consolidated leverage remaining below 64%, could lead to an upgrade

## **LIQUIDITY AND DEBT STRUCTURE**

As of FYE24, UUW held cash and cash equivalents of about GBP1.3 billion, along with undrawn committed borrowing facilities of around GBP555 million with various maturity dates. This is sufficient to cover short-term debt maturities of about GBP900 million, and our expectations of negative free cash flow of about GBP400 million in FY25.

## ISSUER PROFILE

UUW is an Ofwat-regulated regional monopoly providing water and wastewater services in the north-west England with an RCV of GBP14.2 billion at FYE24. We forecast this to increase to about GBP21.8 billion by the end of AMP8.

## SUMMARY OF FINANCIAL ADJUSTMENTS

- Profit and loss interest cost is adjusted by adding capitalised interest cost of GBP81 million in FY24
- Fitch reconciled statutory total debt and cash interest with annual report, by making an upward adjustment of GBP149 million for derivatives in FY24

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

[Click here](#) to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

## ESG CONSIDERATIONS

UUW and UU each has an ESG Relevance Score of '4' for Exposure to Environmental Impacts, due to the Environment Agency's and Ofwat's heightened regulatory scrutiny and stricter controls over wastewater networks. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process;

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<https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
United Utilities PLC	LT IDR	BBB Rating Outlook Stable		BBB+ Rating Outlook Stable
	Downgrade			
senior unsecured	LT	BBB+	Downgrade	A-
United Utilities Water Limited	LT IDR	BBB+ Rating Outlook Stable		BBB+ Rating Outlook Stable
	Affirmed			
senior unsecured	LT	A-	Affirmed	A-
United Utilities Water Finance PLC				
senior unsecured	LT	A-	Affirmed	A-

[VIEW ADDITIONAL RATING DETAILS](#)

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**APPLICABLE CRITERIA**[Parent and Subsidiary Linkage Rating Criteria \(pub. 16 Jun 2023\)](#)[Corporate Recovery Ratings and Instrument Ratings Criteria \(pub. 02 Aug 2024\)  
\(including rating assumption sensitivity\)](#)[Corporate Rating Criteria \(pub. 06 Dec 2024\) \(including rating assumption sensitivity\)](#)[Sector Navigators – Addendum to the Corporate Rating Criteria \(pub. 06 Dec 2024\)](#)**APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring &amp; Forecasting Model (COMFORT Model), v8.1.0 (1)

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United Utilities PLC	UK Issued, EU Endorsed
United Utilities Water Finance PLC	UK Issued, EU Endorsed
United Utilities Water Limited	UK Issued, EU Endorsed

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