

MOODY'S

RATINGS

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

13 Nov 2024

London, November 13, 2024 -- Moody's Ratings (Moody's) has today changed the outlook to negative from stable on United Utilities Water Limited (UU Water), UU Water's guaranteed financing subsidiary United Utilities Water Finance PLC (UUWF), and UU Water's parent United Utilities PLC (UU PLC). Concurrently, we have affirmed the A3 senior unsecured debt ratings and long-term issuer rating of UU Water, the (P)A3 backed senior unsecured MTN programme ratings and backed senior unsecured debt ratings of UUWF, and UU PLC's Baa1 senior unsecured debt ratings and (P)Baa1 senior unsecured MTN programme ratings.

RATINGS RATIONALE

Today's rating action reflects a deterioration in the sector's business risk profile and associated tightening of our ratio guidance for a given rating level. The negative outlook reflects the risk that United Utilities Group PLC (UU) may not achieve these new ratio targets.

In the face of continuing public scrutiny and heightened political and regulatory focus, there has been a material and sustained weakening of credit quality for nearly all companies. Across the sector, past decisions, including to prioritise affordability and shareholder distributions, have contributed to underinvestment and exacerbated the sector's exposure to changing weather patterns, population growth and shifting expectations. Regulatory targets have become more demanding and penalties for those that fall short have continued to grow. With widespread investigations, fines for UK water companies breaching environmental legislation are likely to increase further. In addition, a perception that the water sector is "broken" has prompted a government-initiated strategic review that aims to improve the regulatory environment and create a stable backdrop to attract investment. However, until completed and any potentially credit positive recommendations are successfully implemented, this review also brings increased near-term uncertainty.

Taking account of the above, we have changed our assessment of stability and predictability of the regulatory environment for the UK water sector under our rating

methodology to A from Aa.

The risk that public concern over environmental, social or affordability issues could drive adverse regulatory or political intervention is a key aspect of demographic and societal trends that are assessed under the social risk considerations of our framework for assessing environmental, social and governance risks. The water companies in England face elevated social risk (S4-score).

Considering our changed view of the sector's business risk, UU will need to achieve gearing, measured as net debt to regulatory capital value (RCV), no higher than 60% (65% previously), and an adjusted interest coverage ratio (AICR) of at least 1.8x (1.7x previously) on a sustainable basis in order to maintain its current ratings.

The negative outlook, in particular, reflects the risk that a final regulatory settlement, expected in December 2024, that is not materially more favourable than Ofwat's draft determination will expose UU Water to the risk of material cost overruns (predominantly on enhancement expenditure) and overall net performance penalties. Without measures to protect credit quality, this would likely result in credit metrics below our new guidance levels for the current ratings.

We expect that UU will be able to meet our revised AICR guidance in a scenario where operational performance is in line with the regulatory settlement. This reflects that interest coverage metrics will be supported by the company's low interest costs, particularly on a cash basis, and, at the start of the period, the receipt of sizeable performance rewards earned in the current regulatory period (paid with a two year lag). However, UU's ability to meet our revised leverage guidance would likely require mitigating action to protect credit quality given UU Water's large investment programme. We expect UU to provide clarity on its capital structure and future financial framework when it announces whether it will appeal its final regulatory determination to the Competition and Markets Authority. UU's current financial and dividend policy is to maintain consolidated group net debt to RCV in the range of 55-65% (which equates to a slightly higher level on a Moody's adjusted basis).

The rating affirmation reflects UU Water's position as a licensed monopoly provider of water and wastewater services in the North West of England and a solid performance track record, particularly with respect to outcome delivery incentives (ODIs).

The Baa1 rating of UU PLC is one notch below the A3 rating of UU Water, because holding company creditors are structurally subordinated to those of the cash flow generating operating company.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Given our revised view of the sector's business risk and the current negative outlook, a rating upgrade is considered unlikely. Nevertheless, we could consider an upgrade,

if both UU Water and UU appeared likely to achieve net debt to RCV sustainably below 50% and an AICR consistently above 2.1x.

The outlook could be stabilised if UU were to exhibit net debt / RCV no higher than 60% and an AICR of at least 1.8x on average over AMP8. Conversely, the ratings could be downgraded if UU appeared likely to demonstrate net debt / RCV consistently above 60% or an AICR below 1.8x on average over AMP8.

In addition, downward rating pressure could result from a change in corporate strategy towards higher-risk unregulated activities or a significant increase in business risk for the sector as a result of legal or regulatory changes leading to a further reduction in the stability and predictability of regulated earnings, in each case if not offset by credit enhancing measures. The rating could also be downgraded as a result of unforeseen funding difficulties.

The principal methodology used in these ratings was Regulated Water Utilities published in August 2023 and available at <https://ratings.moodys.com/rmc-documents/406788>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

UU Water is the main operating subsidiary of UU PLC, an intermediate holding company under United Utilities Group PLC (UU). UU Water is the second largest of 10 water and sewerage companies in England and Wales, with an RCV of £14.0 billion as of 31 March 2024. UU is one of the three publicly listed water and sewerage groups and had a market capitalisation of around £7.1 billion as of 8 November 2024.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824.

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