Research Update:

United Utilities Water Rating Affirmed At 'BBB+', Parent United Utilities PLC Affirmed At 'BBB'; Outlook Stable

October 13, 2022

PRIMARY CREDIT ANALYST

Gustav B Rydevik
London
+ 44 20 7176 1282
gustav.rydevik
@spglobal.com

SECONDARY CONTACTS

Julien Bernu
London
+ 442071767137
Julien.Bernu
@spglobal.com

Aarti Sakhuja
London
+ 44 20 7176 3715
aarti.sakhuja
@spglobal.com

Rating Action Overview

- Although inflation is significantly affecting United Utilities Water Ltd.'s (UUW) operating and financing costs, and its capital expenditure (capex) is sizable, we expect it will post ratios commensurate with the 'BBB+' rating by 2025, when the current regulatory period (AMP7) ends.
- Even though the group's exposure to inflation-linked financing costs is broadly sector average, its regulatory gearing and debt to EBITDA ratios are lower than the rest of the U.K. water sector. At the same time, its operational and environmental performances are sector-leading. Its credit ratios are less vulnerable to deterioration than peers and are easier to predict against a challenging macroeconomic backdrop.
- We affirmed our 'BBB+' rating on UUW and our 'BBB' rating on parent United Utilities PLC (UU). The outlook on both is stable.
- The stable outlook is based on UU's low-risk, regulated U.K. water and wastewater operations, which continue to deliver stable operating and financial performances, combined with UUW's excellent operational record. Although we do not forecast the group to operate above our current funds from operations (FFO) to debt target until the fiscal year ending March 2025, we anticipate that its credit metrics will gradually recover to levels commensurate with a 'BBB+' rating.

Rating Action Rationale

We expect that UU will withstand the financial pressure stemming from the current macro environment. Inflation typically benefits regulated water companies like UUW, given that both future allowed revenues and regulatory capital value (RCV) rise in line with inflation as measured by the consumer prices index including owner-occupiers' housing costs (CPIH). However, with inflation at a multi-decade high, operational costs such as power, labor, and chemicals have increased sharply. We expect inflation to remain high in fiscal years 2023 and 2024, before gradually normalizing in fiscal 2025. While the group has so far managed to keep wage inflation below average inflation for fiscal 2023, labor costs could still rise during 2024 and 2025. The group should be able to mitigate the impact of higher energy costs via its robust power-price hedging policy. On top of this we expect financing costs to increase, in part because UU, like other water companies, uses inflation-linked financing--accounting for about half of its outstanding debt. We therefore expect its credit metrics to deteriorate, temporarily breaching some of our thresholds at the current rating level and leaving limited overall headroom. For example, we forecast that its S&P Global Ratings-adjusted FFO to debt will remain below our 9% target until fiscal 2025, after averaging 6.8% over fiscals 2023 and 2024. That said, debt to EBITDA is not affected by financing costs and we forecast that it will remain significantly below the 9x threshold throughout this period, which supports the current ratings.

Although about 50% of UU's total debt is linked to inflation, the group benefits from favorable cost of debt. This is in line with the sector average. We expect large noncash accruals related to inflation-linked financing will weigh on UUW's metrics for fiscal years 2023 and 2024, but recover by fiscal 2025. Somewhat mitigating this is its strong record of outperforming the cost of debt allowance given the low cost of embedded debt. We expect this to continue for the rest of AMP7.

In terms of variable power costs, we see UUW as well positioned compared to peers.

On top of generating about 25% of power itself in fiscal 2022, the group has significant hedging agreements for the rest of AMP7--for about 90% of power generated for fiscal 2023 and roughly two-thirds for the last two years of the AMP. This places the group in a good position to ride out currently volatile power markets and makes this significant cost easier to forecast.

UUW's additional capital expenditure (capex) stands to benefit UU. While UUW expects to at least meet its final determination commitments, it plans to invest £765 million above its baseline allowance in projects to improve operational and environmental performance. At 61%, UU's regulatory gearing is one of the lowest in the sector and likely to remain low despite its debt-funded capex program. The full benefits of these investments will be realized only at the beginning of the next regulatory period (AMP8) in April 2025, through an uplift in AMP8 revenues. They will also likely translate into enhancements in operating performance, for instance through improved customer performance and outcome delivery incentives (ODI) and better river water quality alongside other environmental improvements. Sewer flooding and water quality where UUW is currently not meeting its targets are two areas of management's focus. We also expect proactive investments will position UUW well when submitting its business plan for AMP8.

So far in AMP7, UUW has delivered sector-leading operational and environmental performance, supporting its finances and reputation. UUW met about 80% of its ODI targets in fiscal 2022 and earned net reported ODI rewards (after tax and based on 2017-2018 prices) of £25 million. During its annual results, UU revised its five-year guidance on ODI rewards to £200 million, from £150 million previously. Overall pollution has reduced by one-third since the start of AMP7. On top of this, UUW has received a four star (highest) environmental performance assessment.

The group has a relatively inflexible dividend policy. Under the policy, it expects to increase dividend distributions in line with CPIH over AMP7, while maintaining its commitment to meeting its target gearing of 55%-65%. We expect discretionary cash flows (operating cash flows after capex and dividends) to be slightly negative until 2025, meaning there is little room for natural deleveraging by the end of the AMP.

Outlook

The stable outlook on UU reflects our expectation that the group's strong operating performance will continue, while maintaining debt to EBITDA below 9x. Although we expect FFO to debt to be below the current ratings threshold for the next two years, we expect it will recover to above 9% by fiscal 2025. The stable outlook also assumes no political or regulatory interference that could prevent UUW from passing inflation on to customers.

Downside scenario

We could lower the ratings on UU and UUW if FFO to debt does not seem likely to recover to above 9%, the level we view as commensurate with the current ratings, by March 2025. If we see debt to EBITDA increasing above 9x we could also take a negative rating action. This could happen if inflation has a worse than forecast impact on credit metrics, through higher inputs or financing costs.

We could also lower the rating if UUW's operational performance deteriorates significantly, thereby reducing ODI rewards, or if we consider the regulatory outcome for UUW for AMP8 will lead to less favorable operating conditions.

Upside scenario

We see limited upside to our ratings on UUW and UU before the end of AMP7 given that credit metrics are expected to be below target for fiscals 2023 and 2024 and the group faces inflationary pressures while it delivers a significant capital program during the rest of AMP7.

However, we would consider raising the ratings if adjusted FFO to debt exceeded 11% and debt to EBITDA stayed sustainably below 7x, while the group continued to demonstrate above-average operating performance.

Company Description

With an RCV of £12.4 billion as of March 31, 2022, UUW is the second-largest water and sewerage company in the U.K. after Thames Water. Its parent, UU, is listed on the London Stock Exchange. It is a monopoly supplier of water and wastewater services to about 3 million households and 200,000 businesses in northwest England and generates annual EBITDA of about £1.1 billion. UU has a joint venture with Severn Trent to operate in the competitive non-household retail business segment. It has minimal unregulated activity.

Our Base-Case Scenario

Assumptions

- Revenue growth in line with regulatory assumptions and the ability to entirely pass through CPIH inflation for the 12 months to November 2022 via bills.
- RPI inflation in the U.K. of 12.5% as of March 31, 2023; 4.5% as of March 31, 2024; and 2.5% as

of March 31, 2025.

- EBITDA margins of 53%-55% for the remainder of AMP7.
- £765 million of investment above its PR19 regulatory settlement.
- Average capex of £500 million-£550 million per year for the rest of the AMP.
- The group's gearing remaining among the lowest in the sector at 55%-65%.
- Dividends to grow by CPIH each year, as per the group's financial policy.
- Net ODI rewards to average about £40 million a year over AMP7 (based on 2017/2018 prices after tax).

Key metrics

GBP mil.	2021A	2022A	2023F	2024F	2025F
EBITDA	1,034	1,024	1,020-1,040	1,060-1,090	1,080-1,120
Capital expenditure	639	627	620-630	530-550	390-410
Debt	7,285	7,556	7,850-7,900	8,050-8,150	8,000-8,200
FFO/debt (%)	10.9	8.4	5.5-6.5	7.5-8.5	8.5-9.5
Debt/EBITDA (x)	7.0	7.4	7-8	7-8	7-8

Liquidity

Our assessment of UUW's liquidity as adequate reflects our expectation that sources of liquidity will exceed uses by 1.1x in the next 12 months. We also see the group as having a high standing in the credit markets and generally prudent risk management.

Liquidity sources for the 12 months from the end of March 2022 include:

- Unrestricted cash and equivalents of £240 million;
- Access to an undrawn long-term committed facility of £800 million; and
- Cash FFO of about £900 million.

Liquidity uses over the same period include:

- Upcoming debt maturities of approximately £235 million;
- Expected capex of about £630 million; and
- Dividends of about £320 million.

Environmental, Social, And Governance

ESG credit indicators E-2, S-3, G-2

Social factors are a moderately negative consideration in our credit rating analysis of UU. As one of the U.K.'s water and wastewater network operators, UU provides a key service with a significant social impact. This exposes UU to additional scrutiny from regulators and the government to ensure high quality, reliability, and affordable costs for customers, as evidenced by the latest price review in April 2020. Environmental and governance factors are a neutral consideration. The company has shown strong performance in both water and waste, achieving good metrics, in line with regulatory targets, and delivering significant outperformance in the first year of the regulatory period. We expect UU will continue to invest to make its network more sustainable by reducing leakage and pollution incidents. UU's geographical monopoly covers 41% of the U.K.'s most deprived areas and has therefore implemented a large social tariff scheme. UU has also set a target to reach net zero by 2030. 100% of its electricity usage has been from renewable sources since October 2021.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Very Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers:

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Positive (+1 notch)
- Liquidity: Adequate
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Stand-alone credit profile: bbb+

Group credit profile: bbb+

Entity status within group: Core

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019

- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Northumbrian Water Ltd. And Northumbrian Water Group Ltd. Downgraded To 'BBB' From 'BBB+'; Outlook Stable, Oct. 12, 2022
- Severn Trent Water Ltd. 'BBB+' And Parent Company Severn Trent PLC 'BBB' Ratings Affirmed; Outlook Stable, Sept. 30, 2022
- Outlook On Southern Water Services (Finance)'s Debt Revised To Negative On Inflationary Pressure, Sept. 20, 2022
- Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable, Sept. 16, 2022
- Why We See England And Wales' Water Regulatory Framework As Strong, July 1, 2022

Ratings List

Ratings Affirmed	
United Utilities Water Ltd.	
Issuer Credit Rating	BBB+/Stable/--
United Utilities PLC	
Issuer Credit Rating	BBB/Stable/--
Issue-Level Ratings Affirmed	
United Utilities Water Finance PLC	
United Utilities Water Ltd.	
Senior Unsecured	BBB+
United Utilities PLC	
Senior Unsecured	BBB-