



Fitch Affirms United Utilities at 'BBB+; 'Stable Outlook

Fitch Ratings - London - 20 September 2019:

Fitch Ratings has affirmed United Utilities PLC's (UU) and United Utilities Water Limited's (UW) Long-Term Issuer Default Ratings (IDRs) at 'BBB+' with a Stable Outlook. Fitch has also affirmed the senior unsecured ratings for UU, UW and United Utilities Water Finance PLC (UWFF) at 'A-'.

The affirmations and Stable Outlooks reflect Fitch's expectation that UW's and UU's financial profiles will remain commensurate with the current ratings for the remainder of the current price control period ending March 2020 (AMP6) and over the next price control for the period 1 April 2020 to 31 March 2025 (AMP7).

The ratings also take into account the fast-track status of UW as set by the regulator, Ofwat, in January 2019 and the draft determination published in April 2019. They also reflect UW's strong regulatory and operational performance, and the low cost of debt embedded in the company's capital structure. UU is a Holdco which owns UW, the regulated monopoly water and sewage service provider for north-west England with a higher net gearing compared with UU, and a number of subsidiaries, mainly in the UK. UW is the most important Opco of UU, and UWFF is the debt-raising vehicle of UW.

Key Rating Drivers

AMP6 Credit Metrics Within Guidelines: Fitch expects UW's pension-adjusted net debt/regulatory asset value (RAV) to be around 64% for the financial year to end-March 2020, and cash post-maintenance interest coverage ratios (PMICR) to average around 2.8x for AMP6, which are comfortably within our guidelines for the ratings. We also expect UU's gearing to be about 61% for the remainder of AMP6, due to some cash held at the UU level and intra-group treasury arrangements owed to UU by UW, which are eliminated on the consolidated level.

AMP7 Credit Ratios Within Guidelines: Based on our assessment of the draft determination, we expect UW's pension-adjusted net debt/RAV to reduce to around 62% by the end of AMP7. We also expect average cash and nominal PMICRs to be around 2.0x over AMP7. Both credit metrics are comfortable within our rating guidelines. In addition, we assume that group treasury arrangements will continue to be in place, and therefore, we expect UU's net gearing to be lower than UW's over AMP7. UU will provide guidance on the group's dividend policy and leverage targets after the final determination is published by Ofwat in December 2019.

Further Reduction in Allowed WACC: The regulator announced in the draft determination published on 18 July 2019 a reduction in its allowed cost of equity by 57bp to 6.56% in nominal terms, which will also apply to fast-tracked companies. This reduction reflected new market data available and resulted in the allowed wholesale weighted average capital cost (WACC) falling by 22bp. The revised figure is now 3.08% (CPIH based excluding retail margin) compared with 3.3% in the previous draft.

EBITDA Hit from New WACC: For UW, we calculate the indicated change in WACC would result in around GBP135 million lower EBITDA and post-maintenance cash flow, with PMICR ratios being most impacted. This reduction in WACC is reflected in our forecast. In our view, UW is better placed to withstand this negative impact than Fitch's rated peers due to its low cash interest costs resulting from a combination of the high proportion of index-linked debt and the interest rate hedging approach targeted by the UU Group which historically have resulted in PMICR ratios being significantly above our rating guidelines.

Early Draft Determination: U UW was one of the three companies whose business plan was classified as fast-track by Ofwat in January 2019 and viewed as one of the best in the sector. The regulator proposed a limited number of interventions which the company accepted including more challenging targets for leakage, pollution incidents, internal sewer flooding and supply interruptions. The company received its draft price determination in April 2019, which includes a fast-track reward of GBP22.5 million (2017-18 CPIH deflated) of additional revenue in AMP7. Consequently, the company is in a position to start implementing the delivery of its plans earlier than peers, resulting in greater certainty around its forecast financial profile.

The draft determination includes an asymmetrical Outcome Delivery Incentives (ODI) package of +1.7/-2.9% (including C-Mex and D-MEX and retail) of return on regulatory equity. In addition, U UW's pay-as-you-go (PAYG) rates included in the draft determination at above 60% are slightly higher than its natural rate in order to increase notional cash flow to ensure financeability. We will, however, adjust PMICRs to align accounting treatment of opex with the regulatory treatment. Our forecast does not include any total expenditure (totex) or ODIs out/under-performance, but it includes some financing out-performance assumed in embedded debt.

Better-Positioned to Meet Cost Challenge: U UW's draft determinations totex allowance was set at GBP5.3 billion (2017-18 CPIH deflated prices) which was 4% below the level requested by the company in its September 2018 business plan. The company accepted Ofwat's cost challenge, which is reflected in its wholesale totex allowance in the draft determination. We expect the company to be better-positioned to meet Ofwat's cost efficiency challenge than rated peers for which the range of cost challenge percentages is between 12% and 21%.

Nominal PMICR Rating Sensitivity: We will be monitoring nominal PMICRs alongside the cash flow-based ones to complement our assessment of companies' financial profiles and cost of debt performance (see 'The Importance of Post-Maintenance Interest Coverage Ratios for Credit Analysis of UK Regulated Networks' dated 8 January 2019 on www.fitchratings.com). For U UW we have set negative nominal PMICR sensitivities at 1.8x and positive at 2.0x.

Improved Operational, Regulatory Performance: For FYE19 U UW earned a net ODI reward of GBP19.2 million, compared with a GBP7 million penalty in FY18. U UW met its drinking water compliance, pollution incidents and leakage targets. Its Service Incentive Mechanism (SIM) score, which reflects customer satisfaction, was stable at 88, maintaining its position in the upper quartile among water and sewage companies. U UW also expects to achieve a GBP16 million reward related to the SIM performance.

Strong Performer despite Missed Targets: U UW received one penalty for GBP3.62 million for failing to meet the water quality service index target. The reliability service also continued to be below its ODI target but was within the 'dead band' (range for which no reward or penalty is given), resulting in no financial penalty. Overall, we continue to view U UW as an upper middle-ranking performer in the sector, compared with its Fitch-rated peers.

AMP6 ODI Rewards and Outperformance: U UW expects to achieve a reward of around GBP30 million related to ODIs on AMP6 performance, having achieved a cumulative net reward of GBP21.4 million over the first four years of the price control. These will be reflected in the allowed revenues set for AMP7. In addition, management has stated that it intends to increase its commitment to reinvesting its outperformance to GBP350 million from GBP250 million as its fast track status provides more clarity for targeted investment. The additional GBP100 million will be used to accelerate the delivery of further performance improvements for AMP7 to affront the tougher operational and regulatory targets.

Ratings Aligned: Fitch rates both U UW's and U UW's Long-Term IDR at 'BBB+'. Fitch often attributes a one-notch difference between the Opco and the Holdco due to structural subordination and regulatory ring-fencing provisions. In this case, Fitch assumes that group treasury arrangements will remain similar to those seen in AMP6 and, therefore, expects the Holdco's net gearing to remain lower than that of the Opco over the remainder of AMP6 and in AMP7. As a result, Fitch continues to equalise the ratings.

Derivation Summary

UW is one of the regulated monopoly providers of water and wastewater services in England and Wales. The company's ratings reflect adequate credit metrics and improving regulatory and operational performance compared with peers'. UW was one of only three companies in the sector to achieve fast-track status and received its early draft determination in April 2019 which in our view provides more clarity around the business and financial profile of the company compared with Fitch-rated peers.

The closest peer is Wessex Water Services Limited (BBB+/Negative). We have relaxed UW's rating guidelines, following the company's improved operational and regulatory performance, so that they are now more in line with those of Wessex Water. The latter's Negative Outlook reflects financial profile pressure expected for the next price control, particularly with regards to gearing.

Similar to Wessex Water, UW's 'A-' senior unsecured rating benefits from a one-notch uplift due to regulated cash flows, which in our view would warrant above-average creditor recoveries upon default. UW's rating continues to be aligned with that of UW, given the group's treasury arrangements and our expectations that UW's leverage will continue to be lower than the operating company. In comparison, Wessex Water Limited, the holding company of Wessex Water, is rated one notch below the operating company, given its structural subordination and low amount of standalone debt.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer For AMP6

- Regulated revenue in line with the final determination of tariffs for April 2015 to March 2020, assuming no material over- or under-recoveries;
- Retail price inflation of 3% for FY20;
- GBP350 million to be reinvested into the business over FY18 to FY20;
- Accelerated pension deficit repair payment of GBP81 million in FY20;
- Retail costs in line with allowances; no outperformance related to ODIs as the company has deferred them to AMP7:
- Non-regulated EBITDA of around GBP5 million per annum;
- No new debt to be raised at UW level; and
- UW's dividends to increase by at least RPI inflation for FY20.

For AMP7

- Regulated revenue in line with the draft determination except for WACC;
- Allowed wholesale WACC in AMP7 decreases to 2.08% (RPI-based) and 3.08% (CPIH-based) in real terms, excluding retail margins;
- Fast-track reward of GBP22 million;
- Long-term RPI at 3%, long-term CPIH at 2%;
- 50% of the regulatory capital value (RCV) is RPI-linked and another 50% plus capital additions is CPIH-linked, starting from FY21;

- AMP7 wholesale totex of around GBP5.3 billion in 2017-18 prices;
- Average PAYG ratio slightly above 60%, run-off (regulatory depreciation) rate at slightly under 5%;
- No totex outperformance or ODI-related rewards;
- Average retail EBITDA of GBP18 million p.a;
- Non-regulated EBITDA of around GBP5 million per annum;
- U UW's dividends at 4.52% of regulatory equity; and
- No pension deficit allowance included in draft determination.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- A sustainable reduction in U UW's gearing to below 62%
- Cash PMICR above 1.9x and nominal PMICR above 2.0x at U UW on a sustained basis
- Top-quartile regulatory performance

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- Gearing increasing above 67% at U UW, which could have an impact on both U UW's and U U's ratings
- Cash PMICR below 1.6x and nominal PMICR below 1.8x at U UW on a sustained basis
- Further adverse regulatory decisions that may materially impact cash flow generation
- An ambitious dividend policy for AMP7 leading to an increase in group gearing with a resulting impact on U U's and U UW's financial metrics
- Additional debt-raising by U U, which could be negative for its ratings or changes to the group treasury arrangements leading to U U's net gearing increasing above 63%

Liquidity and Debt Structure

Adequate Liquidity: At FYE19, U UW had cash and cash equivalents of GBP326 million along with GBP565 million of undrawn committed borrowing facilities against short-term debt of GBP662 million. This funding position provides sufficient financial resources for operating requirements, debt maturities and dividends in the short term.

Summary of Financial Adjustments

- P&L interest cost is adjusted by adding capitalised interest cost of GBP37.4 million in FY19.
- Net debt includes the impact of derivatives of GBP409.2 million and is consistent with the company's reported net debt.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

UW has an ESG Relevance Score of 4 for EWT Water & Wastewater Management as the company's top quartile operational performance is expected to add around GBP30 million performance-related rewards to free cash flow during the next price control (in nominal terms). This has a positive impact on the credit profile, and is relevant to the rating in conjunction with other factors.

UW has an ESG Relevance Score of 4 for EIM Exposure to Environmental Impacts due to rapid freeze/thaw conditions in winter and extreme heat in summer during 2018, which caused higher leakage and numbers of main bursts, which eventually resulted in additional costs. This has a negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
United Utilities PLC	LT IDR BBB+ ● Affirmed	BBB+ ●
senior unsecured	LT A- Affirmed	A-
United Utilities Water Limited	LT IDR BBB+ ● Affirmed	BBB+ ●
senior unsecured	LT A- Affirmed	A-
United Utilities Water Finance PLC		
senior unsecured	LT A- Affirmed	A-

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Applicable Criteria

Sector Navigators (pub. 23 Mar 2018)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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UNSOLICITED ISSUERS

Entity/Security	ISIN/CUSIP/COUP ON RATE	Rating Type	Solicitation Status
United Utilities Water Finance PLC GBP 450 mln 2% bond/note 14-Feb-2025	XS1769818227	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 25 mln 0.013% Gtd Notes 23 Apr 2025	XS1222728260	Long Term Rating	Unsolicited
United Utilities Water Finance PLC HKD 320 mln 2.867% bond/note 21-Jan-2026	XS1937712898	Long Term Rating	Unsolicited
United Utilities Water Finance PLC HKD 739 mln 2.92% bond/note 23-Feb-2026	XS1777190130	Long Term Rating	Unsolicited
United Utilities Water Finance PLC EUR 52 mln 1.129% Gtd Notes 27 Apr 2027	XS1223999316	Long Term Rating	Unsolicited
United Utilities Water Finance PLC HKD 830 mln 2.37% bond/note 04-Oct-2027	XS1692878991	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 20 mln 0.01% bond/note 30-Sep-2028	XS1497735412	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 35 mln 0.178% Gtd Notes 23 Apr 2030	XS1222727965	Long Term Rating	Unsolicited
United Utilities Water Finance PLC EUR 30 mln 2.058% Gtd Notes 26 Oct 2030	XS1309718572	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 350 mln 2.625% bond/note 12-Feb-2031	XS1950827078	Long Term Rating	Unsolicited
United Utilities Water Finance PLC EUR 30 mln 1.641% Gtd Note 09-Jun-2031	XS1432572318	Long Term Rating	Unsolicited
United Utilities Water Finance PLC HKD 600 mln 2.9% Gtd Note 13-Jun-2031	XS1429528315	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 20 mln 0.245% bond/note 09-Dec-2031	XS1531583471	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 38 mln 0.01% bond/note 09-Dec-2031	XS1531582150	Long Term Rating	Unsolicited
United Utilities Water Finance PLC EUR 28 mln 1.707% bond/note 06-Oct-2032	XS1695535994	Long Term Rating	Unsolicited
United Utilities Water Finance PLC EUR 26 mln 1.653% bond/note 06-Dec-2032	XS1732148397	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 250 mln 2% bond/note 03-Jul-2033 XS2022043256	XS2022043256	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 26.5 mln 0.01% bond/note 30-Sep-2036	XS1497735099	Long Term Rating	Unsolicited

Entity/Security	ISIN/CUSIP/COUP ON RATE	Rating Type	Solicitation Status
United Utilities Water Finance PLC GBP 20 mln 0.379% bond/note 09-Dec-2036	XS1531583984	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 29 mln 0.01% bond/note 09-Dec-2036	XS1531582747	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 60 mln 0.093% bond/note 10-Feb-2037	XS1563467569	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 32 mln 0.359% bond/note 05-Oct-2048	XS1694666451	Long Term Rating	Unsolicited
United Utilities Water Finance PLC GBP 33 mln 0.387% bond/note 05-Oct-2057	XS1694666535	Long Term Rating	Unsolicited
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