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United Utilities Water Ltd

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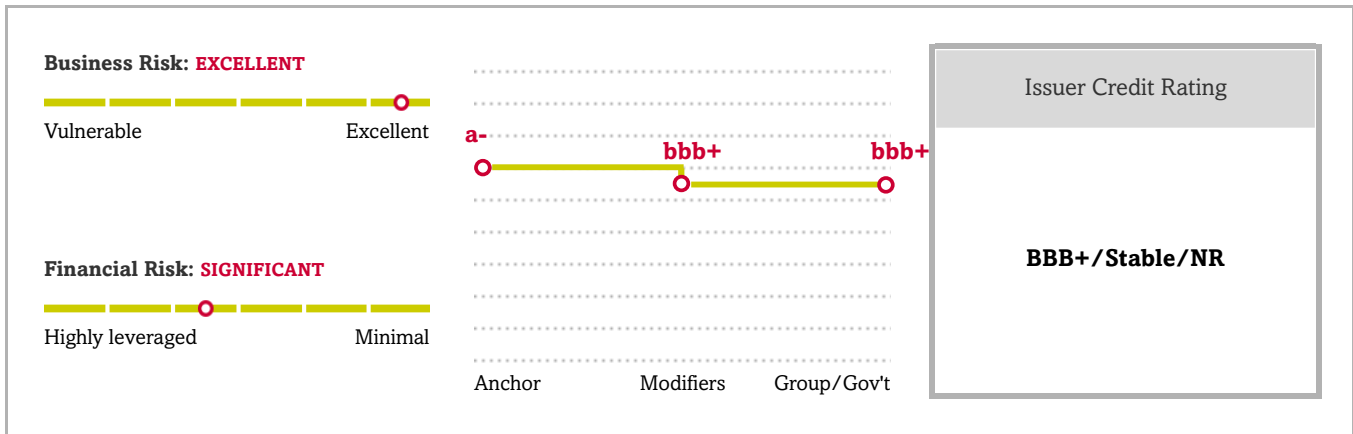
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United Utilities Water Ltd



Credit Highlights

Overview

Key strengths

Focus on low-risk regulated water and wastewater monopoly activities in North West England.

Transparent, credit supportive regulatory framework results in financial stability during regulatory periods.

Lower regulatory leverage than most of its regulated peers, with a debt to regulatory capital value of about 60%-65%.

Improving operational performance.

Key risks

Our expectation of a more challenging regulatory period for the sector from April 2020.

Financial headroom is gradually declining, with funds from operations (FFO) to debt of 9%-10%.

A rise in bad debt as a result of the COVID-19 pandemic remains a risk, although regulatory mechanism provides protection for under-recovery of revenues.

Major investments needed to secure long-term regional resilience.

The group, which consists of United Utilities PLC (UU) and its operating subsidiary, United Utilities Water Ltd (UUW), is relatively resilient to the effects of COVID-19, given the essential service it provides and the regulated nature of its activities. However, like other water utilities, we still expect UU will face adverse impacts of the pandemic on its revenue in the fiscal year ending March 31, 2021 (fiscal 2021), due to lower volumes and an increase in bad debt. We note that regulatory mechanisms provide protection for under-recovery of revenue, and we expect lost revenue from lower volumes will be recovered, albeit with a lag of about one to two years between any under collection and the subsequent true-up.

The group's operating performance, although average, will continue gradually improving. The company met most of its regulatory targets last year, leading to a £22.4 million regulatory net reward for fiscal 2020. Overall, the company earned £44 million in net rewards during Asset Management Plan Period 6 (AMP6). Treasury policies provided material outperformance during the AMP5 and AMP6 regulatory periods.

The group should be more prepared for the new regulatory period, thanks to fast-track status in draft determinations. UU is one of the three companies that the regulator placed on a fast track in draft determinations. UU will receive £24 million of additional revenue as a reward, and provided with more time and clarity to prepare for the new regulatory period.

We expect the new regulatory period AMP7, which started in April 2020, will be challenging for the group. UU will see a lower cost of capital, and a challenging range for its outcome delivery incentives of -1.8% to 1.5%, with a 13.8% real reduction in average bills.

Financial headroom is gradually declining, and we estimate FFO to debt of 9%-10% during AMP7, compare with 11%-12% during most of AMP6. Nevertheless, the company has lower regulatory leverage than most of the regulated peers, at about 60% debt to regulatory capital value.

Outlook: Stable

S&P Global Ratings' stable outlooks on UU reflects our expectation that the group will continue to demonstrate solid operating performance, while keeping FFO to debt above 9% and debt to EBITDA below 9x. The stable outlook also reflects our expectation that UU will remain relatively resilient to the impact of the COVID-19 pandemic, while the regulatory mechanism provides protection for under-recovery of revenues.

Downside scenario

We could lower the ratings if the adjusted FFO-to-debt ratio declines and remains below 9%. This could occur during the next regulatory period if UU does not deliver on its business plan, leading to total expenditures materially in excess of Ofwat's allowance or potential operational penalties. We could take a negative rating action if the adverse impacts of the pandemic are more severe than we anticipate, with a higher-than-expected level of bad debt default of businesses.

Upside scenario

We would consider raising the ratings if adjusted FFO to debt exceeded 11% and debt to EBITDA stayed below 7x on a sustainable basis, while the company demonstrated above-average operating performance.

Our Base-Case Scenario

Assumptions

- Retail price index (RPI) assumptions as per our in-house projections. We forecast inflation as measured by RPI in the U.K. of 1.5 % in 2021, 2.6% in 2022, and 3.3% in 2023.
- EBITDA margins of about 55%-58% in AMP7.
- Capital expenditure (capex) of about £500 million-£600 million in fiscals 2021-2023, declining to about £300 million-£400 million in fiscals 2024-2025 .
- Lower growth in dividends in AMP7 than AMP6. The group's dividend policy for AMP7 states that dividends will increase by the consumer price index including housing costs (CPIH) each year. We expect the growth rate will be about 1% lower than in AMP6, given the decision to shift to CPIH from RPI.
- Gearing to remain low at about 60%. Although UUW's regulatory capital value (RCV) will decline by about 3.3% in real terms by the end of AMP7, the group's gearing will remain at about 60%.

Key Metrics

United Utilities PLC--Key Metrics*				
(Mil. £)	--Fiscal year ended March 31--			
	2019a	2020a	2021e	2022f
EBITDA margin (%)	57.2	60.5	55.0-57.0	56.0-58.0
Debt to EBITDA (x)	6.8	6.4	7.0-8.0	6.5-7.5
FFO to debt (%)	10.9	11.3	9.0-10.0	9.0-10.0
DCF to debt (%)	(1.0)	(1.6)	(3)-(2)	(2.5)-(1.5)
EBITDA interest coverage (x)	4.3	4.4	3.5-4.5	3.5-4.5
FFO interest coverage (x)	6.3	6.5	3.5-4.5	3.0-4.0

a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. DCF--Discretionary cash flow. *All figures adjusted by S&P Global Ratings.

Company Description

UUW is the second-largest water and sewerage company in the U.K. after Thames Water by RCV, which was £11.7 billion as of March 31, 2020. UUW is a monopoly supplier of water and wastewater services to about 3 million households and 0.2 million businesses in North West England, and generates annual EBITDA of about £1.1 billion. UU has created a joint venture with Severn Trent to operate the competitive nonhousehold retail business segment. UU has minimal unregulated activities.

Peer Comparison

Table 1

United Utilities PLC--Peer Comparison			
Industry sector: Water			
	United Utilities PLC	Severn Trent PLC	Northumbrian Water Ltd.
Ratings as of Aug. 17, 2020	BBB/Stable/--	BBB/Stable/A-2	BBB+/Watch Neg/--
	--Fiscal year ended--		
	March 31, 2020	March 31, 2020	March 31, 2019
(Mil. £)			
Revenue	1,859.3	1,843.5	899.7
EBITDA	1,125.8	947.8	484.1
Funds from operations (FFO)	820.4	693.7	310.0
Interest expense	256.3	231.7	154.8
Cash interest paid	149.4	186.2	125.8
Cash flow from operations	815.2	670.4	301.0
Capital expenditure	645.3	812.4	217.6
Free operating cash flow (FOCF)	169.9	(142)	83.4
Discretionary cash flow (DCF)	(117.4)	(370.4)	(57.0)
Cash and short-term investments	528.1	26.8	22.2
Debt	7,241.4	6,640.4	3,287.6
Equity	2,962.1	1,243.7	(568.3)

Table 1

United Utilities PLC--Peer Comparison (cont.)			
Industry sector: Water			
	United Utilities PLC	Severn Trent PLC	Northumbrian Water Ltd.
Debt and equity	10,203.5	7,884.1	2,719.3
Adjusted ratios			
EBITDA margin (%)	60.5	51.4	53.8
Return on capital (%)	6.0	6.8	12.9
EBITDA interest coverage (x)	4.4	4.1	3.1
FFO cash interest coverage (x)	6.5	4.7	3.5
Debt/EBITDA (x)	6.4	7.0	6.8
FFO/debt (%)	11.3	10.4	9.4
Cash flow from operations/debt (%)	11.3	10.1	9.2
FOCF/debt (%)	2.3	(2.1)	2.5
DCF/debt (%)	(1.6)	(5.6)	(1.7)

UUW's closest peers are rated U.K. water and sewerage utilities, the vast majority of which have excellent competitive positions due to the supportive regulatory regime. UU is the second-largest of the 10 regulated water and sewerage companies in the U.K. and Wales by RCV, with £11.7 billion as of March 31, 2020.

UU accrued net rewards of £43.9 million in AMP6. This places the company in the first tier of the sector along with Severn Trent PLC, Wessex Water Services Ltd., and Anglian Water on the basis of net rewards in absolute terms or when benchmarked against RCV or revenue.

Business Risk: Excellent

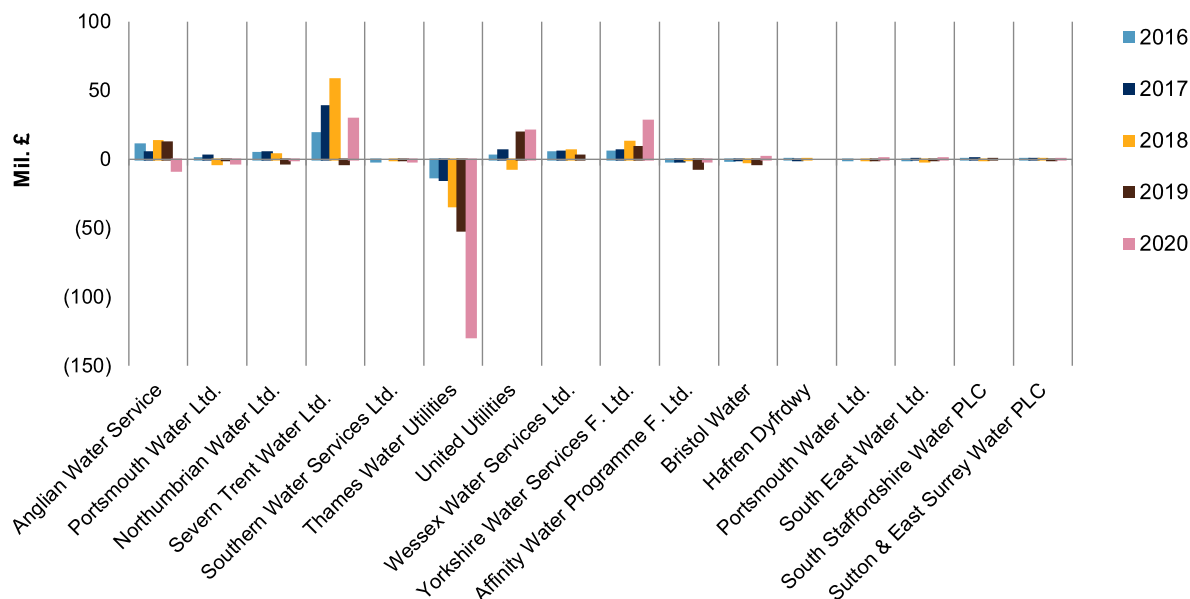
Strong regulatory framework. UUW's excellent business risk profile primarily reflects the strong regulatory framework and the low risk associated with UUW's regulated water and wastewater businesses, which contribute almost all of the consolidated EBITDA (see "Why We See The Regulatory Framework For U.K. Utilities As Supportive," published Sept. 26, 2017, on RatingsDirect).

We consider the regulatory framework for the water sector in England and Wales to be credit-supportive, with revenues set prospectively for periods of five years, ensuring transparency and predictability of earnings and cash flows. Given the company's status as a natural monopoly within its service areas, the regulation protects end-consumers.

Operational performance is average, yet gradually improving. In the regulatory year ending March 2020, the company met most of its regulatory targets. The company was not able to meet the parameters of its water quality service index, sewer flooding index, or reliable water service index in 2019/2020, and incurred a total penalty of £21.1 million. While it outperformed in the private sewer service index, Thirlmere transfer to West Cumbria and pollution incidents, and gained rewards of £43.5 million in 2019/2020.

Chart 1

Accumulated ODI Reward/Penalties Per Year From 2016-2020



ODI--Outcome delivery incentives. Source: S&P Global Ratings.
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We expect AMP7 will be challenging for UU. We believe that the regulatory period that started in April 2020 will be challenging, with more focus on performance, particularly customer-related and environmental performance commitments. Based on the final determination, UU will be subject to an outcome delivery incentives (ODI) range of -1.8% to 1.5%, with a 13.8% real reduction in average bills.

In order to address these challenges, the company has invested about £350 million of revenue associated with outperformance generated during AMP6 to enhance its performance in AMP7. This additional investment will support operating performance, and we expect it will place UU in a good position at the beginning of the current regulatory period. Overall we believe UU will continue to demonstrate solid operating performance and potentially benefit from rewards.

Financial Risk: Significant

We believe that, like the rest of the sector, UUW will operate under tougher conditions in AMP7 that will ultimately weaken its credit metrics. Specifically, we forecast FFO to debt will drop to 9%-10% in AMP7, from about 11% in 2020, mainly due to the reduction in the allowed cost of capital to 1.96% assuming an RPI of 3%, versus 3.74% in the current regulatory period.

We expect capex will remain significant at about £500 million-£600 million a year over the next three years. The group's dividend policy for AMP7 states that dividends will increase by the CPIH each year. We expect the growth rate will be about 1%, which is lower than in AMP6, given the decision to shift to CPIH from RPI. Although UUW's RCV will decline by about 3.3% in real terms by the end of AMP7, the group's gearing will remain at about 60%.

Financial summary

Table 2

United Utilities PLC--Financial Summary					
Industry sector: Water					
	--Fiscal year ended March 31--				
	2020	2019	2018	2017	2016
(Mil. £)					
Revenue	1,859.3	1,818.5	1,735.8	1,701.0	1,727.4
EBITDA	1,125.8	1,040.3	1,028.3	982.4	956.3
Funds from operations (FFO)	820.4	769.3	708.1	777.8	731.9
Interest expense	256.3	240.9	284.4	243.2	205.5
Cash interest paid	149.4	145.1	146.9	163.4	171.3
Cash flow from operations	815.2	835.5	819.9	827.4	691.6
Capital expenditure	645.3	627.0	711.0	695.8	683.0
Free operating cash flow (FOCF)	169.9	208.5	108.9	131.6	8.6
Dividends paid	284.5	274.4	267.0	263.1	258.7
Discretionary cash flow (DCF)	(117.4)	(68.7)	(161.5)	(133.9)	(256.7)
Cash and short-term investments	528.1	339.3	510.0	247.8	213.6
Gross available cash	528.1	339.3	510.0	247.8	213.6
Debt	7,241.4	7,027.4	6,870.7	6,429.3	6,101.0
Equity	2,962.1	3,110.8	2,950.9	2,821.6	2,705.5
Debt and equity	10,203.5	10,138.2	9,821.6	9,250.9	8,806.5
Adjusted ratios					
EBITDA margin (%)	60.5	57.2	59.2	57.8	55.4
Return on capital (%)	6.0	6.6	6.8	6.8	6.8
EBITDA interest coverage (x)	4.4	4.3	3.6	4.0	4.7
FFO cash interest coverage (x)	6.5	6.3	5.8	5.8	5.3
Debt/EBITDA (x)	6.4	6.8	6.7	6.5	6.4
FFO/debt (%)	11.3	10.9	10.3	12.1	12.0
Cash flow from operations/debt (%)	11.3	11.9	11.9	12.9	11.3
FOCF/debt (%)	2.3	3.0	1.6	2.0	0.1
DCF/debt (%)	(1.6)	(1.0)	(2.4)	(2.1)	(4.2)

Reconciliation

Table 3

United Utilities PLC--Reconciliation Of United Utilities PLC Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. £)						
--Fiscal year ended March 31, 2020--						
United Utilities PLC reported amounts						
	Debt	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
	8,305.5	1,113.1	630.3	231.7	1,125.8	810.3
S&P Global Ratings' adjustments						
Cash taxes paid	--	--	--	--	(55.7)	--
Cash interest paid	--	--	--	--	(149.4)	--
Reported lease liabilities	57.6	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	--	6.2	6.2	--	--	--
Accessible cash and liquid investments	(528.1)	--	--	--	--	--
Capitalized interest	--	--	--	40.6	--	--
Share-based compensation expense	--	1.5	--	--	--	--
Dividends received from equity investments	--	4.9	--	--	--	--
Nonoperating income (expense)	--	--	(28.1)	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	4.9
Debt: Other	(593.6)	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	13.9	13.9	--	--	--
EBITDA: Other	--	(13.8)	(13.8)	--	--	--
Interest expense: Other	--	--	--	(16)	--	--
Funds from operations: Other	--	--	--	--	(100.3)	--
Total adjustments	(1,064.1)	12.7	(21.8)	24.6	(305.4)	4.9
S&P Global Ratings' adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
	7,241.4	1,125.8	608.5	256.3	820.4	815.2

We make a number of adjustments to UU's reported figures. The main adjustments in fiscal 2020 are as follows:

- Surplus cash: We deduct from debt £528 million cash that we consider unrestricted and surplus as defined by our criteria.
- We also adjust debt by £493 million for the effective swapped debt amount.

Liquidity: Adequate

Our assessment of UUW's liquidity as adequate reflects our expectation that the company's sources of liquidity will

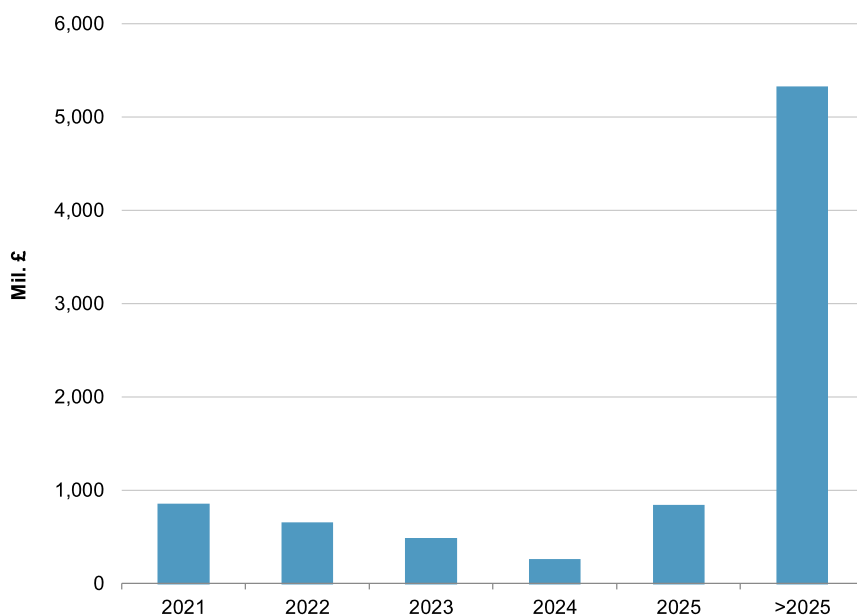
exceed its uses by 1.1x. We also think that the group has a high standing in the credit markets and generally prudent risk management.

Principal Liquidity Sources	Principal Liquidity Uses
<p>We anticipate the following principal liquidity sources over the 12 months from March 31, 2020:</p> <ul style="list-style-type: none"> • Cash and liquid investments of about £530 million; • FFO of about £745 million; and • Undrawn committed facilities of £680 million, with maturities of more than 12 months. 	<p>We anticipate the following principal liquidity uses over the 12 months from March 31, 2020:</p> <ul style="list-style-type: none"> • Short-term debt maturities of about £755 million); • Capex of about £650 million; and • Dividends of about £290 million.

Debt maturities

Chart 2

United Utilities PLC--Debt Repayment Schedule



Source: S&P Global Ratings.

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Group Influence

We base our ratings on our assessment of the group, which comprises the parent, UU, and the operating and entity, UUW. We rate the holding company, UU, one notch lower than the operating company, UUW, at 'BBB' compare to 'BBB+'. This differential reflect the regulatory ring-fencing risk associated with the water industry in the U.K.

According to the regulations, and the license agreement for UUW, if the rating on UUW is below 'BBB-', the regulator could impose a lock-up on dividends, which could impair UU's ability to repay its creditors.

Issue Ratings - Subordination Risk Analysis

Capital structure

UU's capital structure consists of £8.3 billion of unsecured debt as of March 31, 2020, of which £7.8 billion was issued by UUW and its financing subsidiary United Utilities Water Finance PLC.

Analytical conclusions

We rate the debt issued by UUW and its financing subsidiary 'BBB+', in line with the long-term issuer credit rating on UUW. The issue rating on the unsecured debt issued by the parent, UU, is 'BBB-', one notch below the 'BBB' long-term issuer credit rating on UU, to reflect the structural subordination of holding company debt to total debt.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Significant (low volatility table)

- Cash flow/Leverage: Significant

Anchor: a-

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral

- Management and governance: Satisfactory
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb+

- Group credit profile: bbb+
- Entity status within group: core

Related Criteria

- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Four U.K.-Based Water Utilities Downgraded On Tougher Regulations; Two Put On Watch Negative; Four Outlooks Negative, Feb. 25, 2020

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of August 24, 2020)***United Utilities Water Ltd**

Issuer Credit Rating	BBB+/Stable/NR
Senior Unsecured	BBB+

Issuer Credit Ratings History

25-Feb-2020	BBB+/Stable/NR
09-Aug-2019	A-/Negative/NR
25-Jul-2017	A-/Stable/NR
08-Sep-2015	BBB+/Positive/NR

Related Entities**United Utilities PLC**

Issuer Credit Rating	BBB/Stable/NR
Senior Unsecured	BBB-

United Utilities Water Finance PLC

Senior Unsecured	BBB+
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*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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