Article Title: ARCHIVE | Criteria | Corporates | Utilities: U.K. Water Industry Faces Critical Stage Data: (Editor's Note: An article on March 25, 1999, misstated the ratings on Southern Water Services Ltd. and ScottishPower PLC. The correct ratings are A+/Watch Neg/— and A+/Watch Neg/A-1, respectively. A footnote to table 1 explaining the CreditWatch placement of Southern Water has been added. A line explaining the same has been added to paragraph 14. A rewritten article follows.) The U.K. water industry faces the most critical period of its post-privatization history in 1999 as the regulator, the Office for Water Services (OFWAT), decides on the tariff regime for the first five years of the new millennium. The new price caps, which OFWAT will set in November 1999, are expected to shape the ongoing credit quality of the 10 water and sewerage companies (WSC), eight of which are rated by Standard and Poor's (see table 1.) Table 1 Ratings Before and After "Prospects for Prices" COMPANY* AFTER CREDITWATCH RESOLUTION Anglian Water Services Ltd. AA/Stable/- A/Negative/- Dwr Cymru (Welsh Water) A/Stable/A-2 A-/Negative/A-2 Northumbrian Water Ltd. AA-/Stable/- A+/Stable/- North West Water Ltd. AA-/Stable/A-1 A+/Negative/A-1 Yorkshire Water Services Ltd. AA/Stable/- AA-/Stable/- Southern Water Services Ltd.¶ A+/Stable/- A+/Watch Neg/- Thames Water Utilities Ltd. AA/Stable/- AA-/Stable/- Wessex Water Services Ltd. A/Stable/- A/Stable/- *Companies are operating companies. ¶Southern Water remains on CreditWatch as a result of the CreditWatch placement of its parent, ScottishPower PLC, following the announcement of the proposed all-paper merger of ScottishPower and PacifiCorp. 1999 Price Review Under the regulatory regime set by OFWAT, WSCs are subject to a price-cap regime. Prices increase annually by the retail price index (RPI) plus a 'K' factor, which is a maximum real percentage rate. The 'K' factor incorporates an efficiency target (known as X) for reducing operating costs and cash required for ongoing investments. The 'K' factor should also ensure that the WSCs are able to finance their activities and to earn a reasonable rate of return on capital. As many companies have substantially outperformed their cost of capital since privatization in 1989, the regulator is concerned that shareholders have benefited more from achieved efficiencies than the water consumers. Although OFWAT has recognized that the vast scale of the investments made so far by the water companies has led to improved service and better operational standards (i.e. reducing leakage), it is the regulator's intention to bring rates of return in line with the cost of capital while maintaining ongoing high levels of investments. The latter is driven by EU Directives for water quality and environmental standards, which are included in the U.K. government's quality improvement program. This program will be accounted for by the regulator when setting prices at the forthcoming periodic review for the 2000-2005 charging period. Before the announcement of "Prospects for Prices" by OFWAT in October 1998, the government indicated that it had a vast quality improvement program in mind for the industry, and, at the same time, requested average one-off price cuts in 2000 of 10%. OFWAT's actual proposals in the "Prospects for Prices", which sets the underlying guidelines for the 1999 periodic review, were much harsher than expected by Standard & Poor's and the water industry in general. The main elements were: Profile of household bills to reduce with a one-off price cut (P-nought) in 2000, ranging from up to 12.5% to over 17.5% for individual companies (see table 3); Household bills in 2005 to be within a range of well below the expected 2000 water bill or above the expected 2000 water bill in real terms depending on the final 'K'-factor for each WSC (see table 3); Assume a level of £8 billion-£8.5 billion for capital expenditure set by the government's quality improvement program; The cost of capital to range between 4.0%-5.5% after tax in real terms; and Reduction in operational expenditure of between 2% to 4% per year and between 5% and 10% for capital expenditure. Table 2 Debt Issuance After the "Prospect for Prices" Announcement ISSUER TYPE OF ISSUE AMOUNT ISSUE DATE MATURITY SPREAD* RATING ASSIGNED AT TIME OF ISSUE Thames Water Eurosterling £330 million Oct. 30, 1998 2028 180bp AA/Negative Hyder PLC¶ Eurosterling £140 million Dec. 4, 1998 2020 235bp BBB+/Negative Hyder PLC Yankee Dec 4, 1998 BBB+/Negative Anglian Water Eurosterling £200 million Dec 15, 1998 2038 190bp A/Negative Severn Trent Eurosterling £300 million Jan 27, 1999 2024 175bp N.R. Hyder PLC** Eurosterling £60 million Feb 15, 1999 2020 210bp BBB+/Negative North West Euro MTN £500 million Mar 4, 1999 2009 73bp¶¶ A+/Negative Wessex Water Eurosterling £300 million Mar. 15, 1999 2009 135bp A/Stable *Spread over U.K. government bonds in basis points (0.01%). ¶Hyder PLC is the holding company of Dwr Cymru (Welsh Water). §Spread over U.S. Treasuries. **Increase of Hyder's £140 million issue of Dec. 4, 1998. ¶¶Spread over German bund. As a result of "Prospects for Prices", all rated WSCs were placed on CreditWatch in October 1998 with negative implications except for Wessex Water and Southern Water. Wessex Water had incorporated the regulator's proposals sufficiently following its acquisition by Azurix Europe Ltd. (A-/Stable/--) and Southern Water benefits from the credit strength of its parent ScottishPower (A+/Watch Neg/A-1). Standard & Poor's reviewed the regulator's proposals to determine the potential impact on the WSCs' credit profile and took into consideration the companies' financial forecasts, including the most likely assumptions of the impact of the 1999 Price Review. All the CreditWatch actions were resolved by the end of 1998 (see table 1). Generally, the WSCs on CreditWatch were downgraded one notch except for Anglian Water, while three WSCs were given a negative outlook pending the regulatory review. An important issue in "Prospects for Prices" that is still being debated between industry and the regulator is the shape of the price profile over the 2000-2005 period. In chart 1 the regulator's preference is shown as profile 1, while profile 2 represents the industry's preference. 1 The first profile sets a larger P-nought cut in 2000, with subsequent price increases in real terms to fund capital expenditure, while the second profile has a lower P-nought cut, but has subsequent broadly stable prices in real terms. OFWAT's main objection against the second profile is that it carries less incentives for WSCs to outperform as it will allow them to earn higher-than-average returns in the earlier years and consequently lower-than-average returns in later years. The regulator fears that, potentially, the WSCs could dividend "excess" returns in early years and thereafter claim they need more cash in later years. On a net present value basis, however, companies would be provided with broadly the same revenues. Standard & Poor's considers both profiles to have similar deteriorating impact on the credit quality of the WSCs. Although in the first profile, with a high P-nought, the impact of such a P-nought is mitigated partly by price increases in real terms in subsequent years, the tariff reduction could stress the WSCs' credit profile. However, considering OFWAT's announcements in "Prospect for Prices" and the WSCs' current credit quality, there is unlikely to be a material deterioration in credit quality as a result of the P-nought cut in 2000. Further comfort can be taken by the regulator's stated intention to maintain investment-grade ratings (threshold of 'BBB-') for which it assumed a requirement to maintain gearing (total debt to total debt plus equity) of 50%-60% and an earnings before interest and taxes (EBIT) interest cover of about 2 times (x). Although EBIT (pretax earnings) interest cover is an element of Standard & Poor's rating assessment, cash flow coverages (i.e. funds from operations interest and debt cover) are considered to have more value. Also, interest coverage and gearing are only two elements among many in the financial part of the rating analysis (see sidebar). Standard & Poor's views a pretax interest cover of between 1.5-2.0x and a funds-from-operations interest cover of about 2.0-2.5x on average as broadly consistent with low investment-grade ratings in this sector. While it may be feasible for WSCs to tap capital market funds in the U.S. at this level of rating, it is questionable whether the sterling institutional investor base is willing to price efficiently risk at this level of the credit spectrum. This obviously has implications for the cost of capital. A final concern for the industry's credit quality is the possible referral to the Monopolies and Mergers Commission (MMC). At the announcement of "Prospects for Prices", some of the WSCs threatened to refer the price review to the MMC. This could bring uncertainty over the sector while the outcome of such a referral is unpredictable. As can be concluded from chart 2, the WSCs' credit quality has deteriorated over the past two years and on average ratings are moving into the 'A' to 'BBB' ratings category. Standard & Poor's generally expected this over the longer term. However, the timing of the credit deterioration has come sooner than anticipated in last year's review of the sector (see U.K. Water: Clouds Over the Horizon, CreditWeek April 1, 1998) because of the regulator's harsher stance on key financial issues in "Prospect for Prices" and the ongoing challenges of the industry's sizeable capital investment program. Nonetheless, Standard & Poor's still believes the sector has strong credit fundamentals and does not anticipate any further significant movement in ratings as a result of the final outcome of the 1999 Periodic Price Review. Going forward, the sector's credit strength is underpinned by the following factors: An established regulatory environment that will continue to be the basis for the sector's stable underlying cash flows; Regulator's desire to keep water companies at an investment-grade level; Stable monopoly markets with only limited potential for competitive threats in the next five years; Improving operational and capital expenditure efficiency; and Renewed focus on core business while moving away from overseas investments with full recourse to U.K. operations. Credit strengths are offset by the following factors: A harsher political and regulatory regime; Likelihood of large price cuts in charging years 2000-2001; Low or negative growth in water consumption; Uncertainty on the introduction of metering and who will bear these costs; Large capital expenditure programs; and Weakening of interest and capital expenditure coverages and increasing debt requirements to fund ongoing investments. After the announcement of "Prospects for Prices", the WSCs have not shied away from the capital markets. Improved capital market conditions after the turmoil caused by the Russian crisis and the anticipated need to raise funds for their extensive capital expenditure program resulted in eight capital market issues between Oct 1, 1998, and April 1, 1999, totaling £1,759 million. More issuance is expected in the near future. Although the 1999 Price Review is expected to set a tariff regime with a high P-nought in 2000, with subsequent real price increases, investors should expect a stable regulatory and political environment over the next five years. The tariff regime over the 2000-2005 period will include the government's quality program set at £8 billion. Unless there is some movement from the stance taken in "Prospects for Prices" on issues such as cost of capital and efficiency assumptions, Standard & Poor's expects some further deterioration in the credit quality of WSCs that currently have negative outlooks (Anglian Water, Dwr Cymru, and North West Water). Dwr Cymru and North West Water are part of the multi-utilities Hyder PLC (BBB+/Negative/A-2) and United Utilities PLC (A/Negative/A-1), respectively, which also face a price review for their electricity distribution activities that could affect their respective consolidated credit quality. No further rating actions are anticipated for the other rated WSCs (Northumbrian, Thames, Yorkshire, and Wessex, however, resolution of Southern's CreditWatch placement is dependent on the outcome of the ScottishPower/PacifiCorp. merger) as a result of the regulatory review since current ratings have incorporated the harsher regulatory environment for the next charging period 2000-2005. The expected extensive capital expenditure program for the 2000-2005 period will lead to higher leverage and lower cash flow interest and debt coverages, which also has been taken into account in the current ratings level. Although the regulatory framework and requirements affect the ratings level, the WSCs have the ability to support their credit ratings by means of their dividend policy, acquisition and investment strategy, and cost-control capability. Table 3 Prospect for Prices and WSCs' Efficiency CHANGE IN OPERATING COSTS 1997-1998 COMPARED WITH 1992-1993 (%) RELATIVE OPERATING EXPENDITURE EFFICIENCY GROSS CAPITAL INVESTMENTS IN WATER/ SEWERAGE 1997-1998 RELATIVE CAPITAL MAINTENANCE EXPENDITURE EFFICIENCY POSSIBLE P-NOUGHT IN 2000-2001 POSSIBLE AVERAGE HOUSEHOLD BILL IN 2004-2005 COMPARED WITH EXPECTED BILL IN 1999-2000 Anglian (11) Average 171.1/201 Least efficient over 17.5% Around 1999-2000 bill Dwr Cymru 0 Least efficient 97.0/180.4 Leading 15%-20% Well above 1999-2000 bill NorthWest Water 7 Average 213.2/285.4 Inefficient 12.5%-17.5% Around 1999-2000 bill Northumbrian (23) Average 71.0/178.2 Inefficient over 17.5% an increase compared with 1999-2000 bill Severn Trent (8) Average 242.9/268.2 Average 15%-20% Well below 1999-2000 bill South West (10) Average 76.8/88.5 Average 15%-20% small reduction compared with 1999-2000 Southern (14) Leading 55.8/229.2 Leading over 17.5% Increase compared with 1999-2000 bill Thames (12) Above Average 283.5/224.4 Least efficient 10%-15% well below 1999-2000 bill Wessex (27) Leading 48.4 / 79.6 Least efficient over 17.5% small reduction compared with 1999-2000 bill Yorkshire (9) Above average 182.6 Least efficient 15%-20% Around 1999-2000 bill Source: OFWAT's "Prospects for Prices", Oct 1998; OFWAT's 1997-1998 Report on the financial performance and capital investment of the water companies in England and Wales; and OFWAT's 1997-1998 report on water and sewerage service operating costs and efficiency. Criteria The ratings for a WSC are based on many factors that are incorporated into a business and financial profile. These factors include: Business Profile. Regulation: transparency, consistency of regulations, political environment. Markets: geographical area, population growth and density, macroeconomic developments, metering, customer concentration and profile, international activities, and growth assumptions. Operations: capital expenditure management, leakage, water bans, customer service, compliance with regulatory standards, water sources, quality of water and sewerage mains, and European Union regulations. Competitiveness: common carriage, water/sewerage charges, and direct competition. Financial Profile Financial policy: dividend policy and funding strategy. Earnings protection: profitability, stability and source (quality) of operating profits, and pretax interest coverage (current and five-year forward-looking average). Capital structure: current total debt to total capital (gearing) ratio and five-year forward-looking, potential

debt-raising factors (windfall tax, capital expenditure, etc.) Cash flow protection: funds from operation interest coverage and funds from operation total debt. Internal Funding: net cash flow as percent of capital expenditure and capital expenditure as percent of total capital. Financial flexibility: funding sources, access to capital market, dividend payout ratio, and standby credit facilities.
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