Water – PR19 looms

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- Since their privatisation in 1989, the 10 water companies have faced a periodic review every five years; it is undertaken by Ofwat, and prescribes customer prices, along with the investment requirements.
- As part of the ongoing review, PR19, Ofwat will publish its Final Determination numbers on 11 December 2019; they will apply as from April 2020, although water companies do have the option to seek a reference to the CMA.
- The three quoted water companies – Severn Trent, South West and United Utilities – have been fast-tracked, so their numbers are broadly known.
- The other seven are facing tough regulatory scrutiny, with several seriously considering appealing Ofwat's Final Determination via the CMA – Southern, Thames and Anglian are the most likely to do so.

Background

Privatisation in 1989

In 1989, the 10 water companies in England and Wales were floated – their shares were heavily over-subscribed. The water companies in Scotland and Northern Ireland were not included, and they remain in the public sector to this day.

Quinquennial periodic reviews

Every five years (beginning with 1990), the water companies face a periodic pricing review, which determines the charges that they can levy on their customer base: there is minimal competition at the retail level.

PR19

11 December is "D Day"

Ofwat has been working on the current review, PR19, for several years. It will announce details of the Final Determination Ofwat on 11 December 2019, with the new pricing formulas applying as from April 2020 and lasting until March 2025.

Few water companies – South West's parent company, Pennon, with its Viridor waste business, is an exception – have material non-core revenues; the regulatory outcome is therefore key in determining their finances, their ongoing debt levels and their capacity to pay dividends.

Of the 10 privatised water companies, five – Anglian, Northumbrian, Southern, Thames and Yorkshire – are under private equity ownership, while Wessex is owned by YPL, a Malaysian power company. Dwr Cymru, in Wales, is a not-for-profit company.

Highly indebted private equity-owned quintet

All five water companies in private equity have comparatively high debt levels. With PR19 set to be far tougher than its predecessors, these companies face major risks to their long-term financial models.

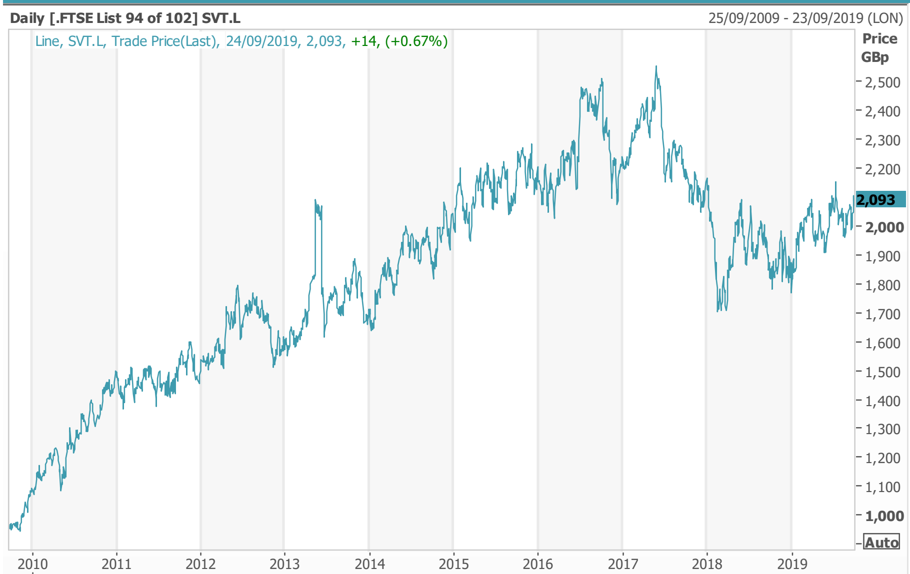
The quoted trio

Marked outperformance since 1989

The three quoted companies – Severn Trent, United Utilities and Pennon, the owner of South West – have prospered since 1989; they have markedly outperformed the market.

The two graphs below show, respectively, the 10-year share price performances of Severn Trent and United Utilities – both are FTSE 100 companies.

Severn Trent – quoted share price



Source: Refinitiv

United Utilities – quoted share price

Source: Refinitiv

All three quoted stocks are "fast-trackers"

For these two water companies and South West, all of which have been accorded "fast-tracker" status by Ofwat – and therefore a more favourable regulatory settlement – future dividend payment capacity is crucial.

Over the past five years, Severn Trent and United Utilities have both increased their annual dividend. In Severn Trent's case, its 2014/15 payment was 84.9p, while its 2015/16 payment was re-based at 80.7p; by 2018/19, its dividend had risen to 93.4p. For United Utilities, the figures were 37.7p and 41.28p for 2014/15 and 2018/19, respectively.

Dividend cuts post 2019/20?

For Severn Trent and United Utilities, underlying dividend cover for the 2018/19 financial year was 1.4x and 1.3x, respectively. As such, both may be able to avoid a dividend cut, although they could choose to switch to a lower divided base and pay higher annual dividend increases subsequently.

Price-setting methodology

RCVs crucial for price-setting process

Ofwat's price-setting methodology is based on using the Regulatory Capital Values (RCVs) for each water company as the denominator in the equation. RCVs rise each year, based on that year's investment, net of depreciation. Details of the RCVs, as at March 2019, are set out below.

RCVs (end-March 2019)

£m	
Anglian	7,981
Dwr Cymru	5,672
Northumbrian	4,272
Severn Trent	9,166
Southern	5,035
South West	3,505
Thames	14,274
United Utilities	11,404
Wessex	3,233
Yorkshire	6,687

Source: Ofwat

Price adjustments via K factor movements

The numerator is effectively the operating profit – calculated from the rate of return that Ofwat judges is appropriate – which should accrue from an efficiently-run regulated water business. Retail price rises/cuts are imputed, via the adjustment of the K factor, to the projected revenue base.

Test Area Assessments

To differentiate more clearly – and fairly – between the 10 water companies, Ofwat recently undertook a wide range of Test Area Assessments (TAAs), which examined key parts of each company's water and waste-water provision.

Sector did badly

Few companies did well in these TAAs. By far the worst performers were Southern and Thames, both of which received D ratings – the lowest level. In all, nine categories were assessed by Ofwat.

Sector finances

Mainly debt-free balance sheets in 1989

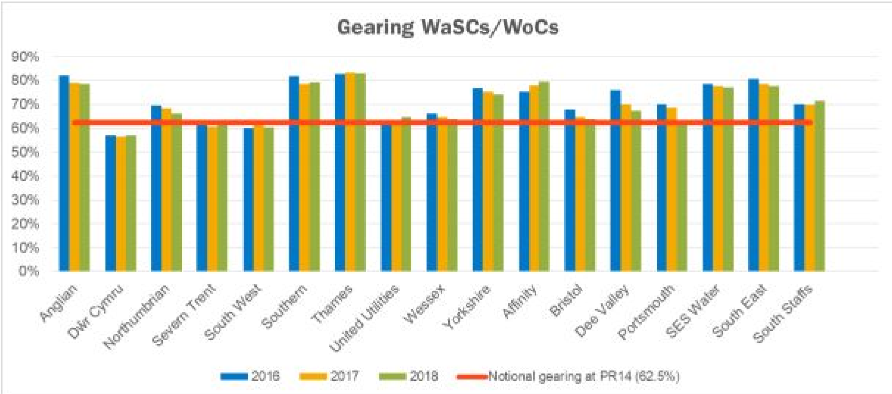
At flotation in 1989, in the light of the massive backlog of investment, most water companies were allocated debt-free balance sheets. In the intervening years, net debt levels have risen very appreciably – and are now more redolent of a traditional utility.

Thames's £11bn+ net debt

In the case of the five private equity-owned water companies, net debt levels have increased far more steeply than the sector average – Thames's net debt now exceeds £11bn.

The graph below, published by Ofwat, shows the gearing levels – as a percentage of RCV – of all 10 water companies under review, along with those water companies that were not part of the original privatisation process in 1989.

Gearing levels



Source: Ofwat

Sharp cut to Ofwat's WACC assumption

So far, PR19 has been known for its much more robust assumption by Ofwat of the pivotal Weighted Average Cost of Capital (WACC). Its indicative 2.4% figure is around a third lower than the comparable figure that Ofwat adopted for the PR14 review.

Not surprisingly, several water companies are very concerned about the very low WACC figure, although Ofwat would argue that the current yield on 10-year gilts is among the lowest for many decades.

Ofwat's "don't go there" implication

Indeed, in its TAA, Wessex raised the WACC issue. In its conclusions, Ofwat gave Wessex a pointed reminder – "there is limited and unconvincing evidence in support of Wessex's proposed uplift to the 'early view' cost of capital".

Credit ratings

Overall, with the sector starting out with much higher net debt levels and set to face far tighter finances than previously, PR19 is crucial – and, inevitably, of major interest to the credit rating agencies.

De facto regulatory floor

For the highly geared companies, however, there will be some comfort in the belief that, whatever Ofwat throws at them, they must be allowed to retain investment-grade status with the credit agencies in order to be able to fund their formidable capital investment programmes. In effect, a regulatory floor is in place.

Draft Determinations

Southern and Thames in "significant scrutiny" group

In preparation for publishing its Final Determination on 11 December, Ofwat has recently announced its Draft Determinations for both the designated "fast-trackers" – the three quoted stocks, Severn Trent, United Utilities and Pennon's South West – and for the other water companies, which were designated as either "slow-trackers" or the small group requiring "significant scrutiny"; Southern and Thames were both placed in the latter group.

The table below shows Ofwat's average household price projections for 2024/25, based on Ofwat's Draft Determinations and on the actual figures submitted by the water companies as part of their business plans. All the figures in the table are quoted in real terms.

Draft Determinations (£)

Water company	2019/20 Bill	2024/25 Company Bill	2024/25 Ofwat Bill	Cut between 2019/20 and Ofwat Bill
Anglian	421	416	370	-12.1%
Dwr Cymru	439	417	378	-13.9%
Northumbrian	429	337	319	-25.6%
Severn Trent*	343	325	327	-4.7%
Southern	422	392	362	-14.2%
South West*	527	454	450	-14.6%
Thames (ex TTT)**	382	373	344	-9.9%
United Utilities*	427	382	378	-11.5%
Wessex	457	430	390	-14.7%
Yorkshire	380	379	342	-10.0%

** Fast-tracked*
***Thames Tideway Tunnel*
Source: Ofwat, Nigel Hawkins Associates

Anglian's meagre offering

It is clear from the above table that several water companies proposed decidedly modest price reductions, including Anglian, with an offer of just 1.2% in real terms over the five years; Ofwat's Draft Determination sought a 12.1% cut. Bridging this gap, without a CMA referral, will require major backdowns by at least one party, if not both.

Ofwat's 26% cut for Northumbrian

The gap between what most water companies – excepting the "fast-trackers" – have offered and what Ofwat is seeking remains large, especially in the case of Northumbrian, where Ofwat is seeking a 26% real price cut by 2024/25, over 80% of which Northumbrian seems ready to accept.

CMA appeals

Given the sizeable gaps discussed above, some water companies are expected to use their right to appeal Ofwat's ruling to the CMA – unless Final Determination day on 11 December provides evidence of a substantial softening in Ofwat's stance.

Poor record of concessions from CMA

Given that the record of water companies securing material concessions from the CMA is not good, any appeal should be carefully analysed by the water company concerned.

Three approaches, including TAA "hornet's nest"

There are probably three approaches that water companies can use whereby they have a decent chance of getting change from the CMA:

- To argue that the overall deal they have been given by Ofwat is simply unacceptable – on several counts. Some of the harsh price cuts being proposed by Ofwat would underpin this viewpoint.

- To contest Ofwat's 2.4% WACC assumption. After all, it is around a third lower than the comparable 3.6% WACC that was used by Ofwat back in 2014. Wessex, in particular, is known to feel strongly about Ofwat's aggressive WACC.

- The TAAs may have opened up a "hornet's nest", especially given Ofwat's somewhat dismissive approach in summarising many complex issues. Company lawyers will undoubtedly scrutinise the validity of some of these broad-brush judgments, and may test them before the CMA.

Political developments

General election widely expected shortly

It is also pertinent that PR19 is taking place against the background of major political uncertainty, with a general election widely expected shortly – subject to Parliamentary approval.

Labour's threat to the water sector

Given the Labour Party's declared – and unequivocal – policy to establish publicly-owned regional water authorities, the impact of any general election result is very relevant to the sector and, more specifically, to its valuation.

Railtrack precedent

While, in our opinion, a resounding Labour Party majority – sufficient to pursue a wide-ranging re-nationalisation policy – is unlikely, discerning investors accept that any shareholder compensation is likely to be way below current market values. The controversial Railtrack re-nationalisation settlement could provide a precedent in this respect.

Conclusion

Critical six months

The next six months will be critical for the water sector. PR19 should be complete by early next year, subject to any CMA referrals, and its financial implications across many fronts will become far clearer.

Undoubtedly, the UK's political system is in considerable disarray, primarily as a result of the deep divisions caused by Brexit and the Government's aim, which may or may not be achievable, to leave the EU on 31 October, either with an acceptable deal or, more likely, without one.

Interesting times for water sector

The water sector is living in interesting times.

About the author

Nigel Hawkins is the Utilities and Renewables sector analyst at Hardman & Co.

Nigel is responsible for analysing the UK Utility companies, including those privatised in the 1980s and 1990s, as well as newer arrivals in the sector. He has been involved in the Utilities sector since the late 1980s, as a feature writer at Utility Week magazine and as an analyst at Libertas Capital, which specialised in the renewable energy sector. Prior to that, he was the Telecoms analyst at Williams de Broë. Between 1989 and 1995, he worked at Hoare Govett as the Water and Electricity analyst.

Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street.

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