UUW69

Evidence of financeability

October 2023

Chapter 9 supplementary document

This document sets out the detailed evidence and calculations that support our financeability assessment and the Board Assurance Statement (UUW11).

United Utilities

Water for the North West

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1. Evidence of Financeability

1.1 Key headlines

- **Board assures plan as financeable:** Our plan is assured as financeable by our board on both a notional and actual company basis, this is also supported by third party assurance. This is subject to raising the necessary debt and equity financing. We anticipate that the final determinations (FD) will set a WACC at a sufficient level to facilitate this.
- **Target credit ratings at least two notches above minimum investment grade:** We have targeted credit ratings of Baa1/BBB+ for the notional company and A3/BBB+ for the actual company and this document sets out the relevant ratios and thresholds needed to meet these targets.
- **Equity returns and dividends key to attracting capital:** Competing for equity investment not just domestically but also internationally requires adequate returns and the ability to distribute a sufficient and stable return to investors.
- **Financeability constraints clearly identified:** We have identified our large investment programme as the key financeability constraint for both the notional and the actual companies.
- **Equity issuance and dividend restriction used as financeability levers:** We have applied a c100 basis point dividend restriction and c£1.35 billion and £2.25 billion equity issuance as financeability levers for the actual and notional companies respectively, with the addition of using our beneficial AMP7 reconciliation adjustments as a financeability lever for the actual company.
- **Financeability levers inter-generationally neutral:** AMP8 PAYG and RCV run off rates have not been used as a financeability lever.
- **Financeable plan on both actual and notional financial structure:** On the assumption that the overall PR24 risk and return package and the level of allowed return are set at an appropriate level at the FD, we are confident that our plan is financeable from a debt and equity perspective on both a notional company basis and an actual company basis.

1.2 Structure

1.2.1 The purpose of this document is to set out the detailed evidence and calculations that support our financeability assessment and associated board assurance as set out in Chapter 9 and is structured as follows:

- Section 2: Our plan is assured as financeable
- Section 3: Our financeability assessment approach
- Section 4: What a financeable company looks like
- Section 5: Financeability constraints and levers
- Section 6: Financeability assessment

2. Our plan is assured as financeable

2.1 Business plan assured as financeable by our board

2.1.1 Our business plan as set out in our main submission document is financeable on both a notional and an actual company basis. Our board takes responsibility for our PR24 business plan and has provided a clear statement of assurance in document UUW11 – Board Assurance Statement stating:

- ***The board confirms the plan is financeable on the basis of a notional capital structure (taking in to consideration all of the component parts of the business plan, including the early view on allowed return on capital for PR24 and consistent with maintaining target credit ratings at least two notches above the minimum investment grade).***
- *The board can confirm that the plan is financeable on both the notional and actual capital structures. This is subject to raising the necessary debt and equity financing and the board anticipate that the final determination will set a WACC at a sufficient level to facilitate this. The board also confirm that the cost recovery rates proposed ensure that these are reasonable and do not store up a financeability problem beyond the period of the price control.*
- *For the notional company, the board has targeted credit ratings of Baa1 with Moody's and an Issuer Default Rating (IDR) of BBB+ and senior unsecured debt rating of A- with Fitch. For the actual company, this corresponds to targeting credit ratings with the benefit of AMP7 reconciliations of A3 with Moody's and an IDR of BBB+ and senior unsecured debt rating of A- with Fitch. Reflecting differences in S&P's ratings methodology compared with Moody's and Fitch, the board expects both the notional and actual company to be on the cusp of BBB+/BBB, although an increase in the WACC from Ofwat's early view should increase revenues and thus improve financeability in respect of S&P's key credit metrics for both the notional and actual company.*
- *The board notes that Ofwat's guidance for notional company financeability in the PR24 Final Methodology is to target credit ratings of at least Baa1/BBB+ and the board believes that our plan clearly demonstrates attainment of these ratings with each of Moody's and Fitch after the application of our proposed financeability levers.*
- *The Board also believes the actual company ratings targets provide a robust degree of headroom above the threshold for investment grade and should enable UUW to maintain efficient access to the debt capital markets throughout the economic cycle.*
- *To meet key credit metrics commensurate with the above credit ratings, we have modelled a series of equity injections into UUW totalling £2.25 billion for the notional company and £1.35 billion for the actual company. On the assumption that the overall PR24 risk and return package and the level of allowed equity return are set at an appropriate level at the final determination, we are confident that our plan is financeable from a debt and equity perspective on both a notional company basis and an actual company basis.*
- *The Board has assessed the financeability of the business plan under both the notional and actual capital structures and has reviewed the supporting independent assurance undertaken.*
- *Specific reviews have been undertaken of a number of aspects of the financeability of the plan including by Deutsche Bank and JP Morgan and Deloitte for the long-term viability statement (LTVS).*

2.1.2 The board has also provided assurance on the financial resilience of the actual company which is included in document *UUW11 – Board Assurance Statement*.

2.2 External partners have reviewed a number of financeability aspects

2.2.1 In support of our financeability assessment, we asked JP Morgan and Deutsche Bank to undertake an independent review of certain financial information that formed the basis of our board's financeability assurance. JP Morgan and Deutsche Bank principally based their review on our company proposed financial ratios as presented in table RR16. JP Morgan and Deutsche Bank did not contribute to the preparation, modelling, or derivation of these metrics, however, JP Morgan and Deutsche Bank did make their own independent assessment as to the relevant thresholds for each ratio.

2.2.2 In the resultant letters to our board (supplementary document *UUW74 - Capital Market Assessments*), and subject to the assumptions and caveats set out in those letters, JP Morgan and Deutsche Bank state:

Deutsche Bank letter extracts:

Conclusion: Ability to fund the UUW Business Plan

Based upon, and subject to, the foregoing, it is Deutsche Bank's indicative view as investment bankers that, as of the date of this letter:

(a) Based on the UUW Notional Capital Structure and the UUW Actual Capital Structure, in the event that UUW's projected financial metrics as set out in Appendix 1 to this letter are achieved and maintained, in our view: Moody's would be likely to rate UUW at Baa1 or higher on the basis of the UUW Notional Capital Structure and A3 on the basis of the UUW Actual Capital Structure (with the benefit of the revenue adjustments relating to the prior regulatory period); Fitch would be likely to assign an IDR of BBB+ (or higher) and a senior unsecured debt rating of A- (or higher) on the basis of both the UUW Notional Capital Structure and the UUW Actual Capital Structure; and S&P would be likely assign a rating of BBB (or higher), acknowledging that S&P's primary metric is outside of threshold whilst the other key metric is within threshold, on the basis of both the UUW Notional Capital Structure and the UUW Actual Capital Structure;

(b) Assuming an A3 (or higher) rating from Moody's and a BBB+ IDR (or higher) and A- senior unsecured debt rating from Fitch (or higher), along with a rating of at least BBB from S&P, in our view, based on historical financial market conditions, a UK regulated water business with such ratings (or higher) would generally have been able to access the debt capital markets over recent years, with only few periods during that time when such an issuer would have had limited or restricted access to such markets; and

(c) Subject to the final determinations of the PR24 being sufficient to provide reasonable returns (comprising both capital growth and dividend yield) for the Client's shareholders, in our view, any required equity finance is likely to be available to the Client in the international public equity capital markets should it be deemed appropriate for the Client to finance any funding, to be provided by the Client to UUW on an actual company basis in accordance with the UUW Business Plan, through an issuance of equity securities by the Client.

Among other assumptions and qualifications, Deutsche Bank's letter to our board provides that:

This letter necessarily speaks only as of its date, and any views expressed in this letter are subject to change based upon a number of factors and circumstances, including macroeconomic, debt and equity capital market conditions, investor attitude and demand (both in relation to the Client specifically, its sector and markets generally), the condition (financial and other) and business prospects of the Client and UUW, and other specific issues. Any such changes and/or events occurring after the date of this letter could materially affect the views set out in this letter. This letter and its contents are necessarily based on business, economic, financial, market and other conditions, as in effect on, and the information which the Client and UUW have made available to Deutsche Bank as of, its date. Deutsche Bank has conducted its analysis based on certain assumptions which it deems reasonable, including assumptions concerning such conditions, as well as industry specific factors.

J.P. Morgan letter extracts:

Conclusion: Ability to fund the UUW Business Plan

……………………………………

Based on the notional capital structure, in the event that UUW's projected financial metrics are achieved, in our view Moody's are likely to rate UUW at Baa1 or higher. Fitch would likely assign an IDR of BBB+ and senior unsecured debt rating of A- (or higher), whilst S&P would potentially assign a rating of BBB, one notch below the target rating, given the ratios for S&P's primary metric are outside of the indicated BBB+ threshold, absent the beneficial revenue adjustments for UUW arising from the AMP7 regulatory period, whilst S&P's other key metric (debt-to-EBTIDA) is within the indicated BBB+ threshold. However, as noted above, an updated view of the WACC could provide the necessary improvement to FFO-to-debt.

Based on the actual capital structure, in the event that UUW's projected financial metrics are achieved, in our view Moody's are likely to rate UUW at A3 rating. Fitch would likely assign an IDR of BBB+ and senior unsecured debt rating of A- (or higher), whilst S&P would most likely assign a rating of BBB notwithstanding the beneficial revenue adjustments for UUW arising from the AMP7 regulatory period and the modelled equity injections. However, as previously noted, an updated view of the WACC could provide the necessary improvement to FFO-to-debt, particularly as debt-to-EBTIDA is consistent with S&P's BBB+ credit ratings threshold.

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Based upon our review of the UUW Business Plan and on the assumption that UUW will continue to target maintaining ratings from at least two of the credit ratings agencies at BBB+/Baa1 (or higher) for the notional company structure, and BBB+/A3 ratings for the actual company structure, more specifically A3 from Moody's, an Issuer Default Rating of BBB+ and senior unsecured debt rating of A- (or higher) from Fitch, and a rating of BBB or BBB+ from S&P it is J.P. Morgan's view as of the date of this letter that:

i) *Based on historical financial market conditions, a UK regulated water business with such ratings would generally have been able to access the debt capital markets over recent years to raise the majority of the funding requirement, with only few periods during that time when such an issuer would have had limited or restricted access to such markets, even then only for limited periods of time;*

ii) *Subject to the PR24 Final Determinations being sufficient to provide reasonable returns (comprising both capital growth and dividend yield) for UUW's ultimate shareholders, and based on historical financial market conditions, in our view equity finance is likely to be available to UUW's listed parent, UUG, in the international public equity capital markets for the purposes of funding any finance to be provided by UUG to UUW in accordance with the UUW Business Plan;*

iii) *Based on the above i) and ii), we expect that UUW could raise an aggregate amount of up to £7.5 billion across debt and equity financing, during the regulatory period between 1 April 2025 to 31 March 2030, as of the date of this letter, although we note that UUW is highlighting a potential c£1 billion reduction in its enhancement programme subject to regulatory approval which could lead to a reduction in the amount of debt and equity financing requirements;*

iv) *Any views expressed above, in i), ii) and iii), are subject to change based upon a number of factors and circumstances, including, without limitation, macroeconomic factors, debt and equity capital market conditions, investor attitude and demand, the condition (financial and other) and business prospects of UUG and UUW. Any such changes and/or events occurring after the date of this letter could materially affect the views set out in this letter. This letter and its contents are necessarily based on business, economic, financial, market and other conditions, as in effect, and the UUW Business Plan. The views expressed herein are based on certain assumptions which we consider reasonable, including assumptions concerning such conditions, as well as industry specific factors.*

2.2.3 It be should be noted that whilst a copy of these letters has been provided as part of our business plan submission (see supplementary document *UUW74 - Capital Market Assessments*), they are subject to contractual arrangements between UU and JP Morgan / Deutsche Bank that allow us to share a copy with Ofwat but not with other third parties. Therefore each letter is provided to Ofwat on the basis that it should not be published or shared further.

3. Our financeability assessment approach

3.1 Investment needs and macro-economic environment impacts on financeability

3.1.1 Our plan for PR24 represents a step-change in the level of investment for AMP8 compared with previous AMPs. Our totex programme will require significant amounts of financing. Effectively, UUW and the rest of the water sector will be competing to attract the necessary investment not just domestically but internationally, as global investment drivers in infrastructure ramp-up to meet the challenges of climate change and the pathways to net zero.

3.1.2 This is also set against a macro-economic environment that has turned decisively following the end of the COVID pandemic, with increasing evidence that the post-global financial crisis era of ultra-low interest rates and central bank Quantitative Easing has given way to higher interest rates and more elevated risk premia. This is highlighted in the update to Frontier Economics' PR24 Cost of Capital Report (included in supplementary document *UUW73 – Cost of Capital Considerations* and from now on referred to as the Updated Frontier Economics Report).

3.1.3 Therefore, it will be essential for the UK regulated water sector risk and return framework to be appropriately calibrated to attract the necessary investment to successfully deliver our plan, including the setting of an appropriate allowed return at the Final Determinations (FD).

3.1.4 There is clearly some way to go until the FD, and our expectation is that up-to-date market based evidence will be taken into account in setting the final PR24 WACC, taking account of changes between the 30 September 2022 data cut-off (for Ofwat's early-view WACC) used in our plan submission and the FD.

3.1.5 We see benefits for customers in setting an overall package with the right balance of incentives and a level of returns that secures financeability on a sustainable basis for an efficient company from both a debt and equity perspective, taking account of higher risk associated with the delivery of significantly bigger investment programmes, a tendency to see a downside bias in performance incentives (as discussed in Chapter 9), thus avoiding the asymmetry in 'aiming down' by setting too low a cost of capital that would exacerbate associated cost and delivery risks.

3.2 Framework underpinning our financeability assessment

3.2.1 UUW has a financial framework and financial policies which underpin our objective to maintain a robust capital structure, with an efficient mix of equity and debt financing, ensuring that our business remains financeable on a sustainable basis.

3.2.2 We monitor our performance against key credit ratios to help us maintain strong and stable investment grade credit ratings, which provides us with efficient access to debt capital markets across the economic cycle.

3.2.3 The key attributes underpinning the financeability of our plan are:

- On an actual company basis targeting to maintain gearing for the appointed business (UUW) of no higher than 65%. This is aligned with the listed group parent's longstanding policy of maintaining group debt to regulatory capital value (RCV) of between 55% and 65%, which is consistent with a robust capital structure and strong solvency position;
- This gearing limit on an actual company basis supports UUW targeting a long-term issuer credit rating of A3 with Moody's and a long-term IDR of BBB+ and senior unsecured debt rating of A- with Fitch;
- UUW's pension schemes are fully funded on a low dependency basis and fully hedged for market risk;

- The listed group parent's policy of maintaining a robust liquidity position, with liquidity to cover expected cash outflows for the next 15 – 24 months on a rolling basis (with flexibility to exceed the upper end of this range) to maintain a significant buffer to absorb any short-term cash flow impacts;
- UUW's track record of being an upper quartile performer on customer, environmental and operational key metrics; and
- The current regulatory framework within which UUW operates – which provides a high degree of cash flow certainty over the regulatory period, and the broader regulatory protections outlined below.

3.2.4 From a regulatory perspective, UUW benefits from a rolling 25-year licence and a regulatory regime in which regulators are required to have regard to the principles of best regulatory practice. These include that regulation should be carried out in a way that is transparent, accountable, proportionate, consistent and targeted.

3.2.5 Ofwat's primary duties provide that it should protect consumers' interests, by promoting effective competition wherever appropriate; secure that the company properly carries out its statutory functions; secure that the company can finance the proper carrying out of these functions – in particular through securing reasonable returns on capital; and secure that water and wastewater supply systems have long term resilience and that the company takes steps to meet long-term demands for water supplies and wastewater services.

3.2.6 The above factors underpin our expectation that UUW will be able to maintain efficient access to equity (via its listed parent, UUG) and debt capital markets to ensure our plan is financeable, and operate with sufficient capital buffer and cash liquidity to maintain a robust level of financial resilience.

3.2.7 Regulated utilities in the UK have raised equity in the past, with UUW's listed parent successfully completing a £1bn two-part right issue in 2003 and 2005, National Grid PLC completed a £3.2bn rights issue in 2010, and more recently in 2021 Severn Trent PLC undertook a £250m new issue of shares via placement. Several listed utilities also use scrip dividend programmes to supplement equity formation at time of high asset growth.

3.3 We have followed Ofwat's guidance in our financeability assessment

3.3.1 In assessing the financeability of our business plan we confirm that we have followed Ofwat's guidance. This includes:

- Providing board assurance of financeability for the notional company with supporting evidence;
- Completing the PR24 financial model and using this for testing financeability;
- Adopting the early view WACC as set out in the final methodology;
- Adopting the required notional company capital structure assumptions for the notional company financeability assessment, being:
  - an AMP8 opening gearing of 55%,
  - 33% of AMP8 opening debt being index linked and new debt issuance assumptions to ensure that the proportion of index linked doesn't fall below the opening value,
  - Aligning the notional company costs of debt with the embedded and new cost of debt assumptions in the early view WACC.
- Adopting notional company dividend yield and growth assumptions that are in line with Ofwat's expectations in the final methodology – using a dividend yield that takes account of the significant investment over AMP8, reinvesting the inflationary component of the equity return, plus an additional 1% over the base return – for our plan, we have therefore used a cash dividend yield of 3% on the equity portion of the RCV (being 4.14% early view cost of equity less 100 basis points (bps) rounded down), although as highlighted in the Updated Frontier Economics Report, if the

macro-economic and capital markets conditions that have emerged across the last 12 months are sustained, then base returns are likely to be higher at the time of the PR24 final determinations.

- Proposing AMP8 PAYG and RCV run-off rates in line with natural rates that balance the recovery of costs between generations, and have provided appropriate evidence;
- Targeting a credit rating for the notional company at least two notches above the minimum investment grade (i.e. BBB+/Baa1) with at least 2 of the 3 credit ratings agencies;
- Considering notional company ratios before the impact of reconciliations/revenue adjustments relating to prior AMPs.
- For the actual company, we have used expected beneficial PR19 reconciliations/AMP7 RCV and revenue adjustments as a financeability lever to reduce the need to use other levers, such as equity issuance.

3.4 Process for testing financeability

3.4.1 It is in the best interests of all stakeholders to maintain a robust capital structure and stable credit ratings profile, given our significant financing requirements across AMP8 and need to access finance at an efficient cost. As such, our financeability assessment targets maintaining appropriate credit ratings and investor returns to enable us to finance our activities, albeit with limited headroom, in order to achieve a stretching, fair and balanced plan.

3.4.2 As is set out in the rest of this document, in concluding whether our plan is financeable we have evaluated both our notional and actual company's financial metric from both an equity and a debt perspective. We have:

- Assessed whether the company has good prospects for accessing equity finance and can attract sufficient levels of investment in a competitive market where international investors have a choice of where to invest; and
- Assessed whether the company has resilient access to debt capital market financing in a range of market conditions at an efficient cost. This has been measured by whether the company can achieve appropriately strong investment grade credit ratings.

3.4.3 We have targeted appropriate credit ratings with an adequate level of headroom for AMP8 that offer robust access to funding (including in times of market disruption) and efficient debt financing costs, compared to lower ratings. Our experience of operating with similar ratings over most of the past 15 years has proven such ratings offer robust access to debt markets in a variety of conditions and has proven acceptable to customers.

3.4.4 Whilst we have completed the financial model and used this for testing financeability, we have proposed a number of additional financial ratios. We have proposed additional ratios as certain ratios used by rating agencies (particularly Fitch) are not included in Ofwat's standard list of ratios. We have also proposed amended ratios that include various adjustments that the rating agencies make, particularly in relation to the use of gross as opposed to net interest. The details of the calculations of the company proposed ratios is set out in the table commentary to RR16.

3.4.5 When assessing the resultant financial ratios we have carried out our financeability assessments 'in the round', taking account of a range of factors. This includes not having a strict requirement for every ratio to meet the required thresholds in every year, but to have due consideration of which metrics are primary or secondary and overall performance and trend.

3.4.6 We have identified the relevant financeability constraints for both the notional and actual company and used financeability levers where appropriate to address those constraints, taking into account the effects on customer bills and Ofwat's guidance that where there is significant investment this should be funded by a mixture of debt and equity.

4. What a financeable company looks like

4.1 Attributes of a financeable company

4.1.1 The main attributes of a financeable water company are:

- The company has good prospects for accessing equity finance and can attract sufficient levels of investment in a competitive market where international investors have a choice of where to invest; and
- The company has resilient access to debt capital market financing in a range of market conditions at an efficient cost.

4.2 Good prospects for accessing equity finance requires a cost of equity and risk-reward balance that will attract investment

4.2.1 Successfully accessing equity finance requires companies to be able to earn adequate returns that are at least in line with the cost of equity of the company and to be able to distribute a sufficient and stable return to investors.

4.2.2 The most efficient cost borne by customers stems from a regulatory framework that appropriately reflects the risks facing the industry. It is important to understand equity investor considerations in order to establish the requirements for the equity returns. In general equity investors will examine the following when allocating capital to companies:

- The risk-reward on offer in light of rising political and regulatory risks. This will often include an assessment of any changes in operating and capital delivery risks.
- How this risk-reward balance compares to similar regimes in related sectors such as energy networks and in jurisdictions like Continental Europe, USA and Australia.
- The stability of company financial strength without the use of short-term financing levers.
- An assessment of financial resilience under a range of scenarios.

4.2.3 Debt investors draw comfort from the strength of equity financeability. Similarly, equity investors benefit from a strong credit rating through strengthened financial resilience and lower debt finance costs.

4.2.4 We consider the following factors to be important in determining what a financeable plan looks like from an equity perspective:

- Competitive dividend yield
- Strong dividend coverage
- ROCE at least in-line with WACC

4.2.5 The step-change in investment facing the UK water industry makes equity financeability considerations even more important due to the increase in capital delivery risk. This is especially the case in the current operating environment, which sees the UK and European economies facing considerable global supply chain constraints, heightening the risk of project construction delays and/or cost overruns.

4.3 Resilient access to debt capital markets requires strong investment grade credit ratings

4.3.1 Resilient access to debt capital market financing in a range of market conditions requires companies to hold strong investment grade credit ratings. In turn this means that water companies need sufficiently strong financial ratios that meet the required thresholds set out in rating agency methodology.

4.3.2 Other business risk factors, such as assessment of the regulatory regime and the scale and complexity of investment programmes, are also part of each ratings agency's assessment of the sector and the rated companies within the sector. Such elements are dynamic and can change over time.

4.3.3 Target credit ratings

4.3.4 Our plan targets notional company credit ratings of Baa1 and BBB+[1] with at least 2 of the 3 ratings agencies, and for the actual company credit ratings of A3 and BBB+[1] with Moody's and Fitch respectively. For S&P we would assess both the notional and actual company as being on the cusp of BBB+/BBB, with FFO/debt more in line with BBB and debt to EBITDA more in line with BBB+.

4.3.5 These credit rating targets are at least two notches above the minimum investment grade ratings with 2 out of the 3 ratings agencies, providing a reasonable level of headroom to allow UUW to cope with most cost shocks and is consistent with the expectation that UUW maintains headroom against the minimum credit rating requirement set out in the licence.

4.3.6 The Moody's targeted rating for the actual company is one notch higher than that for the notional company, as the actual company benefits from beneficial AMP7 Reconciliations and also its higher proportion of index linked debt and below sector average cost of embedded debt that improves certain but not all key metrics.

4.3.7 Evidence supporting target credit ratings

4.3.8 With the addition of the Fitch ratings, our plan's targeted credit ratings are broadly aligned with those that we used at PR14 and PR19. These long-term target ratings provide an appropriate level of financial headroom for cost shocks over AMP8 and deliver adequate levels of financial resilience. Our experience of operating with ratings of A3/BBB+ over the majority of the past 15 years has proven that such ratings offer robust access to debt capital markets in a variety of market conditions, including times of market disruption such as the great financial crisis in c2009 and the Covid pandemic in c2020.

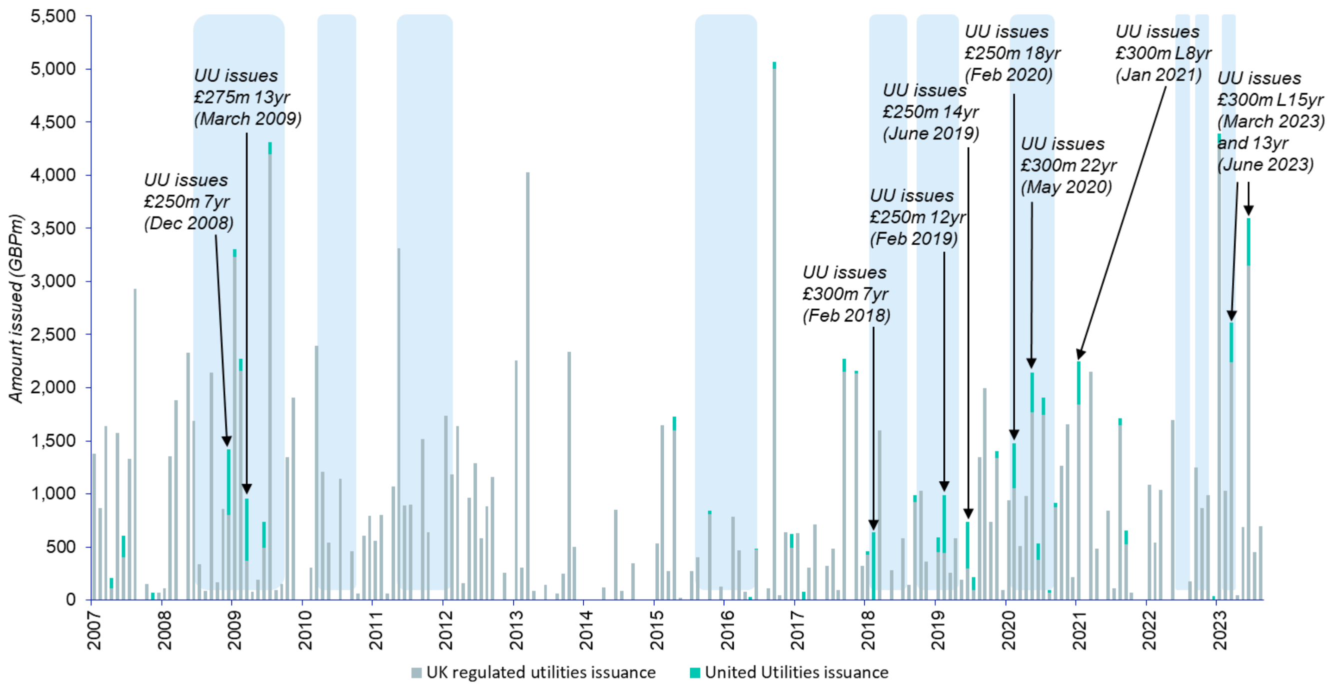
4.3.9 These target ratings have also proven to be acceptable to customers, who have supported our business plan proposals at both PR14 and PR19 and continue to support our current business plan proposals at PR24, all of which were formulated including the A3/BBB+ ratings target.

4.3.10 A3/BBB+ ratings offer robust access to funding (including in times of market disruption) and efficient debt financing costs compared to lower ratings, which remains important given our significant AMP8 financing requirements. The targeted ratings and the access they give to funding are also a key supporting element of our financial resilience and long term viability (see Chapter 9 and supplementary document *UUW68: Financial Resilience* for more details).

4.3.11 The below charts demonstrate the impact of ratings on market access and financing costs. Figure 1 shows UK regulated utility issuance since 2007, UU's bonds are included in turquoise blue and periods of market weakness are highlighted in blue, demonstrating that UU's A3/BBB+ credit ratings enabled access to debt capital market funding even in times of market weakness. Figure 2 shows how the credit spread on one of UU's bonds and the iBoxx GBP A and BBB non-financial index spread to gilts reacted to varying market conditions. This graph demonstrate that during periods of market weakness (highlighted in blue), UU's credit spread reacted similarly to the 'A' band corporate index, whereas the 'BBB' band corporate index (which includes lower rated credits than our targets) widened materially more. This indicates that at times of market disruption, access to funding by corporates in the BBB rated index might be more problematic and is likely to be more expensive.

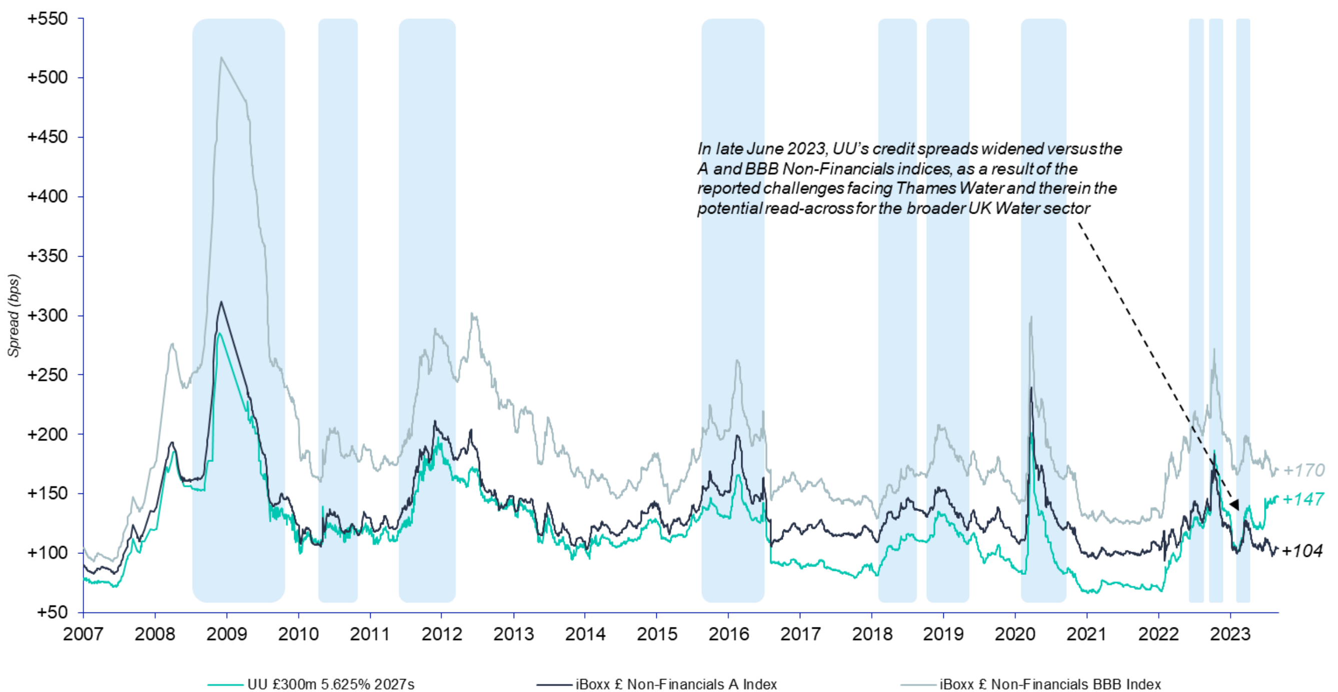
[1] For water companies Fitch apply a one notch differential between the issuer default rating (IDR) and the senior unsecured debt ratings. The target credit rating set out here is the IDR, which equates to an A- senior unsecured debt rating.

Figure 1 – UK regulated utilities bond issuance volumes (since 2007)



Source: Bloomberg Finance L.P., 4 September 2023

Figure 2 – Credit spread analysis: United Utilities' GBP 2027s vs A and BBB Non-Financials Indices (since 2007)

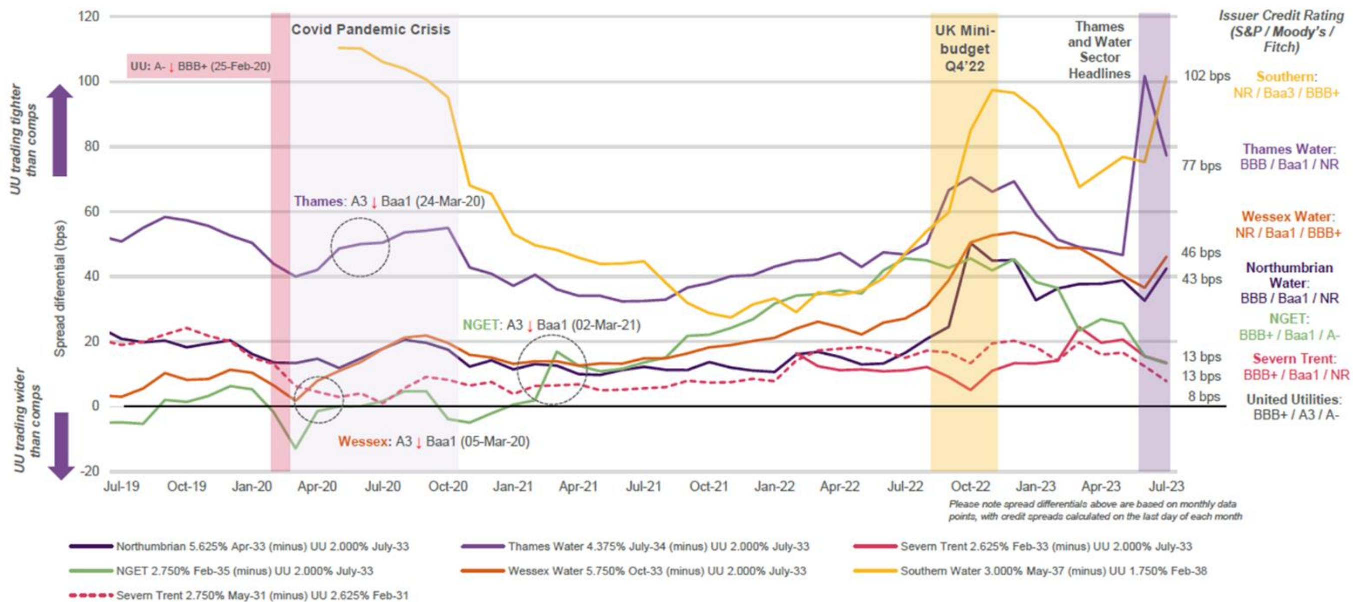


Source: Bloomberg Finance L.P., S&P Dow Jones Indices, 4 September 2023

4.3.12 Further, more recently the differential in financing costs for different rating levels has widened following the end of the central bank QE era, making the choice of rating target even more important. Figure 3 shows the difference in credit spread between one of UU's bonds and other similar maturity bonds across the sector. This highlights the larger divergence in spread for differently rated bonds over the calendar year 2022 and in particular during times of market disruption such as the UK mini-budget in autumn 2022. The chart shows that whilst the difference in cost between A3/BBB+ (UU) and Baa1/BBB+

(SVT) is relatively modest, one notch lower ratings (such as NWG) can lead to c45bps more expensive debt, and two notch lower ratings (such as STH) can result in c100bps more expensive debt. This demonstrates that our target credit ratings of A3/BBB+ for the actual company and Baa1/BBB+ for the notional company should deliver efficient debt costs, which benefits customers as new debt raised moves into embedded debt benchmarks, over time.

Figure 3 – Relative spread performance between UU bond and similar maturity sector bonds



Source: Source: BBG, NatWest, July 2023

Targeted financial ratios and thresholds for debt financeability

4.3.13 We set out below the key financial ratios that Moody's, S&P and Fitch use to assess companies in the UK water sector. We also identify the relevant thresholds for our targeted ratings. The thresholds identified are based on a conventionally equity financed company without any structural enhancements and with the presence of shareholders, as we believe these are appropriate assumptions to make for the notional company, and which also mirrors our actual company.

4.3.14 It should also be noted that the below reflects each agencies methodology for the UK regulated water sector at the time of preparing our plan. In response to a re-evaluation of the regulatory regime (e.g. Moody's 22 May 2018 report – "Regulator's proposals undermine the stability and predictability of the regime") or in response to broader macroeconomic conditions (e.g. Moody's 16 January 2023 report – "UK regulated water utilities – 2023 outlook turns negative amid macroeconomic pressures"), ratings agencies can from time-to-time reappraise sector risk assessments which could lead to changes in ratio thresholds for any given level of rating.

Moody's:

4.3.15 Moody's 5 October 2021 publication "Regulated Water Utilities – UK: Companies could face another cut in allowed returns in AMP8"[2] includes Moody's generic ratio guidance for the UK water sector on page 10 (included as Figure 4 below). This highlights RCV gearing and AICR (adjusted interest cover ratio) as Moody's primary financial ratios and show A3 rating thresholds of 65% for RCV gearing and 1.7x for AICR and Baa1 rating thresholds of 72% for RCV gearing and 1.5x for AICR. We understand that these thresholds remain at the same levels at the time of our business plan submission.

[2] https://www.moodys.com/research/Regulated-Water-Utilities-UK-Companies-could-face-another-cut-in--PBC_1301228

Figure 4 - Moody's ratio guidance for the UK water utilities

Exhibit 12

Moody's ratio guidance for the UK water utilities

Issuer's Rating	Maximum RCV gearing	Minimum AICR
A2	≤ 55%	≥ 2.0x
A3	≤ 65%	≥ 1.7x
Baa1	≤ 72%	≥ 1.5x
Baa2	≤ 80%	≥ 1.3x

Ratio guidance applies to standalone regulated businesses funded on a senior unsecured corporate basis. Actual credit quality may also reflect the consolidated financial profile of a wider group, or the benefits of structural enhancements. Because of their smaller size and the associated risks in relation to cash flow stability, we would expect smaller companies, such as the water-only companies, to exhibit a stronger AICR for an equivalent gearing level.

Source: Moody's Investors Service

S&P:

4.3.16 S&P does not tend to publish generic ratio guidance for the UK water sector, and so to identify the relevant financial ratios and thresholds we have used company specific publications. We have used conventionally equity financed companies as the example companies, using UU for the BBB+ thresholds and Northumbrian Water for the BBB thresholds.

4.3.17 Whilst FFO to debt remains S&P's key financial metric, in recent years S&P has introduced a supplementary ratio of debt to EBITDA and therefore we also include this metric in our plan.

4.3.18 The below extract (Figure 5) from page 2 of S&P's 30 June 2023 publication "Tear Sheet: United Utilities PLC"[3] demonstrates that the BBB+ threshold for FFO to debt is 9% and 9x for debt to EBITDA.

Figure 5 – S&P ratio guidance for United Utilities

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.

4.3.19 The below extract (Figure 6) from page 4 of S&P's 12 October 2022 publication "Northumbrian Water Ltd. And Northumbrian Water Group Ltd. Downgraded To 'BBB' from 'BBB+'; Outlook Stable"4 demonstrates that the BBB threshold for FFO to debt is 6% and 11x for debt to EBITDA.

Figure 6 – S&P ratio guidance for Northumbrian Water

Downside scenario

In our view, further downside risks are limited in our base case until at least the end of AMP7. We could lower the rating on NWL and NWG if the water operator was to significantly underperform against its regulatory allowances, and achieved a much poorer than average performance on its outcome delivery incentives with FFO to debt falling below 6% and debt to EBITDA above 11x on a prolonged period. We could take a negative rating action by the end of 2022 should we observe that the group is yet to refinance its £350 million Eurobond due in February 2023.

4.3.20 Our understanding from our ongoing close engagement with S&P is that FFO to debt remains S&P's primary metric, with debt to EBITDA being a much more secondary metric. However, in the current period of high inflation, debt to EBITDA is currently more prominent than previously.

4.3.21 This is because whilst high inflation is generally beneficial to water companies, in the short term FFO to debt has an opposite, significantly negative impact, resulting in FFO to debt being a less reliable indicator in times of very high (and low) inflation. This is due to the asymmetrical treatment of inflation in S&P's version of FFO, with the inclusion of (non-cash) indexation on index linked debt in finance expense but exclusion of indexation on RCV. It can reasonably be expected that the usual

[3] platform.ratings360.spglobal.com/web/client?auth=inherit&ignoreIDMContext=1#r360/article?id=207346276

[4] platform.ratings360.spglobal.com/web/client?auth=inherit&ignoreIDMContext=1#r360/article?id=193879591

primary/secondary relationship between FFO to debt and debt to EBITDA to resume once inflation normalises.

Fitch:

4.3.22 Similar to S&P, Fitch does not tend to publish generic ratio guidance for the UK water sector, and so to identify the relevant financial ratios and thresholds we have used company specific thresholds. We have used conventionally equity financed companies as the example companies, using UU for the A- senior unsecured debt rating (equivalent to BBB+ issuer default rating (IDR)) thresholds and Wessex Water for the BBB+ senior unsecured debt rating (equivalent to BBB IDR) thresholds.

4.3.23 Table 1 below, extracted from page 5 of Fitch's 28 April 2023 publication "What Investors Want to Know: UK Water Companies"[5], demonstrates that the A- senior unsecured debt rating threshold for RCV gearing is 67%, is 1.6x for cash PMICR and 1.8x for nominal PMICR and the BBB+ senior unsecured debt rating threshold for RCV gearing is 72%, is 1.4x for cash PMICR and 1.7x for nominal PMICR.

Table 1 Fitch ratio guidance for certain UK water companies

Company	Class of debt	Senior debt rating	IDR	Outlook	Net Debt/ RCV (%)	Cash PMICR (x)	Nominal PMICR (x)
Corporate Structure							
United Utilities Water Limited (UUW)	Senior unsecured	A-	BBB+	Stable	62-67	1.6-1.9	1.8-2.0
Wessex Water Services Limited (WWSL)	Senior unsecured	BBB+	n.a	Stable	67-72	1.4-1.6	1.7-1.8

Source: Fitch publication " What Investors Want to Know: UK Water Companies"

Rating agency and Ofwat model financial ratio differences and the impact on thresholds

4.3.24 Financial ratio thresholds published by rating agencies are only relevant where the calculation of the financial ratio is in line with the calculation methodology used by the relevant rating agency. Therefore where there are calculation differences then different thresholds will need to be used.

4.3.25 For financeability testing at PR24, the final methodology sets out the ratios to be assessed and how they should be calculated. The final methodology acknowledges that for FFO to debt and AICR the standard ratios included in the Ofwat financial model are calculated differently from certain rating agencies and therefore also provides *"alternative versions of adjusted interest cover and FFO/net debt. The adjustments broadly replicate the adjustments made by the credit rating agencies."*

4.3.26 Whilst some differences remain (see table below), we agree that the 'adjusted cash interest cover ratio (ACICR) – alternative measure' and the 'funds from operations (FFO) / net debt – alternative measure' are more reflective of the Moody's and S&P methodologies respectively than the 'non-alternative' versions. Therefore the rating agency thresholds should not be applied to the 'non-alternative' versions of the ratios and use of the non-alternative ratios should be very limited.

4.3.27 We have also identified a number of other differences between the financial model financial ratio calculations and those used by the relevant rating agencies that are listed in the table below. In particular this includes the financial model calculating financial ratios using net interest, whereas Moody's adjusted interest cover and S&P FFO to debt both use gross interest. For Moody's, p14 of their Rating Methodology: Regulated Water Utilities dated 18 August 2023[6] confirms that the calculation of adjusted interest coverage ratio uses interest expense (i.e. gross as opposed to net interest). For S&P,

[5] app.fitchconnect.com/search/research/article/RPT_10232310

[6] moodys.com/research/doc--PBC_1345390

p3 of their Corporate Methodology: Ratios and Adjustments dated 1 April 2019[7] defines FFO to be "EBITDA, minus cash interest paid minus cash tax paid".

4.3.28 In presenting ratios in this document, ratios that have been calculated in line with the Ofwat financial model standard calculations have been prefixed by 'Ofwat'. Ratios that have been proposed by UU and calculated in line with our understanding of the rating agency calculations have been prefixed with the relevant rating agency name.

4.3.29 Identified rating agency thresholds will be applied to ratios calculated in line with the rating agencies. Where calculations differ we will calculate adjusted thresholds to compensate for the calculation differences. This includes the thresholds for Moody's: adjusted interest cover and S&P: FFO to debt for the notional company only, as the Ofwat financial model does not enable us to correctly calculate gross interest[8] we are unable to show these ratios on a gross interest basis and so the one difference remaining with these ratios is gross versus net interest, which will be compensated for by a threshold adjustment.

Table 2 Differences between financial model ratio calculations and those used by rating agencies

Ratio	Calculation difference	How resolved
Ofwat: Gearing	Average vs year end RCV	Threshold amendment
Ofwat: Adjusted cash interest cover (alternative)[9]	Financial model uses net interest where gross interest should be use Additional immaterial FFO differences, e.g. other income, profit on sale of assets	Threshold amendment
Ofwat: Adjusted cash interest cover	As above except fast money adjustment not included	Threshold amendment as above, no further change is needed as UU is not using AMP8 PAYG as a financeability lever
Ofwat: FFO to debt (alternative)	Financial model deducts net interest from FFO where gross interest should be deducted Additional immaterial FFO differences, e.g. other income, profit on sale of assets	Threshold amendment
Ofwat: FFO to debt	As above except indexation on index linked debt not deducted from FFO	Threshold amendment
Moody's: Adjusted interest cover (notional company only)	Notional company modelling doesn't permit full gross interest calculations and so only net interest is available for the notional company, but gross interest should be used	Threshold amendment
S&P: FFO to debt (notional company only)	As above	Threshold amendment

[7] platform.ratings360.spglobal.com/web/client?auth=inherit&ignoreIDMContext=1#r360/article?id=106176796

[8] The Ofwat financial model only enables companies to enter an opening cash balance but not to specify target levels of cash held during each year. Any opening cash balances are reduced by annual cash flows calculated in the model, which in a high expenditure environment are eroded quickly. In reality financially resilient companies will hold certain levels of liquidity to cover the next 12 months plus of cash flows (including refinancing of debt) of which a material proportion will be cash. Therefore the Ofwat financial model cannot accurately reflect how cash is held in practice and does not accurately reflect gross interest amounts.

[9] We note that Moody's adjusted interest cover ratio also removes any revenue profiling, which is not reflected in the Ofwat/ financial model calculation of this ratio. However, as we are not proposing any revenue profiling we have not needed to adjust ratios for this point.

Calculation of thresholds for the financial model financial ratios

4.3.30 In our plan submission we have included company specified ratios for each of the key financial ratios used by the rating agencies using our detailed understanding of how each rating agency calculates those ratios. As there are differences in calculations between the financial model version and the company specified version of these ratios, it would be inappropriate to apply the rating agency identified thresholds to the financial model financial ratios.

4.3.31 To compensate for the differences in calculations, we have calculated thresholds for the financial model ratios by applying the difference between the AMP8 average ratio for the relevant ratio pairs and adding or subtracting that from the rating agency threshold, where appropriate, to make it more comparable when using the financial model versions of those ratios, as set out in the table below.

4.3.32 As the difference in calculations can differ between the actual and notional company (for example where the difference in calculation involves indexation on index linked debt) there will be a different threshold adjustment needed for each of the notional and actual companies.

Table 3 Calculation of financial ratio thresholds for the financial model ratios

Ratio	Calculation difference	Ofwat ratio AMP8 average	Company specified ratio AMP8 average	Difference / threshold adjustment
Gearing	Average vs year end RCV	N: 55.62% A: 63.58%	N: 55.41% A: 63.33%	N: +0.2% A: +0.2%
Adjusted cash interest cover ACICR and Adjusted cash interest cover ACICR – alternative	Gross versus net interest	A: 1.94x	A: 1.88x	N/A: +0.1x[10]
FFO to debt – alternative	Gross versus net interest	A: 7.80%	A: 7.58%	N/A: +0.2%[10]
FFO to debt	Indexation on index-linked debt not deducted from FFO and gross versus net interest	N: 9.19% A: 8.99%	N: 8.40% A: 7.58%	N: +1.0%[11] A: +1.4%

Summary of debt financeability financial metric thresholds

Table 4 Summary of debt financeability financial metric thresholds

Financial metric	Threshold A3/A-	Threshold BBB+/Baa1	Comment
Ofwat: Gearing	≤65.2%	≤72.2%	As per Moody's thresholds plus the +0.2% adjustment for calculation differences
Ofwat: Interest cover	N/A	N/A	Metric not commonly used in credit rating assessments
Ofwat: Adjusted cash interest cover ACICR	≥1.8x	≥1.6x	As per Moody's thresholds plus the +0.1x adjustment for calculation differences.
Ofwat: Adjusted cash interest cover ACICR – alternative version	≥1.8x	≥1.6x	As per the 'non-alternative' version as we have not accelerated any AMP8 revenue via PAYG

[10] We have applied the threshold adjustment from the actual company as the Ofwat financial model doesn't enable correct gross interest calculation

[11] In addition to the +0.8% threshold adjustment to reflect the lack of indexation adjustment for the notional company, we have also added on +0.2% (calculated from the actual company ratios) to reflect the lack of gross interest

Financial metric	Threshold A3/A-	Threshold BBB+/Baa1	Comment
Ofwat: FFO to debt	N/A	≥10.0% (notional) ≥10.4% (actual)	As per S&P's thresholds plus the +1.0% (notional) and +1.4% (actual) adjustments for calculation differences
Ofwat: FFO to debt – alternative version	N/A	≥9.2%	As per S&P's thresholds plus the +0.2% adjustment for calculation differences
Ofwat: RCF/Net debt	N/A	N/A	This metric appears to be no longer used by Moody's in its credit rating assessments
Ofwat: RCF to capex	N/A	N/A	Metric not commonly used in credit rating assessments
Moody's: Gearing	≤65%	≤72%	Company specified ratio, as per Moody's thresholds
Moody's: Adjusted interest cover	≥1.8x (notional) ≥1.7x (actual)	≥1.6x (notional) ≥1.5x (actual)	Company specified ratio. As per Moody's thresholds (actual), as per Moody's thresholds plus the +0.1x adjustment for gross interest differences (notional)
S&P: FFO to debt	N/A	≥9.2% (notional) ≥9.0% (actual)	Company specified ratio. As per S&P thresholds (actual), as per S&P thresholds plus the +0.2% adjustment for gross interest differences (notional)
S&P: Debt to EBITDA	N/A	≤9.0x	Company specified ratio, as per S&P's thresholds
Fitch: Gearing	N/A	≤67%	Company specified ratio, as per Fitch's thresholds
Fitch: Cash PMICR	N/A	≥1.6x	Company specified ratio, as per Fitch's thresholds
Fitch: Nominal PMICR	N/A	≥1.8x	Company specified ratio, as per Fitch's thresholds

5. Financeability constraints and levers

5.1 Financeability metrics before the application of financeability levers

5.1.1 The below tables show our forecast debt financeability financial ratios for the notional and actual companies over AMP8. These ratios are prior to the application of any financeability levers.

5.1.2 Green indicates that a required threshold is met, amber indicates a near miss that should be acceptable in the round and red indicates that a required threshold is not met.

Table 5 Financeability metrics before financeability levers (notional company)

Ratio	Thresholds Baa1/BBB +/BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: Gearing	≤72.2%	57.51%	60.90%	64.86%	67.73%	68.50%	64.42%
Ofwat: Cash Interest cover	N/A	3.62	3.37	3.08	2.87	2.83	3.10
Ofwat: Adjusted cash interest cover	≥1.6x	1.57	1.48	1.38	1.31	1.29	1.39
Ofwat: Adjusted cash interest cover (alternative)	≥1.6x	1.57	1.48	1.38	1.31	1.29	1.39
Ofwat: FFO/Net Debt	≥10.0%	9.29%	8.29%	7.23%	6.64%	6.77%	7.46%
Ofwat: FFO/Net Debt (alternative)	≥9.2%	8.52%	7.47%	6.39%	5.86%	5.96%	6.66%
Ofwat: Dividend yield	N/A	4.14%	4.14%	4.14%	4.14%	4.14%	4.14%
Ofwat: Dividend cover	N/A	0.46	0.99	0.70	0.55	0.55	0.64
Ofwat: RCF/Net Debt	N/A	0.06	0.05	0.04	0.04	0.04	0.05
Ofwat: Return on capital employed (ROCE)	N/A	4.57%	4.43%	4.25%	4.21%	4.33%	4.34%
Ofwat: Return on regulated equity (RORE)	N/A	4.18%	4.18%	4.16%	4.16%	4.16%	4.17%
Ofwat: RCF/Capex	N/A	0.37	0.28	0.22	0.25	0.56	0.30
Moody's: Gearing	≤72%	57.29%	60.63%	64.61%	67.48%	68.25%	64.17%
Moody's: Adjusted interest cover	≥1.6x	1.60	1.51	1.41	1.33	1.31	1.41
S&P: FFO to debt	≥9.2%	8.63%	7.56%	6.47%	5.93%	6.03%	6.74%
S&P: Debt to EBITDA	≤9.0x	7.65	8.12	9.16	9.64	9.40	8.87
Fitch: Gearing	≤67%	57.29%	60.63%	64.61%	67.48%	68.25%	64.17%
Fitch: Cash PMICR	≥1.6x	1.58	1.49	1.39	1.32	1.29	1.39
Fitch: Nominal PMICR	≥1.8x	2.06	1.94	1.82	1.72	1.69	1.82

Table 6 Financeability metrics before financeability levers (actual company)

Ratio	Thresholds A3/BBB+/ BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: Gearing	≤65.2%	65.88%	68.10%	70.89%	72.79%	73.04%	70.48%
Ofwat: Cash Interest cover	N/A	4.42	3.78	3.20	2.87	2.72	3.23
Ofwat: Adjusted cash interest cover	≥1.8x	1.91	1.66	1.43	1.31	1.23	1.44
Ofwat: Adjusted cash interest cover (alternative)	≥1.8x	1.91	1.66	1.43	1.31	1.23	1.44
Ofwat: FFO/Net Debt	≥10.4%	8.65%	7.74%	6.71%	6.19%	6.20%	6.94%
Ofwat: FFO/Net Debt (alternative)	≥9.2%	7.47%	6.54%	5.53%	5.12%	5.09%	5.80%
Ofwat: Dividend yield	N/A	4.14%	4.14%	4.14%	4.14%	4.14%	4.14%
Ofwat: Dividend cover	N/A	1.18	1.15	0.88	0.80	0.73	0.94
Ofwat: RCF/Net Debt	N/A	0.07	0.06	0.05	0.05	0.05	0.05
Ofwat: Return on capital employed (ROCE)	N/A	4.60%	4.46%	4.28%	4.26%	4.38%	4.38%
Ofwat: Return on regulated equity (RORE)	N/A	4.54%	4.60%	4.67%	4.74%	4.78%	4.68%

Ratio	Thresholds A3/BBB+/ BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: RCF/Capex	N/A	0.45	0.34	0.27	0.32	0.68	0.37
Moody's: Gearing	≤65%	65.63%	67.80%	70.61%	72.52%	72.78%	70.21%
Moody's: Adjusted interest cover	≥1.7x	1.84	1.59	1.39	1.28	1.22	1.40
S&P: FFO to debt	≥9.0%	7.27%	6.22%	5.16%	4.73%	4.85%	5.49%
S&P: Debt to EBITDA	≤9.0x	8.95	9.25	10.19	10.54	10.20	9.88
Fitch: Gearing	≤67%	65.63%	67.80%	70.61%	72.52%	72.78%	70.21%
Fitch: Cash PMICR	≥1.6x	1.90	1.65	1.42	1.31	1.23	1.44
Fitch: Nominal PMICR	≥1.8x	2.07	1.87	1.68	1.58	1.50	1.69

5.2 Financeability constraints

5.2.1 As can be seen from the above financeability assessment before financeability levers, there are a number of financeability constraints for both the notional and the actual company.

5.2.2 The size of our investment programme is the main financeability constraint for both the notional and the actual company. Whilst equity is naturally retained (as the real element of the cost of equity is assumed to be paid out, whilst the inflationary uplift element is retained in RCV), this non-cash equity formation supporting our investment programme is relatively modest compared to our AMP8 investment requirements. This results in both the notional and the actual company gearing increasing over AMP8.

5.2.3 For the notional company, even though gearing increases over AMP8, given the low starting value (re opening gearing of 55%) this metric remains in a comfortable position for the targeted ratings across the entire period. However, for the notional company, this low gearing assumption and associated reduction in finance expense at the start of AMP8 is a key driver in enabling the notional company to meet its adjusted interest cover and PMICR ratios. Once gearing increases to a more normal (for the sector) level, the financeability constraint is then felt on the Moody's adjusted interest cover, the Fitch PMICR and the S&P FFO to debt ratios.

5.2.4 For the actual company, as the opening gearing levels are higher than for the notional company, it is the gearing ratios that initially act as a financeability constraint. This is followed swiftly by the various interest cover metrics, as notwithstanding the actual company's higher proportion of index-linked debt and below sector cost of embedded debt, this is not enough to offset the additional interest costs associated with the large amounts of projected debt needed to fund the proposed investment programme.

5.3 Consideration of Financeability levers to be employed

5.3.1 As the main financeability constraint for both the actual and notional company plans is due to our large investment programme the likely key feature of any solution will be equity retention and/or issuance to ensure that the large investment programme is appropriately funded by a mix of debt and equity.

5.3.2 However, in resolving our financeability constraints for the notional and actual company we have considered a full range of financeability levers when deciding how best to mitigate these constraints and whether the chosen approach to addressing the constraint is appropriate taking account of the effects on customers' bills.

5.3.3 Where these constraints are different for the actual company, or are more extreme than the notional company constraints, we have given separate consideration to what levers we will employ to address the constraint, whilst ensuring that the use of such levers to address financeability constraints arising from company choices will not result in customers bearing any additional cost.

5.3.4 We have considered the following financeability levers to address financeability constraints:

a. Retention of the inflation uplift component to the RCV within the equity return;

b. Determination of an appropriate level of dividend pay-out versus the allowed return on equity;

c. Use of company specific index-linked debt proportion and embedded debt costs for the actual company financeability;

d. Use of beneficial PR19/AMP7 reconciliation adjustments for actual company financeability;

e. Equity issuance for both the notional and actual company; and

f. Cost recovery (PAYG / RCV run-off rates).

5.3.5 Dividend restriction and equity issuance

5.3.6 We agree that significant investment in 2025 to 2030 should be financed by a mixture of debt and equity. This has historically been the case, as notional company dividend pay-out assumptions (and UUW actual company dividend pay-outs before outperformance) tend to be either in line with or below the real allowed return on equity, as opposed to the nominal allowed return on equity. This results in the inflationary element of the allowed return on equity, earned as an uplift to RCV, being retained as opposed to distributed, supporting investment. At PR19, with a CPIH real allowed cost of equity of 4.19% and expected CPIH inflation of 2%, over 30% of the 6.27% nominal allowed cost of equity is being retained each year. Therefore, even before any additional dividend restriction or equity issuance a significant amount of equity is already being retained to support investment.

5.3.7 However, above and beyond this retention, our plan includes additional equity retention through dividend restriction along with raising new equity.

5.3.8 As we discuss further at 6.3.5, dividends are an important part of our listed parent company investors' investment decision, and the level of dividend pay-out is closely monitored. As such, we consider that there is a limit as to the amount of dividend restriction that is feasible. Taking that into account, we have adopted a dividend pay-out of 100bps less than the allowed cost of equity, and using Ofwat's early view 4.14% cost of equity we have therefore set the dividend yield at 3% (being 4.14% minus 1% and rounding down).

5.3.9 In addition, we have included £1.35 billion and £2.25 billion of equity injections in our plan for the actual and notional companies respectively, along with the associated 2% equity issuance costs for the actual company equity issuance amount only. These have been scheduled as £150m in FY26, £200m in FY26 and £500m in years FY28 and FY29 for the actual company and £250m in FY26, £333m in FY26 and £833m in years FY28 and FY29 for the notional company.

5.3.10 As this equity requirement is for our appointed business, as discussed in 6.3.19 below, UUW would make a call on its listed parent company, UUG, to consider putting in an appropriate amount of capital at the required time. Subject to the board of UUG being satisfied as to the overall PR24 risk and return package and the level of allowed return, we expect the UU group to be well placed to fulfil such equity calls from UUW, and is likely to consider a range of possible sources of capital, including injection of group cash, issuance of debt higher up the group capital structure to inject as equity into UUW, and/or equity issuance by our listed parent, UUG. The most appropriate action will be decided at the time.

5.3.11 Cost recovery rates (PAYG and RCV run off)

5.3.12 UUW has proposed AMP8 PAYG and RCV run-off rates for each of the wholesale controls in line with natural rates. As a result we are not proposing to use cost recovery rates as a financeability lever in our business plan submission.

5.3.13 In setting these cost recovery rates we have appropriately considered the framework set by Ofwat, including:

- having regard to balancing the recovery of costs between different generations of customers,
- taking account of the financeability of the notional company in both the short and the long term and ensuring rates do not store up a financeability problem beyond the period of the price control, and

- affordability for customers.

5.3.14 AMP8 PAYG rates have been set consistent with operating costs (which includes infrastructure maintenance expenditure) as a proportion of totex for each price control. More specific values for the PAYG rates applicable to each price control are set out in the relevant table commentaries to data table RR1.

5.3.15 Our natural AMP8 RCV run-off percentages for each price control is calculated from our forecast of current cost depreciation. Further details on the proposed rates for each price control is provided in chapter 9, with further justification and supporting evidence (backed by third party assurance) provided in the supplementary document *UUW71: RCV run-off*.

5.3.16 AMP7 reconciliation adjustments

5.3.17 As is described further in supplementary document *UUW78 – PR19 Reconciliation Submission,* we are expecting a material level of beneficial AMP7 reconciliation adjustments to be applied in AMP8 through both revenue and RCV adjustments in our favour.

5.3.18 For the actual company only, and to clearly evidence that customers are not bearing any additional costs of resolving financeability constraints in the actual company, we propose that we use our beneficial PR19/AMP7 reconciliation adjustments as an additional financeability lever for the actual company only.

5.3.19 Using our AMP7 reconciliation adjustments in this manner can be viewed as an alternative choice made by the company to reduce the amount of additional equity issuance or additional dividend retention that the actual company may have otherwise needed to achieve financeability for the actual company.

5.4 Conclusion on levers to address financeability constraints

5.4.1 We have identified that the size of our investment programme is the key financeability constraint associated with both our notional and actual company business plans. We considered a full range of possible financeability levers to identify the most appropriate solution, whilst keeping in mind that equity issuance or retention was likely to be a key feature required of any solution.

5.4.2 To resolve our financeability constraints we have included the following financeability levers in our plan:

- Assumed £1.35 billion and £2.25 billion of equity issuance for the actual and notional companies respectively to ensure that our large investment programme is funded by an appropriate mix of debt and equity;
- Reduced cash dividend pay-out amounts by adopting a policy of a base distribution of the allowed cost of equity less 100bps (using a dividend yield of 3% derived from Ofwat's early view cost of equity of 4.14% less 100bps and rounded down) for both the notional and actual company to further bolster equity retention to fund our investment programme; and
- For the actual company only, we have also utilised beneficial AMP7 reconciliation adjustments due to be received in AMP8 to ensure that customers do not bear additional costs of resolving actual company financeability constraints.

5.4.3 These financeability levers should enable both the notional company and the actual company to maintain strong credit ratings supporting efficient access to debt capital markets and to attract equity investment to support our planned investment, which should benefit customers over the long term.

6. Financeability assessment

6.1 Financeability metrics after the application of financeability levers

6.1.1 The below tables show our forecast financeability financial ratios for the notional and actual companies over AMP8. These ratios are shown after the application of our chosen financeability levers.

6.1.2 Green indicates that a required threshold is met, amber indicates a near miss that should be acceptable in the round and red indicates that a required threshold is not met.

Table 7 Financeability metrics after financeability levers (notional company)

Ratio	Thresholds Baa1/BBB +/BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: Gearing	≤72.2%	55.43%	56.55%	56.13%	55.06%	55.13%	55.62%
Ofwat: Cash Interest cover	N/A	3.71	3.59	3.49	3.49	3.58	3.57
Ofwat: Adjusted cash interest cover	≥1.6	1.61	1.58	1.57	1.60	1.62	1.60
Ofwat: Adjusted cash interest cover (alternative)	≥1.6	1.61	1.58	1.57	1.60	1.62	1.60
Ofwat: FFO/Net Debt	≥10.0%	9.73%	9.17%	8.83%	8.95%	9.36%	9.19%
Ofwat: FFO/Net Debt (alternative)	≥9.2%	8.93%	8.30%	7.90%	8.07%	8.47%	8.31%
Ofwat: Dividend yield	N/A	3.00%	3.00%	3.00%	3.00%	3.00%	3.16%
Ofwat: Dividend cover	N/A	0.65	1.42	1.09	1.02	1.19	1.09
Ofwat: RCF/Net Debt	N/A	0.07	0.07	0.06	0.06	0.07	0.07
Ofwat: Return on capital employed (ROCE)	N/A	4.57%	4.43%	4.25%	4.21%	4.33%	4.35%
Ofwat: Return on regulatory equity (RORE)	N/A	4.18%	4.18%	4.17%	4.16%	4.16%	4.17%
Ofwat: RCF/Capex	N/A	0.42	0.33	0.27	0.33	0.76	0.38
Moody's: Gearing	≤72%	55.22%	56.30%	55.91%	54.86%	54.93%	55.41%
Moody's: Adjusted interest cover	≥1.6	1.64	1.61	1.60	1.62	1.65	1.62
S&P: FFO to debt	≥9.2%	9.04%	8.39%	7.99%	8.16%	8.56%	8.40%
S&P: Debt to EBITDA	≤9.0	7.38	7.51	7.86	7.83	7.50	7.62
Fitch: Gearing	≤67%	55.22%	56.30%	55.91%	54.86%	54.93%	55.41%
Fitch: Cash PMICR	≥1.6	1.62	1.59	1.58	1.61	1.63	1.61
Fitch: Nominal PMICR	≥1.8	2.10	2.06	2.03	2.05	2.09	2.06

Source: Table RR16

Table 8 Financeability metrics after financeability levers (actual company)

Ratio	Thresholds A3/BBB+/ BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: Gearing	≤65.2%	64.00%	64.28%	63.99%	63.21%	62.72%	63.58%
Ofwat: Cash Interest cover	N/A	4.93	4.42	3.93	3.69	3.53	3.99
Ofwat: Adjusted cash interest cover	≥1.8	2.35	2.12	1.92	1.82	1.72	1.94
Ofwat: Adjusted cash interest cover (alternative)	≥1.8	2.35	2.12	1.92	1.82	1.72	1.94
Ofwat: FFO/Net Debt	≥10.4%	9.94%	9.31%	8.71%	8.55%	8.74%	8.99%
Ofwat: FFO/Net Debt (alternative)	≥9.2%	8.73%	8.08%	7.46%	7.41%	7.57%	7.80%
Ofwat: Dividend yield	N/A	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%
Ofwat: Dividend cover	N/A	1.99	2.00	1.65	1.52	1.50	1.70
Ofwat: RCF/Net Debt	N/A	0.08	0.08	0.07	0.07	0.07	0.07
Ofwat: Return on capital employed (ROCE)	N/A	5.21%	5.03%	4.84%	4.76%	4.86%	4.92%

Ratio	Thresholds A3/BBB+/ BBB+	FY26	FY27	FY28	FY29	FY30	AMP8
Ofwat: Return on regulatory equity (RORE)	N/A	4.51%	4.50%	4.48%	4.46%	4.44%	4.47%
Ofwat: RCF/Capex	N/A	0.55	0.43	0.34	0.40	0.87	0.47
Moody's: Gearing	≤65%	63.75%	63.99%	63.74%	62.98%	62.50%	63.33%
Moody's: Adjusted interest cover	≥1.7	2.27	2.04	1.85	1.77	1.69	1.88
S&P: FFO to debt	≥9.0%	8.57%	7.87%	7.21%	7.17%	7.39%	7.58%
S&P: Debt to EBITDA	≤9.0	8.03	7.99	8.38	8.43	8.08	8.19
Fitch: Gearing	≤67%	63.75%	63.99%	63.74%	62.98%	62.50%	63.33%
Fitch: Cash PMICR	≥1.6	2.34	2.11	1.91	1.82	1.72	1.93
Fitch: Nominal PMICR	≥1.8	2.37	2.21	2.07	2.03	1.95	2.10

Source: Table RR16

6.2 Debt financeability assessment

6.2.1 The above financeability metrics are shown after the application of financeability levers, which for both the notional and actual companies are: i) retention of the inflation uplift component of the allowed return on equity; ii) a dividend pay-out of c100bps below the cost of equity (3% dividend yield using Ofwat's 4.14% early view cost of equity less 100bps and rounded down); and iii) £1.35 billion and £2.25 billion of new equity for the actual and notional companies respectively from UUW's listed parent phased across the AMP in order to maintain gearing at a broadly constant level over the AMP.

6.2.2 In addition, for the actual company only, as an alternative to additional equity issuance, retention within UUW of the beneficial AMP7 reconciliation adjustments have been used as a further financeability lever.

6.2.3 For the notional company after financeability levers:

- In relation to the targeted Moody's credit rating of Baa1, the Moody's: gearing levels remain well under the relevant 72% threshold (with gearing remaining close to 55% in line with Ofwat's notional company structure), and the Moody's: adjusted interest cover levels remain above the relevant 1.6x adjusted threshold;
- In relation to S&P, the S&P: FFO to debt ratio is 8.4% on average over AMP8 and so is just outside of the BBB+ required adjusted threshold of 9.2%. However, the S&P: Debt to EBITDA ratio remains comfortably within the relevant 9.0x threshold for BBB+. FFO to debt is S&P's primary metric and Debt to EBITDA is S&P's secondary metric. We note that any update to the WACC for more up to date market data will likely improve FFO to debt;
- In relation to the targeted Fitch IDR of BBB+ (equivalent to A- for senior unsecured debt), the Fitch: gearing levels remain well under the relevant 67% threshold (with gearing remaining close to 55%) and whilst the FY27 and FY28 Fitch cash PMICR ratios only are just below the relevant threshold, all other years and the AMP average ratios for both Fitch: cash and nominal PMICR ratios remain above the relevant 1.6x and 1.8x thresholds respectively, which we consider would be acceptable.

For the actual company after financeability levers:

- In relation to the targeted Moody's credit rating of A3, the Moody's: gearing levels remain under the relevant 65% threshold and whilst the FY30 Moody's: adjusted interest cover ratio is just below the relevant threshold, all other years and the AMP average levels remain above the relevant 1.7x threshold, which we consider would be acceptable;
- In relation to S&P, the S&P: FFO to debt ratio is 7.6% on average over AMP8 and so is outside of the BBB+ required threshold of 9%. However, the S&P: Debt to EBITDA ratio remains comfortably within the relevant 9.0x threshold for BBB+. FFO to debt is S&P's primary metric and Debt to EBITDA is S&P's secondary metric. We note that any update to the WACC for more up to date market data will likely improve FFO to debt;

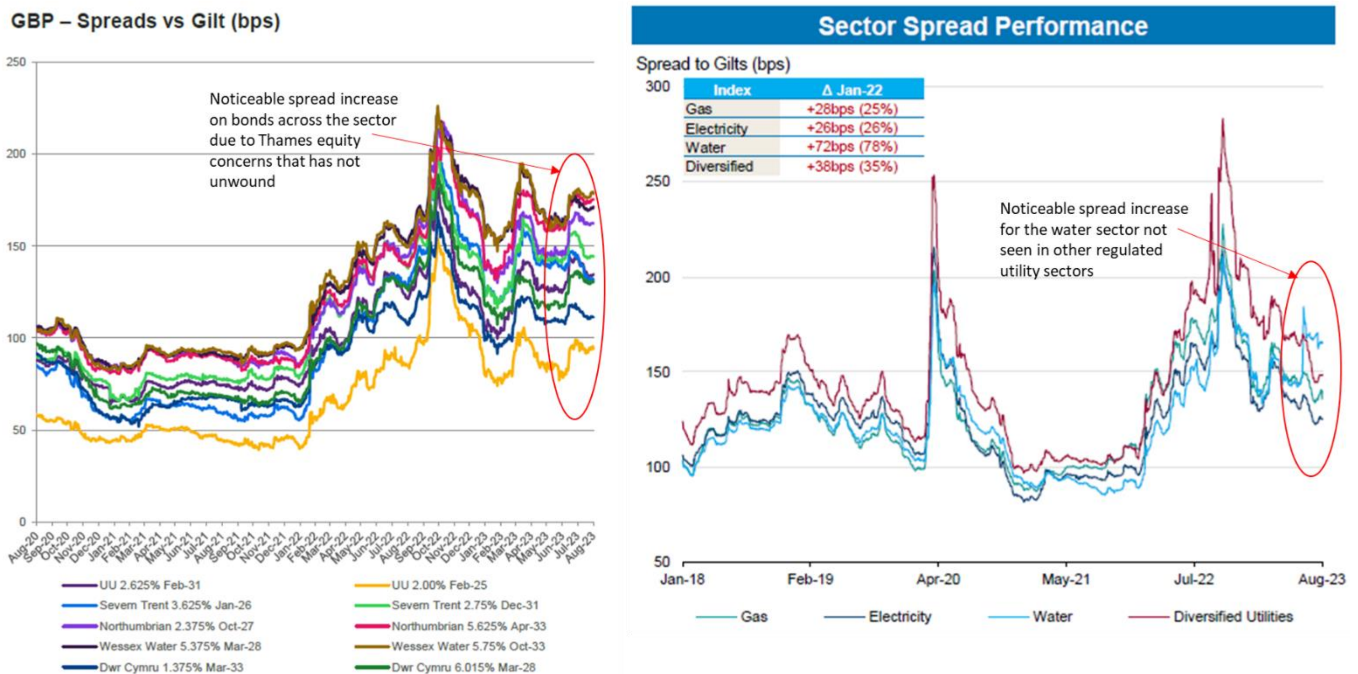
- In relation to the targeted Fitch IDR of BBB+ (equivalent to A- for senior unsecured debt), the Fitch: gearing levels remain well under the relevant 67% threshold and the Fitch: cash and nominal PMICR ratios remain above the relevant 1.6x and 1.8x thresholds respectively.

6.2.4 On the basis of the above, whilst the targeted ratings with Moody's and Fitch are demonstrably met, the S&P key metrics are more challenging. This reflects the differences in S&P's ratings methodology compared with Moody's and Fitch. Both the notional and the actual company are expected to be on the cusp of BBB+/BBB flat after the impact of financeability levers, as the primary metric S&P:FFO/debt looks challenged in terms of maintaining BBB+, but S&P's secondary metric Debt to EBITDA is in a better position. There are limited levers available to improve FFO/debt, which reacts much more strongly to increases in revenue than equity issuance and so any potential increase in the WACC from the early view used should increase revenues and thus improve financeability with reference to S&P's key metrics.

6.2.5 On the basis that the notional and actual companies should achieve target credit ratings with at least 2 of the ratings agencies, and as such we consider that both the actual and notional companies are financeable from a debt perspective after our proposed application of financeability levers.

6.2.6 Finally, whilst our debt financeability assessment necessarily focuses on credit ratings and the associated relevant financial ratios and thresholds, it is important to keep in mind that business risk is also important. In addition a well-functioning equity buffer remains critical to debt investors, with an adequate cost of equity being important to all providers of finance, in maintaining broad-based investor confidence. The absence of confidence in equity can result in lack of access to or higher costs for debt financing irrespective of financial metrics. This can be seen from Figure 7[12] below showing recent market movements associated with the news flow on Thames Water, whereby uncertainty on future equity injections caused significant moves in the cost and availability of debt during the summer of 2023 for the entire sector that was not experienced by other sectors.

Figure 7 – Spread versus gilt for certain GBP bonds across the sector and Sector spread performance



Source: NatWest (GBP bonds) and Barclays (sector spread performance)

6.2.7 Therefore, our debt financeability assessment is also based on the assumption that the overall PR24 risk and return package and the level of allowed return are set at an appropriate level at the FD.

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[12] Annotations on graphs are by UU

6.3 Equity financeability assessment and sources of new equity for UUW

6.3.1 Equity financeability

6.3.2 To fund investment and growth, companies need to be able to attract equity investment. For UUW, as a regulated utility facing a step change in investment, it will be necessary to demonstrate that we are an attractive investment proposition for equity. Here, the regulatory framework, the overall PR24 risk and return package, and the level of allowed returns are all likely to be material factors in determining equity financeability. Demonstrating equity financeability should also help maintain the confidence of the debt markets.

6.3.3 Our equity financeability assessment applies to both the notional company and the actual company. Our business plan assumes that £1.35 billion and £2.25 billion of equity capital is injected into UUW for the actual and notional companies respectively on a phased basis across AMP8 from our listed parent, UUG, and that equity issuance costs for the actual company only are covered by the 2% allowance as per Ofwat's final methodology.

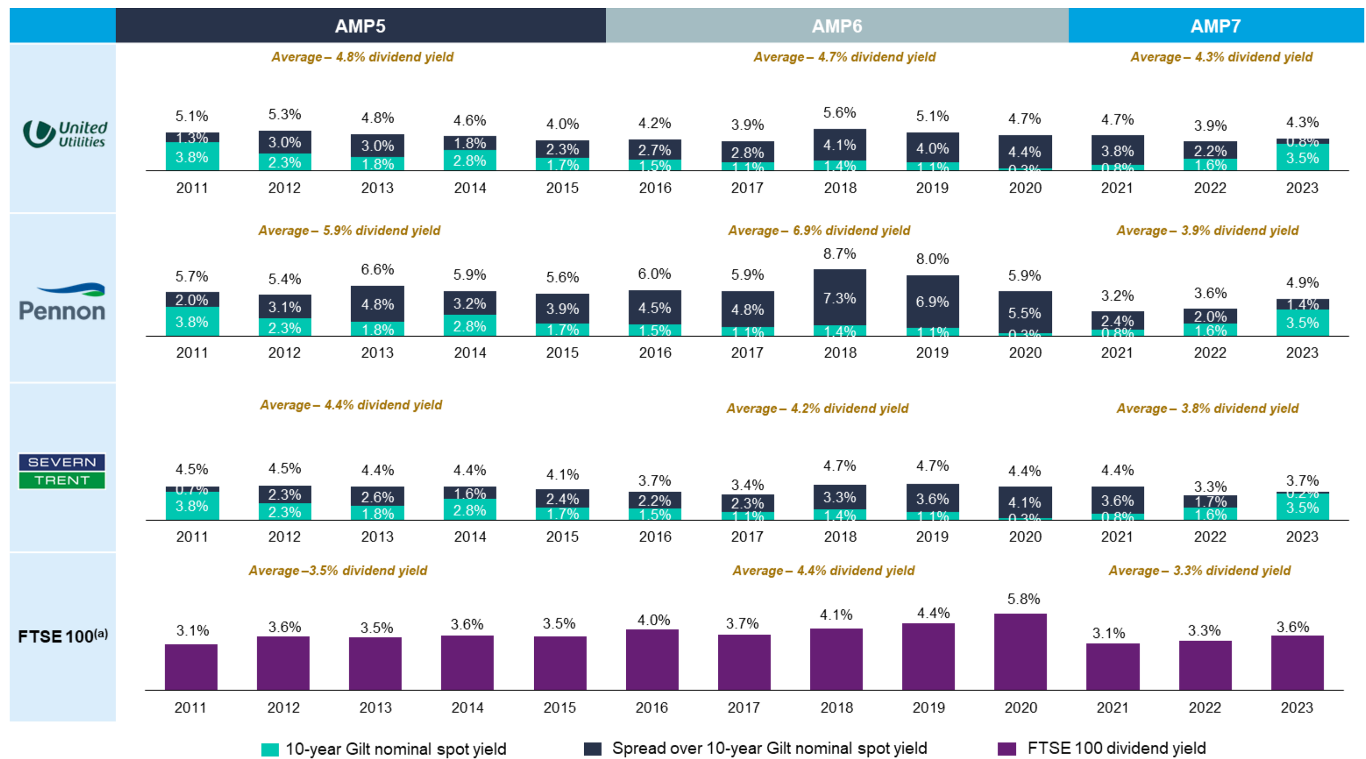
6.3.4 The measures that are commonly used to assess a dividend pay-out for the purpose of equity financeability are dividend yield and dividend cover.

Dividend Yield

6.3.5 Equity financeability is primarily assessed with reference to the level of dividend yield. Institutional investors such a pension funds and asset managers have primarily invested in United Utilities for income purposes, with a stable, growing, inflation-linked, dividend stream being an essential underpin of the investment proposition. Shareholder value is generally measured as total shareholder returns over a period of time, equating to capital appreciation and a dividend stream. As such, expectations of invested capital growth and dividends are critical underpinnings of investor sentiment. In our recent shareholder survey, respondents all provided detailed feedback on our dividend policy, suggesting that the dividend was an important part of their investment decision and the level of dividend pay-out is closely monitored.

6.3.6 Historically, listed UK water companies have averaged 3.8%-6.9% dividend yield, and the FTSE100 3.3%-4.04%. The table below shows dividend yields across listed UK water companies and the FTSE 100. As shown, UK water company have historically traded at dividend yields of around 3.2% to 6.6%, representing a premium to the FTSE100.

Figure 8 UK dividend yield analysis



Note: All based on UU's Mar y/e; Dividend yield is calculated as reported DPS, divided by the share price as at UU's Mar y/e; Historical 10-year gilt spot yield and FTSE 100 dividend spot yield taken as at the last business day of UU's FY Mar y/e
(a) Market cap weighted average

Source: Company information, annual reports, Broker reports, FaceSet financial data and analytics as at September 2023

6.3.7 We note that as of 19 September 2023, UUG currently trades at a next twelve-month (NTM) dividend yield of 5.2%, and an implied FV / NTM RCV multiple of 0.98x. The modelled UUW AMP8 base dividend yield of 3.0% therefore would imply a similar UUG dividend yield of around 2.9%. For comparison, this would place UUG at the lowest for European regulated peer group, among the lowest quartile of the FTSE100, and would compare to the current 10-year U.K. gilt yield of 4.3%. As highlighted in Figure 8 above, Regulated energy networks are trading on NTM dividend yields of 4-7% with similar asset base growth to our AMP8 programme.

6.3.8 Changes to the regulatory model that increase cash generation at the expense of asset growth, such as the change from RPI indexation to CPIH mean, all else equal, investors would expect a higher dividend yield. This was the case in AMP7, with a 4% of regulated equity base dividend reflecting a relatively high pay-out of the cash component of the allowed equity return of 4.19% (CPIH stripped). At the time, the higher pay-out was deemed appropriate given our PR19 investment programme generated relatively low real RCV growth.

6.3.9 Our plan for PR24 represents a step-change in the level of investment for AMP8 compared with previous AMPs. Our totex programme will require significant amounts of financing. Effectively, UUW and the rest of the water sector will compete to attract the necessary investment with domestic and international peers.

6.3.10 This is also set against a macro-economic environment that has turned decisively following the end of the Covid pandemic, with increasing evidence that the post-global financial crisis era of ultra-low interest rates and central bank Quantitative Easing has given way to higher interest rates and more elevated risk premia. This is highlighted in the Updated Frontier Economics Report.

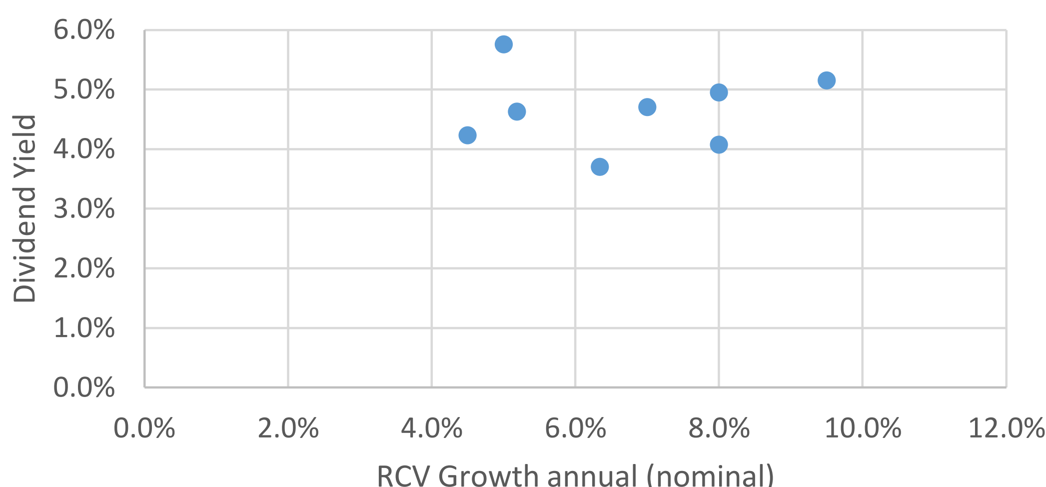
6.3.11 Securing equity investment will require an attractive dividend. Our AMP8 dividend policy is consistent with our AMP7 policy, which is to pay a base annual dividend plus further dividends for demonstrable outperformance. Our base dividend in AMP8 aligns with the Ofwat Final Methodology to retain c.100bp

of the base allowed return on equity to fund real RCV growth, resulting in a 3% payout of regulated equity.

6.3.12 We can see from the Figure 8 above that the listed peers' dividend yields are higher than 3%. However, UUW's elevated asset growth which we expect to accelerate from negligible growth in AMP7 to c.7% (real, CPIH) in AMP8 seeks to compensate investors for accepting a lower yield versus investors' required return on equity.

6.3.13 Our conclusion is while UUW's accelerating growth would suggest that a higher level of reinvestment is appropriate, a base dividend formed around the Ofwat Final Methodology compliant 3% level looks to be below what equity capital markets generally find acceptable. This is particularly the case when considering UUW's growth rate of c.7% (real, CPIH) is comparable to other listed peers – see chapter 9 section 9.4.6 with the chart repeated below:

Figure 10 – European utilities RCV growth vs dividend yield



Source: Company published reports for asset base growth; Bloomberg for dividend yields

6.3.14 As highlighted in the updated Frontier Economics Report (see supplementary document *UUW73: Cost of Capital Considerations*), a significant amount has changed in financial markets. Setting aside methodological differences, Frontier Economics estimates that the cost of equity has increased markedly. In its refreshed report, Frontier Economics use a new cut-off date for its estimates of 30 April 2023, resulting in a cost of equity estimate of 4.81% at the lower bound up to an upper bound of 5.71% (assuming 60% gearing used by Frontier Economics). Converting this range to a cost of equity based on Ofwat's 55% notional company gearing results in a range of 4.44% at the lower bound and up to 5.32% at the upper bound. Assuming c.100bps of reinvestment – consistent with the Ofwat Final Methodology – implies a base dividend of just under 4.0%. Comparing this level of base dividend brings the yield closer to the European peers, helping us to compete for capital and improving financeability.

Dividend Cover

6.3.15 Dividend cover is also a metric that is used to assess dividend sustainability, although some caveats should be placed on this metric, given that metrics derived from regulated utility income statements might not fully capture the true underlying economics.

6.3.16 Table 7 and Table 8 above includes dividend cover for the notional and actual company respectively after the application of financeability levers. As these ratios are above 1.0x times for both the notional and actual company on average over AMP8, then this is deemed to be adequate for the level of dividend assumed in the plan.

Return on Capital Employed (ROCE)

6.3.17 Return on capital employed (ROCE) is a financial ratio used to assess profitability and capital efficiency. While we consider the ROCE to generally apply to equity financeability, as an EBIT measure both debt and equity elements contribute to the ratio. The ratio is commonly assessed against the cost of capital of the company, with ROCE forecasts above the cost of financing investment activities deemed supportive to financeability.

6.3.18 We have adopted Ofwat's early view WACC guidance provided in the final methodology. As we note in Chapter 9, the macro-economic environment observed since the start of 2022 has continued during 2023, which inevitably results in a higher cost of capital for both debt and equity, and we recognise that Ofwat has indicated that it will update its AMP8 WACC assessment as part of the final determinations. For the purpose of our financeability assessment, for consistency and comparability purposes, we consider the base allowed return of 3.29% as relevant is assessing ROCE. The ROCE metrics shown both for the notional company and actual company remain above the threshold, supporting the financeability assessment.

6.3.19 Sources of new capital for UUW

6.3.20 As outlined in section 5.4, in order to fund our proposed significant AMP8 investment programme, UUW would look to raise c£1.35 billion of equity on an actual company basis. As UUW is the principal operating subsidiary of its listed parent United Utilities Group PLC (UUG), UUW would make a call on UUG to consider putting in an appropriate amount of capital at the required time.

6.3.21 Subject to the board of UUG being satisfied as to the overall PR24 risk and return package and the level of allowed return, UUG is expected to be well placed to fulfil such equity calls from UUW, and is likely to consider one or more of the following sources of capital:

- Injection of group cash – the UUG group has typically operated with lower levels of gearing than UUW and therefore could look to inject this cash into UUW and/or convert to equity any existing intra-group loans made from group to UUW.
- Issuance of debt higher up the group capital structure to inject as equity into UUW – UUG's intermediate holding company, United Utilities PLC, has access to debt capital markets and could therefore consider issuing 'holding company' debt (including hybrid debt) to downstream an equity injection into UUW. 6
- UUG equity issuance – as UUG is a listed company on the London Stock Exchange, UUG has access to a deep and liquid pool of equity capital, so it could consider a specific equity raise and/or share increase – via placement, rights issue, hybrids or scrip dividend programme.

6.3.22 It would be for the board of UUG to determine the most appropriate way of making any equity injections into UUW, at the appropriate time.

6.4 Overall assessment of financeability of our plan

6.4.1 Taking account of the above factors, and on the assumption that the overall PR24 risk and return package and the level of allowed return are set at an appropriate level at the FD, we are confident that our plan is financeable from a debt and equity perspective on both a notional company basis and an actual company basis.

6.4.2 Included in our submission as supplementary document *UUW74* are letters from each of our listed parent's corporate brokers, Deutsche Bank and JP Morgan, which support our assertion that our plan is financeable from a debt and equity perspective on both a notional company basis and an actual company basis.

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