Response to Ofwat's PR19 Draft Determination

Appendix

TW-DD-A16

Business plan scenario financeability assessment

30 August 2019

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Section 1

Introduction

A Purpose of this document

1.1 In this appendix, we assess the financeability of our business plan scenario on both an actual and notional basis and the financial resilience of that scenario to a range of plausible but severe downside scenarios, as informed by the outcome of Ofwat's Draft Determination (DD).

Section 2

Notional financeability

2.1 We have conducted an assessment of the notional financeability of our business plan scenario adopting the same methodology, approach, and assumptions as set out in our April plan[1], with the following exceptions:

- Business plan scenario costs of c. £10bn accepted by Ofwat at FD to be in line with its assessment of efficient costs for the notional company;
- Plan delivered in line with performance commitments, i.e. a 'neutral position' with no ODI rewards or penalties, but a recognising £50m C-MeX penalty which is our assessment of the P50 position for the notional company faced by the specific demographics of our region;
- An allowed cost of capital for the appointed business of 2.6% (vanilla, stated in RPI-stripped terms) for the reasons set out in Chapter 6; and
- A notional dividend yield of 3.15% growing at 1.32% per annum in real terms – in accordance with Ofwat's DD statement on how it will assess notional financeability[2].

2.2 We have chosen a target rating of BBB+ by S&P and Baa1 by Moody's for our notional balance sheet financeability assessment for the following reasons:

- To be commensurate with our understanding of how the allowed cost of debt has been estimated by Ofwat within the WACC, including its choice of reference index for the cost of new debt – being the iBoxx indices for non-financial companies. Ofwat states that it will use a 50:50 mix of A and BBB rated indices, which "reflects an appropriate range of credit profile for the notional company."[3]
- To ensure that, in addition to the protection afforded within the target ratios at that BBB+/Baa1 level, there is reasonable headroom of two notches above the minimum investment grade rating, which is a condition of our licence.

2.3 Our target levels for the key ratios are as follows:

- **Cash interest cover**: 2.5x (based on lower end of Baa1 guidance from Moody's);
- **Adjusted cash interest cover:** at least 1.5x reflecting the uncertainty associated with Ofwat's April 2018 consultation on putting the sector back in balance. Moody's analysis[4] shows that this increased target PMICR threshold for Baa1 from 1.4x to 1.5x;
- **Funds from operations to debt (FFO to debt):** 9% to 10% range, primarily an S&P measure where 6% is expected by S&P to be consistent with a BBB rating underpin, with a higher threshold expected for BBB+ basis, Evercore advise targeting FFO to debt of 9% to 10%;
- **Retained cash flow to debt (RCF to debt):** 6% to 10% per Moody's requirement for Baa1; and

1 TW-RR-A2-Finance and Financeability.

2 PR19 draft determinations: Aligning risk and return technical appendix, Ofwat (July 2019) – page 45.

3 Delivering Water 2020: Our methodology for the 2019 price review. Appendix 12: Aligning risk and return, Ofwat (13 December 2017).

4 Moody's Investors Service. TSD 127 Sector in-depth, Regulated Water Utilities – UK Regulator's proposals undermine the stability and predictability of the regime, 22 May 2018.

- **Gearing (net debt to RCV):** opening gearing of 60% for AMP7, consistent with that assumed in Ofwat's initial view of the WACC[5], which can vary dynamically thereafter in line with the dividend assumption set out above.

2.4 The following table sets out the results of our financeability assessment for the notional company.

Table 1: Financeability assessment using notional capital structure

Ratio	2020/21	2021/22	2022/23	2023/24	2024/25	AMP7 average
Cash interest cover	3.73x	3.73x	3.68x	3.73x	3.87x	3.75x
Adjusted cash interest cover	1.64x	1.64x	1.59x	1.55x	1.61x	1.60x
FFO/debt	9.3%	9.3%	9.2%	9.5%	10.1%	9.5%
RCF/debt	7.2%	7.3%	7.2%	7.5%	8.1%	7.5%
Gearing (net debt/RCV)	60.3%	60.7%	60.2%	60.1%	58.2%	59.9%

Source: Ofwat financial model (populated with our business plan scenario)

2.5 We consider that the notional company would just fall short of our target ratios required to achieve a BBB+/Baa1 rating across the entirety of AMP7 (although by 2024/25 ratios appear to support our target rating). Instead, we think that the notional company would meet ratios consistent with BBB/Baa2. The business plan scenario is therefore financeable on a notional basis – with one notch of headroom above minimum investment grade – but at a level one notch below the credit rating which would be consistent with the components of the allowed cost of capital.

2.6 One consequence of meeting a rating of BBB/Baa2 would be to incur an estimated premium of 25-40bp on cost of debt (estimate by our expert financial advisors Evercore) that will erode notional equity returns (all else equal). We have not factored this additional cost into our scenario as we have applied the advantages of our actual financial structure – which is financeable at BBB+/Baa1 – to the benefit of customers, as drawn out below.

2.7 We have considered what mitigation options are available to enable the notional company to meet ratios consistent with the targeted BBB+/Baa1 level. One option would be to use the totex levers, however we reject that on the grounds of affordability. Use of the levers would increase customer bills – which we consider unnecessary given that our business plan scenario is financeable at BBB+/Baa1 on an actual balance sheet basis. One critical differentiator between the two capital structures is the one notch uplift allowed for the beneficial effect of securitisation, which is not available to the notional company.

2.8 There are other notional criteria which could be applied which may mitigate the issue - we consider that we would be able to resolve the issues arising within the notional balance sheet assessment to achieve BBB+/Baa1 by reducing notional dividend yield to 2% - which feeds through into improved interest cover and FFO:debt metrics (additional index-linked debt would also improve interest cover, but have limited impact on FFO:debt).

2.9 Our overall conclusion is that our business plan scenario is financeable on the notional balance sheet at BBB/Baa2 and requires no use of PAYG or run-off levers to support notional financeability. Additional mitigation is available to improve this rating by one notch to BBB+/Baa1 by reducing notional dividends accordingly.

[5] Delivering Water 2020: Our final methodology for the 2019 price review, Ofwat (December 2017) – pages 166 and 172 (inter alia).

2.10 Our expert financial advisor Evercore has independently concluded that the notional company will be able to finance the business plan scenario at a rating in the upper end of BBB/Baa2 by S&P and Moody's respectively.[6]

2.11 In making its assessment, Evercore note the following:

- That the rating is "on the cusp of Baa1 (with Moody's key AICR ratio >1.50x) and the ratios are more in line with BBB+/Baa1 level in the final year of the AMP;
- The cost of debt will be higher by an estimated 25-40bps than a BBB+/Baa1 rated company; and
- Ofwat's allowed cost of new debt issuance in AMP7 is to be indexed to an Iboxx index that comprises both A and BBB rated bonds (less 25bps) i.e. an average rating of BBB+. Therefore, a BBB rated notional company, being a lower rated company than the index, will potentially always underperform on the cost of new debt."

2.12 In calculating the notional ratios, we have followed the approach identified in the Draft Determination, calculating the ratios using the Ofwat PR19 financial model. We have identified that there appears to be an inconsistency in the treatment of pension deficit repair costs and allowances. In the model, the revenues allowed to cover pension deficit repair costs (per IN13/17) are included, but not the offsetting costs. This may therefore be overstating the notional financial ratios. We do not consider that this would undermine the notional financeability of our revised business plan scenario. However, we recommend that Ofwat consider whether to adjust the calculation of the notional ratios when assessing the notional financeability of the Final Determination.

2.13 We have also considered ratios specific to equity investors focusing on dividend cover, regulatory earnings and RCV/EBITDA. These have not changed materially from those presented in our April plan, dividend cover remains below one and results suggest that attracting new equity into the business during AMP7 may present a significant challenge when taking the results of key debt ratios (where limited headroom remains) alongside relatively unattractive equity metrics, factors which must be clearly taken into account by Ofwat when assessing financeability of the company at the draft and final determinations.

2.14 Our base case is founded on a 'P50' basis in terms of costs to deliver our performance commitments on a 'P50' basis.

2.15 Scenario analysis tests how resilient our alternative is, on a notional basis, to 'P10' and 'P90' outcomes. This means there would be a 20 percent chance of the key risk factor(s) falling outside of the P10 (high case) and P90 (low case) assumptions used for these scenarios. We stress test the notional capital structure to the downside (P90) combined risk scenario – i.e. on a basis consistent with our RORE analysis associated with our business plan scenario.

2.16 The detailed impact of the downside scenario on financeability of the notional structure is set out in the table below.

[6] TW-DD-A18 – Financeability opinion of BP scenario

Table 2: Combined scenario – downside case (P90)

Ratio	AMP7 average - downside
Cash interest cover	2.92x
Adjusted cash interest cover	1.01x
FFO/debt	6.82%
RCF/debt	4.97%
Gearing (net debt/RCV)	65.03%

Source: Ofwat financial model (populated with P90 (downside) outcome from our business plan scenario

2.17 The combined scenario – downside case (P90) shows a significant reduction in key ratios, driven by the additional cash drain on the business from crystallisation of unfunded risks (impacts of which can only be passed on to, or shared with, customers to a limited degree in period). Most ratios drop below what we would expect to be consistent with BBB/Baa2 for the whole period, with corrective action falling on equity to resolve through lower dividends or equity injection. Some costs will be recovered from customers during the following AMP, under operation of the cost performance incentives, although the company will need to finance these within period.

Section 3

Actual financeability

3.1 We have conducted an assessment of the actual financeability of our business plan scenario adopting the same methodology, approach, and assumptions as set out in our April plan[7], with the following exceptions:

- Business plan scenario costs of c. £10bn are in line with Ofwat's assessment of efficient costs for the notional company in its FD;
- Plan delivered in line with performance commitments, i.e. a 'neutral position' with no ODI rewards or penalties, but recognising £50m C-MeX penalty which is our assessment of the P50 position for the actual company faced by the specific demographics of our region; and
- An allowed cost of capital for the appointed business of 2.6% (vanilla, stated in RPI-stripped terms) for the reasons set out in Chapter 6.

3.2 We continue to target a rating of BBB+ from S&P for our Class A debt and Baa1 corporate family rating from Moody's with ratios defined in line with those adopted by those rating agencies as follows:

- Moody's adjusted PMICR target set by reference to Moody's 22 May 2018 rating action summary which indicates downward pressure could result from "net debt to RCV likely to be persistently above 80% or adjusted interest coverage persistently below 1.3x";
- Moody's FFO:debt, this forms 12.5% of the 40% weighting allocated by Moody's to leverage and coverage in its ratings grid[8]. A ratio of 6% to 10% is considered to be consistent with what is required to maintain our current rating under Moody's approach; and
- S&P FFO:debt for Class A debt. Since the downgrade to BBB+, S&P has provided guidance of about 6% for the current rating and has not determined a trigger for a downgrade to BBB for Thames or its peers.

3.3 Our key ratios for the business plan scenario are set out in the table below, alongside our projections through to 2024/25:

Table 7: Credit ratios

Ratio	2020/21	2021/22	2022/23	2023/24	2024/25
Covenant senior net debt to RCV	80.6%	80.3%	79.2%	78.6%	76.9%
Covenant senior PMICR (spot)	1.40x	1.47x	1.56x	1.58x	1.59x
Moody's adjusted PMICR	1.34x	1.46x	1.47x	1.48x	1.47x
Moody's FFO:debt	6.3%	6.7%	6.9%	7.3%	7.5%
S&P FFO:debt. Class A	**5.5%**	**5.7%**	**5.9%**	**6.1%**	**6.3%**

Source: Thames Water financial model (populated with our business plan scenario).

3.4 For reference, we also include covenant senior gearing and PMICR levels. These ratios are substantially better than levels which would trigger a distribution lock-up (being 1.1x PMICR and 85% senior gearing) and event of default (being 95% senior gearing) as set out in our debt securitisation covenants.

7 TW-RR-A2-Finance and Financeability.

8 Moody's Investors Service. TSD 402 Rating Methodology: Regulated Water Utilities, 22 December 2015.

3.5 The ratios presented by our business plan scenario show some headroom against covenant trigger levels, with 5% to 8% headroom on gearing and around 0.4x headroom on PMICR over the period. Moody's PMICR averages 1.44x over AMP7 and gearing around or below 80% throughout the period, ending the AMP in the mid-70s, with supporting FFO to debt (as defined by Moody's) also in line with guidance level. We therefore conclude that the key ratios presented are consistent with maintaining our Moody's corporate family rating of Baa1, which is investment grade, two notches above the minimum level required by our licence.

3.6 The FFO/debt ratio averages around 6% over the period, with a strong upward trend, ending AMP7 above 6%. We conclude that the key ratios presented are consistent with maintaining our BBB+ S&P rating for our Class A debt.

3.7 Looking across the broad range of measures our overall conclusion is that our plan is financeable on the actual balance sheet at BBB+/Baa1.

3.8 As noted above, we engaged expert financial advisors, Evercore, to provide advice and opinion to the Board of Thames Water Utilities Limited in relation to financeability of the company on an actual and notional basis. With regard to the actual company, Evercore has independently concluded that the company's business plan scenario is financeable, with an estimated credit rating of BBB+/Baa1 or above[9]. Evercore note that:

- "our financeability assessment is based on the rating agencies maintaining their current guidance and not altering their business/regulatory risk assessment;
- based on current guidance, the forecast credit ratios support an A3 rating with Moody's and a BBB+ rating with S&P for Class A bonds; and
- this in our view will enable TWUL to raise debt as required by the plan during AMP7."

3.9 In support of our financeability analysis of the business plan scenario, we undertake stress tests to assess its resilience to severe but plausible risks. For the actual capital structure, this takes the form of our long-term viability testing which comprises of a comprehensive assessment of a range of risk scenarios.

3.10 Our approach and assessment to these downside risk scenarios is set out as part of our assessment of financial resilience in the following section below.

[9] TW-DD-A18 – Financeability opinion of BP scenario

Section 4

Financial resilience

Approach to financial resilience assessment

4.1 We have assessed the financial resilience of our revised Business Plan scenario consisting of c. £10bn totex. In general, the same methodology outlined in our previous submission in April 2019 has been applied. Our analysis has been updated to reflect the updated totex scenario and corresponding ODIs.

4.2 Similar to before, various criteria have been used to assess financial resilience. This includes (1) sufficient liquidity (2) compliance with key financial covenants and (3) maintenance of investment grade rating (Moody's CFR and S&P Class A).

4.3 The assessment period of 10 years remains unchanged.

4.4 As with our latest Long Term Viability Statement in contained in our 2018/19 Annual Report (published in June 2019), financial resilience has been evaluated based on four combined downside scenarios.

Results of stress testing

4.5 Based on the below considerations, we believe Thames Water is financially resilient. This conclusion has been made assuming capital markets continue to operate under normal market conditions and that no renationalisation of the water sector takes place over the assessment period:

- Liquidity: We continue to believe we have sufficient funds to meet our funding requirements. This is underpinned by our existing £1.65bn RCF provided by our relationship banks and our proven ability to efficiently access debt capital markets. Furthermore, it is reasonable to assume that our relationship banks would carry on in their support of our liquidity facilities and other financing activities over the assessment period;
- Covenant compliance: our analysis shows that we are able to operate within the financial covenants for all four downside scenarios. Details of our analysis are contained in 'TW-DD-A17 – Downside scenario analysis'.
- Maintenance of investment grade – based on the analysis contained in 'TW-DD-A17 – Downside scenario analysis', we are able to maintain an investment grade rating (Moody's CF and S&P Class A) for all four downside scenarios.

Section 5

Tax inputs of the business plan scenario

5.1 We have made one adjustment to the tax inputs, compared to those previously presented in our April 2019 business plan.

5.2 In our capital structure, Thames Water Utilities Ltd has an intercompany loan (currently c.£1.75bn) owed to it from a Holding company. In our April 2019 business plan, we included a tax adjustment to ensure that there was no tax funding generated, associated with the intercompany loan interest income (c.£30m per year). This adjustment was made to lines 89 – 93 of data table App29.

5.3 Based on the Draft Determination financial models, we understand that the calculation of tax funding will be done using the fully notionalised version of the financial model.

5.4 Under the notionalised financial model, there is no intercompany loan, and therefore the tax adjustment to remove the tax effect of the intercompany loan interest income is not required.

5.5 We have therefore adjusted lines 89 – 93 of data table App29 in our resubmitted data tables, to exclude the intercompany loan interest adjustment.