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This is part of the Northumbrian Water Draft Determination Response

28th August 2024

Dear Ofwat

Northumbrian Water Financial Resilience Update in the context of the Draft Determination and the Northumbrian Water response.

As part of the draft determination, Ofwat requested six companies, including Northumbrian Water, to demonstrate how we have updated our assessment of financial resilience in the context of the draft determination.

"In addition, we are requesting six other companies – Affinity Water, Northumbrian Water, Portsmouth Water, SES Water, South Staffs Water and Yorkshire Water – to provide board assurance and supporting evidence to confirm and explain how they have assessed that they will maintain adequate levels of financial resilience in 2025-30.

We do not require these companies to provide financial resilience plans in response to the draft determinations, but we do require them to demonstrate how they have updated their assessment of financial resilience in the context of the draft determinations."
(DD R&R Appendix, p65)

Our financial analysis of the Draft Determination before mitigants

We have carried out financial resilience assessments for both the notional and actual company under the draft determination. In both cases, neither the notional nor the actual company are financeable for debt or equity under the draft determination.

This is due to:
1. The cash flow impact of in period costs that are only funded in PR29. These include business rates, energy costs and contingent or 'gated' investment.
2. The balance of risk to the downside. Under the DD package, we would expect to earn considerably less than the target cost of capital. Our expected loss for the DD ODI package is 0.9% of RORE, and there are further downside risks for costs.
3. The DD cost of capital is too low. The DD cost of debt excludes higher debt costs for 23/24 and 24/25 that, when included, increase it considerably. The DD cost of equity is too low to attract new equity in comparison with other sectors and investment alternatives.

In particular, the DD financeability testing shows that there are insufficient funds from operations in the DD to meet the rating agency interest cover thresholds for Baa2/BBB ratings. Note, these metrics cannot be easily resolved by additional equity - they require improvements to EBITDA (earnings before interest depreciation and amortization). As a result:

1. The notional and actual company would experience a credit rating downgrade to Baa3/BBB- due to the in period costs of business rates, energy costs and contingent capex.
2. This would fall below investment grade credit rating were the debt costs not increased from the draft determination levels of 2.84% real.
3. Further revenue reductions under the NWL DD p50 ODI package of £29m pa would reinforce this downgrade. The Moody's note[1] confirms the average return on equity would be 3% lower if companies performed in line with their business plan assumptions.

Table 1: Impacts on Notional Credit Ratings for Financeability: AICR analysis

Notional NWL	Average 25-30
Draft Determination Ofwat	**1.67**
Reduction in AICR	
Business Rates Changes	(0.16)
Additional power costs in RPEs	(0.20)
Contingent capex	(0.07)
ODIs (p50)	(0.25)
Higher debt costs than Ofwat DD WACC	(0.15)
Draft Determination NWL	**0.83**
Moody's thresholds	
Baa1/BBB+	**1.50**
Baa2/BBB	**1.30**
Baa3/BBB-	**1.00**

Our financial analysis of the Draft Determination post mitigations

We have carried out a financeability analysis based on our DD response, with specific adjustments for:

1. Including additional in period central revenue and RCV allowances for business rates, energy costs and the contingent capex.
2. Mitigation adjustments for ODIs to reduce the skewed downside RORE, along with similar adjustments for totex. This would bring expected returns towards the revised cost of capital in our DD response.
3. A higher cost of capital, using the CMA PR19 assumptions as updated for market data.

Once these adjustments are made, then both the notional and actual company become financeable. In particular:

[1] August Moody's Report page 8

- the notional company is able to maintain a stable credit rating of Baa1/BBB+ across the period to support debt financeability;
- the equity return is more comparable to alternative benchmarks giving confidence that the equity injections that the business needs will be available; and
- the package represents a symmetrical risk/return balance where equity investors have a 'fair bet' in earning their base return.

Full details of our views on financeability can be found in Chapter 4 - Financeability and Financial Resilience of the DD response.

AMP 8 equity injections

We have re-examined the equity requirements of the business based on the DD including the mitigations. With an injection of £400m of equity in 2025, we would expect the actual company to maintain an investment grade credit rating of Baa2/BBB, meeting the requirements of its licence, throughout the 2025-30 period.

Our shareholders set out their understanding of their obligations and a statement in respect of the financeability of the company in our Business Plan, and this remains unchanged. New equity has not been required to date and, given the concerns over the risk/return balance explained in Section 3 of our response, NWL's Board has decided to wait until after the Final Determination to understand the implications for the business.

All equity investors have choices about where they invest their capital and the market for that investment is global it will be essential for the risk and return balance to be fair and competitive to attract that investment. This issue is only elevated by the challenges with the external sentiment of the sector and the financial resilience of other companies.

Stress testing the Draft Determination

We have undertaken further stress testing of the DD (post mitigations)[2] focusing on the actual company. This stress testing is broadly consistent with the approach we use in our annual Long Term Viability Statement (LTVS) as published in our Annual Performance Report (APR).

The stress tests were assessed in the context of maintaining prudent investment grade credit ratings consistent with its Licence, and the Board's target of retaining regulatory gearing of around 70%. None of the stress test scenarios undermined the company's long term financial resilience. However, to the extent that any of the scenarios would place retention of NWL's investment grade credit rating or liquidity position at risk, the Board would seek to take mitigating actions consistent with those set out in the LTVS as published in our APR.

Conclusions

[2] Given that we cannot see how the current DD meets Ofwat's duties we consider that some movement in these areas at the FD is likely.

NORTHUMBRIAN WATER living water

The board has examined the financeability of the actual and notional company under the Draft Determinations. Under the DD response assumptions, including the mitigations we set out in our response, and with the equity restrictions removed, we can confirm that both the actual and notional company would be financeable.

Our financeability checks for both the DD and the DD response were carried out following the viability assessment process that we undertake annually in our APR..

Yours faithfully

Heidi Mottram
CEO, Northumbrian Water Limited