

# **Ofwat review of the financial position of Northumbrian Water Ltd**

## **Conclusion**

**July 2004**

## **Summary conclusion**

In our paper of 19 August 2003<sup>1</sup> we stated that we would review, in June 2004, the financial position of Northumbrian Water Limited (Northumbrian Water) following its acquisition by Aquavit plc (now renamed Northumbrian Water Group plc).

This review has been undertaken. We believe that Northumbrian Water has taken adequate steps to demonstrate to the market and to us that it has the ability to continue to finance itself into the future.

We remain concerned about the links between the debt guaranteed by Northumbrian Water and the non-guaranteed debt raised by its immediate parent company i.e. the 2006 bond which has a sub investment grade credit rating.

However the recent financial performance of the bond indicates a healthier credit quality than its current rating. The company believes the risk of default on this bond is remote and no immediate action is necessary.

We will continue to monitor this position. If the balance of risks changes to the detriment of customers, we would expect the company to remedy the position as a matter of priority.

In any event, the link between the unregulated debt and the bond guaranteed by Northumbrian Water will be eliminated in 2006 when the parent company bond matures. The company has confirmed that, in accordance with its licence, any new financial arrangements will not result in a link between debt guaranteed by the regulated entity and any debt raised for purposes other than the financing of the appointed business.

## **Background**

On 17 May 2003, Aquavit plc announced that it had agreed to purchase Northumbrian Water, a water and sewerage company regulated by Ofwat. Aquavit plc completed the acquisition on 23 May 2003 and changed its name to Northumbrian Water Group plc (NWG plc).

Following completion, Standard & Poor's confirmed a downgrade to the corporate credit rating of Northumbrian Water from A- to BBB, albeit with a stable outlook. Fitch Ratings announced a provisional credit rating of BBB+.

We consulted on the regulatory issues associated with the transaction on 10 June 2003<sup>2</sup> and set out respondents' views and our analysis in our position paper of 19 August 2003. There were concerns that, given its then credit ratings, Northumbrian Water might not readily be able to raise finance in the future. In addition there was a more general concern that a credit rating of BBB is not appropriate for water companies as a whole, largely because there

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<sup>1</sup> Completed acquisition of Northumbrian Water Limited: A position paper by Ofwat

<sup>2</sup> Completed acquisition of Northumbrian Water Limited: A consultation paper by Ofwat

is an expectation that these companies will continue to be required to finance substantial capital expenditure in the foreseeable future.

However, Northumbrian Water appeared at the time to have sufficient cashflows to support its debt and the regulated company had informed us that it had no need to raise money via the debt market until after the current price review<sup>3</sup>. In addition, the company believed that the successful syndication of its loans indicated the debt market's appetite to invest in the company.

In our position paper in August 2003 we explained that it seemed unlikely that any immediate regulatory action, at least on its own, would benefit customers materially or achieve an early improvement in the credit rating of Northumbrian Water. We took account then of the views taken by the credit rating agencies including the "stable" outlook assessment that Standard & Poor's attached to Northumbrian Water's credit rating.

The company explained its commitment to review a number of options that might improve its credit quality and financial position. These options included:

- raising debt against the revenues generated by Kielder reservoir (a non-regulated asset) and using the proceeds to repay existing debt guaranteed against the shares of Northumbrian Water; and
- obtaining from the European Investment Bank (EIB) a waiver to its right to redeem its then loans (amounting to £376 million) on any change of ownership of Northumbrian Water.

We also raised concerns about the fact that the credit ratings of Northumbrian Water reflect the cash flows required to service all of the NWG plc debt i.e. they take account of the debt held outside the regulatory ring-fence. This includes two parent company bonds, a £200 million bond repayable in 2006 and a £350 million bond repayable in 2023 although the latter is guaranteed by and the proceeds passed through to the regulated business.

The proceeds from the 2006 bond were not used by the regulated business, but its holders are many of the same institutions that hold the 2023 bond. Furthermore, in the event of default on the 2006 bond, the 2023 bond may become repayable and hence the two are linked. Shortly after the acquisition, Standard & Poor's downgraded the credit rating of the 2006 bond by three notches to BB+. Fitch Ratings announced a provisional credit rating of BBB- for this bond.

The links between these bonds weakens the ring fence around Northumbrian Water and in our position paper we stated that we expected the company to take all reasonable steps to break the links between the debt guaranteed by the regulated entity and the non-guaranteed debt raised by the parent company.

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<sup>3</sup> Price limits will be determined in December 2004 for the period 2005-10

We stated that we would review the overall situation in June 2004 to see if Northumbrian Water was able to demonstrate to the market and to Ofwat that it had the ability to continue to finance itself into the future. We regarded this as a matter of priority for the company.

### **Progress since August 2003**

Since that time the company has completed the securitisation of the cash flows received from the Environment Agency in respect of its Kielder operating agreement. The net proceeds of £212 million have been used to refinance the remaining short-term debt advanced at the time of NWG plc's flotation last May.

In addition, Northumbrian Water's successful application for an interim determination last December led to a 10% real increase in its price limits for the year from April 2004, with a consequent improvement in cash flows.

These actions and outcomes have had a positive impact on Northumbrian Water's credit quality. Moody's (who had not previously rated the company), has rated the company at Baa1 (equivalent to BBB+). Standard and Poor's have not changed their rating (they consider there is general uncertainty in the sector due to the current regulatory review of future price limits). However, they have changed their outlook on the rating to positive. Fitch Ratings' credit rating was confirmed at BBB+.

EIB has reviewed the terms of its facilities with Northumbrian Water in the context of the recent credit rating reviews. As a consequence, the existing EIB loans will remain in place. Consequently, NWG plc is now in a position to cancel the remainder of the back-up facilities put in place at the time of the acquisition.

Northumbrian Water has been considering the issue of the link between the debt guaranteed by the regulated entity and the non-guaranteed debt raised by the parent company. Any means of removing the link may have associated costs and should be considered in context of the default risk of the 2006 bond. The performance of the 2006 bond has improved markedly over the last few months, indicating credit quality better than its current BB+ rating.

The company believes that the default risk of the 2006 bond is remote given:

- the improvement to its cash flows;
- the improved performance of the 2006 bond; and
- the removal of the subordination to the 2006 bond, now that the syndication facilities have been cancelled.

Therefore Northumbrian Water's view is that no immediate action is necessary and that the issue of the cross default could be dealt with when the 2006 bond matures and is refinanced.

In our August 2003 position paper, we committed to modify the licence of Northumbrian Water to bring the regulatory ring fencing up to the current standard. These modifications have now been made.

### **Conclusion**

We believe that the company has taken adequate steps to demonstrate to the market and to us that it has the ability to continue to finance itself into the future.

However the company must continue to consider the appropriate balance between default risk and any cost of eliminating the link between the external unregulated debt and the bond guaranteed by Northumbrian Water.

Clearly, the better the credit quality of the 2006 bond, then the lower the risk of default. However, the credit rating of the 2006 bond remains at BB+. The performance of the bonds, including the 2006 bond, since August, indicates healthier credit quality than the current ratings. This is encouraging, but not conclusive.

The link between the unregulated debt and the bond guaranteed by Northumbrian Water will be eliminated in 2006 when the parent company bond matures. The company has confirmed that, in accordance with its licence, any new financial arrangements will not result in a link between debt guaranteed by the regulated entity and any debt raised for purposes other than the financing of the appointed business.

In the meantime, we will keep the balance of risk to customers and the cost of remedy to the company under review. If at any time before the 2006 bond matured, we concluded that this balance had changed to the detriment of customers, we would expect the company to remedy the position as a matter of priority.