Market Profile: The water market in England and Wales to 2020

What's powering the switch to AMP6?

The current price review in the UK water sector will mark significant changes to the way in which water companies invest in and operate their assets. A new report from GWI investigates the opportunities and risks.

The conclusion of the current price review process (PR14) in December this year will open a fresh window of opportunity for suppliers looking to sell into a new £40 billion spending wave in the UK water market.

PR14 also marks an important transition for those involved in financing the industry, where a lower weighted average cost of capital (WACC) has clear potential to affect financial returns.

New regulatory landscape

The current periodic review has introduced some substantial changes to the regulatory landscape, which will prove especially challenging against the backdrop of pressure on tariffs: all but two of the eighteen regulated water companies in England and Wales are promising that their customers' bills will fall in real terms during the next five-year Asset Management Plan (AMP6), which runs from April 2015 to March 2020.

Despite this, the switch to a total expenditure (totex) regulatory perspective, rather than the traditional separation of capex and opex, as well as a focus on 'outcomes' in favour of 'outputs', points to a less prescriptive approach from the economic regulator, Ofwat, and will allow water companies to think in a much broader way about complying with European directives on water quality. This will provide challenges for the supply chain, as well as wide-ranging opportunities.

Opportunities for technology suppliers

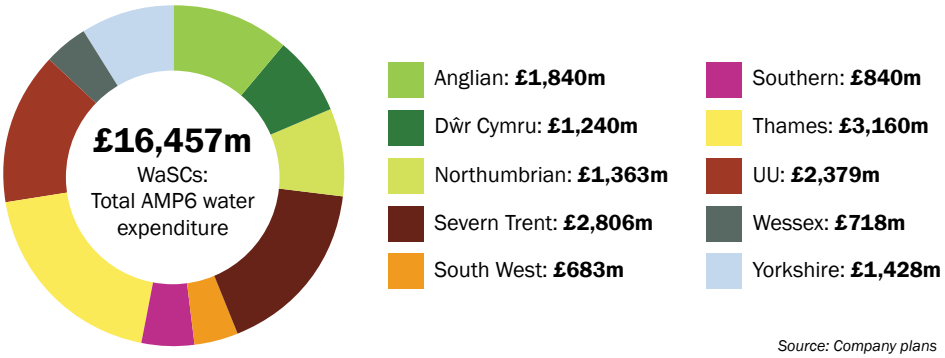
Although engagement with Ofwat is ongoing, the water companies are planning collective totex of nearly £41 billion during AMP6 (although United Utilities proposed on 27 June to exclude around £1.1 billion of previously planned AMP6 expenditure from the totex modelling regime). £19.9 billion of the industry total will go towards wholesale water, while nearly £21 billion will be spent on wastewater treatment and conveyance. For the ten water and sewerage companies (WaSCs), planned water and wastewater expenditure amounts to £37.4 billion (*see charts above*), clearly demonstrating that these should be the focus of suppliers selling into the market. The three companies with the highest forecast expenditure are: Thames Water (£7 billion, of which 55% will be spent on wastewater, excluding the Thames Tideway Tunnel interface costs), United Utilities (£6 billion; 60% wastewater) and Severn Trent (£5.5 billion; 51% water).

Inclusive of the water-only companies (WoCs), the highest portion of water expenditure in the sector will go towards maintaining and improving the distribution system (49%). Along with total wholesale water expenditure, GWI expects total spend on this to peak in 2017/18, at a little over £2 billion, with water treatment spend peaking in 2018/19 at £1.3 billion. Ultraviolet disinfection is increasingly being favoured as the choice of treatment to combat cryptosporidium.

On the wastewater side, total expenditure on maintaining and enhancing wastewater treatment standards is expected to accelerate over the AMP6 period, going from £1.6 billion – a 42% share of expenditure in 2015/16 – to reach a peak spend of over £2.1 billion in 2019/20, which will account for almost 50% of wastewater spending. Ammonia and phosphorus reduction requirements, as well as more stringent standards for the European Bathing Water Directive, which are due to come into force in 2015, are driving the need to upgrade treatment processes, where UV will be the preferred option to add onto a conventional treatment train.

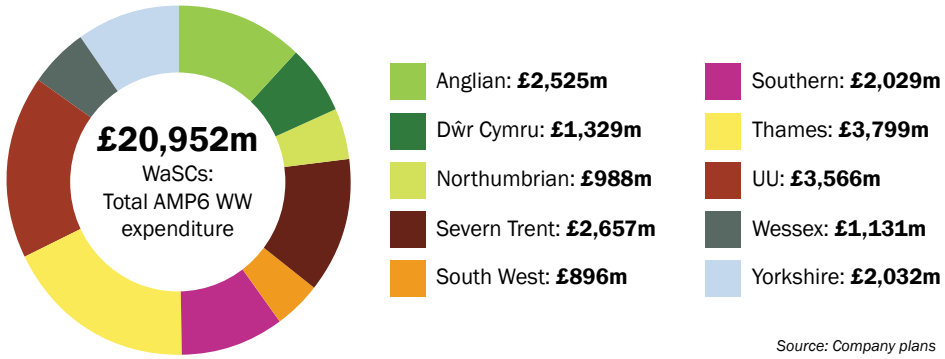
Though there will be historically less in the way of new-build infrastructure during the period, major WWTP upgrades are

UK water & sewerage companies' wholesale water expenditure (2015-2020)



Source: Company plans

UK water & sewerage companies' wholesale WW expenditure (2015-2020)



Source: Company plans

taking place, notably at Thames Water's Deephams WWTP, and United Utilities' Davyhulme plant.

Optimising assets

Coupled with the need to comply with legislation, the regulatory pressure being exerted by Ofwat will mean water companies need to be increasingly efficient and operate current infrastructure in the most optimal way.

Optimising the asset base – as well as reducing the risk profile of assets – is a key theme for AMP6. Water companies are increasingly looking for suppliers of control and automation products, as well as advanced analytical services to process and interpret vast swathes of data in order to manage assets in real time in the most effective way. Technologies to identify and reduce leakage will also be in demand, with water companies increasingly being encouraged to turn away from simply replacing a whole pipe, and move towards a replacing critical sections and monitoring the remainder to avoid future bursts.

Another source of value for water companies is expected to come from maintenance provision-type contractors that are more oriented towards offering a service across the whole life of a project. The ability to provide repair and maintenance services as well as managing these activities in a cost-effective way could stand suppliers to the industry in good stead. With an increase in capital maintenance and smaller, more numerous projects expected in AMP6, there could be an opportunity for players further down the supply chain to undertake small new-builds, albeit largely those with a low level of complexity. Due to the substantial overheads that Tier 1 contractors have, on occasion there is little added value for them to undertake a small project, meaning the water companies might have an extra incentive to turn to Tier 2s.

Water & sewerage companies' financing requirements during AMP6

Company	Refinancing (£m)	Net new debt (£m)	Total (£m)
Anglian Water	720	1,000	1,720
Dŵr Cymru	240	220	460
Northumbrian Water	530	410	940
Severn Trent	1,300	1,300	2,600
Southern Water	380	790	1,170
South West Water	N/A	N/A	N/A
Thames Water	1,040	1,670	2,710
United Utilities	1,100	1,500	2,600
Wessex Water	130	350	480
Yorkshire Water	700	580	1,280

Source: Moody's

In order to encourage efficiencies and find the best solutions for outcomes – as well as smoothing out the historical peaks and troughs in capital spending that have dogged past AMP periods – there is a new trend emerging in water company delivery models. As a rule, there is going to be greater collaboration between water companies and their Tier 1 contractors and equipment suppliers, with the latter two involved at an increasingly early stage, sometimes through an alliance. The main proponent of this is Thames Water, which set up its eight2O alliance in May 2013 to help define its business plan and open the door for all suppliers at an early stage to work towards best solutions.

Risks for investors

To respect the regulatory framework and meet the targets set by Ofwat, water companies will continue to need to rely heavily on ongoing access to the wholesale capital markets. Against this, however, Ofwat has recommended that the industry's WACC – its allowed rate of return – for the AMP6 period between 2015 and 2020 should be 3.85% (compared to the 5.1% allowed in the AMP5 period).

In terms of overall borrowing in AMP6, company business plans point to a total requirement of £14–15 billion at the WaSCs to refinance existing debt that is due to roll over during the period, and to meet new capital spending obligations (*see table above*).

Despite rising regulatory capital values, a dramatic increase in indebtedness has contributed to a decline in credit ratings across the sector over the last 20 years , and any significant further decline could be potentially costly in terms of the margins at which companies can raise new debt.

With a significant proportion of the industry's equity in private equity hands, water companies in England and Wales will also need to continue to demonstrate their ability to pay dividends (the sector paid out a total of £37 billion in regular and special dividends between 1990 and 2013). Ofwat's suggestion of a sub-4% WACC is expected to reduce returns significantly, and may oblige companies to cut dividends in order to maintain their current credit ratings.

Dividend payments are also a vital source of revenue to service debt incurred at the holding company level. If the ability to service high-interest debt is jeopardised, this could potentially lead to insolvency at one or more of the holding companies, although this is not Ofwat's direct concern, given the regulatory ring-fence that exists around the utility businesses.

A further risk for the sector may arise from Ofwat's decision to set a retail price control based on an average cost to serve (ACTS). The move threatens to penalise companies that have above-average costs to serve, as a consequence of geographical and/or demographic factors. The problem is particularly acute for companies operating in large areas of urban deprivation, such as United Utilities.

● The GWI Analysts' report *Water in England and Wales to 2020 – Risks and opportunities in the AMP6 investment period* is available now, priced at £1,200/$2,185. For details on how to order, contact Chantal Marchesi at cmarchesi@globalwaterintel.com.

Credit ratings history of the English and Welsh water sector (1991-2013)