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Business and financial risk implications need to be considered before legislative or regulatory changes are implemented, as adverse changes might trigger covenant breaches in the sector’s financing arrangements.

Early legislation affecting the sector could unravel companies’ financing arrangements. Consequently, significant changes to the industry structure, such as envisaged under our hypothetical scenario 3, will likely require complex negotiations between companies and their investors before they can be implemented in the context of the existing financing arrangements. Alternatively, they may lead to material refinancing requirements.

Varied exposure
Incumbents’ exposure to upstream reform will vary. Companies with a higher proportion of their assets or costs as

more on groundwater) increases their exposure. Of the WOCs, Affinity and Bristol have a comparably high proportion of assets linked to water resources, and could therefore also be exposed.

On top of that, companies’ asset age, asset condition, level of interconnectivity and geographical location will drive risk exposure. Moody’s found: “Areas of water stress and existing or future high population density may attract more entrants to provide additional resources and treatment capacity. While this could expose companies serving the south and east of England, a number of these companies currently do not have a high proportion of their assets and costs allocated to potentially competitive activities. Their exposure will therefore also depend on how the access for new entrants is defined.

“Combining geographical needs and asset/cost allocation, we could see increased risk for Affinity Water and Bristol Water on the water resources and treatment side, while Southern Water and South West Water could be exposed if sewage treatment activities were to become competitive and the areas served by these companies attractive to new entrants.”

Financing structures are of course relevant too, with highly-leveraged firms more exposed to the evolving reform process. These companies have both restrictive financing structures and less flexibility to accommodate downside scenarios. “If existing debt providers were unwilling to support changes to the structure that are legally required, repayment of the debt could be necessary,” noted Moody’s.

The agency concluded: “In summary, the sector’s credit quality will likely become less homogeneous and direct comparison across companies more challenging.”

Outlook
The sector waits for Ofwat’s December Water 2020 proposals with bated breath. Baker’s take is that sludge liberalisation could be “fullest and fastest”, though even here there are multiple hurdles to address. He foresees more water trading will be fostered, with potentially more providers and open procurement of new capacity in the 2020s. He suggested sewage was not suited to trade or unbundling and that in this part of the value chain “new sewage treatment works provision auctions look to be the limit”. In the round, Baker said he expected “costs to militate against more radical solutions” which will no doubt come as music to the ears of many.

Moody’s concluded: “To implement upstream reform while maintaining the sector’s historic access to low-cost and long-term funding, it will be important that all parties, including investors, are engaged within the debate and understand the rationale for any changes. Investors may decide whether or not to support reform depending on their understanding of the ultimate outcome as well as their appetite for the resulting risk profile in the context of available returns.

“Importantly, business and financial risk implications need to be considered before legislative or regulatory changes are implemented, as adverse changes might trigger covenant breaches in the sector’s financing arrangements.”

NERA’s Baker remarked: “It would be “hard for there to be less” competition in the water sector than at present. This is despite the fact that the Water Act 2003 provided a framework for upstream competition. United Utilities’ Mogford put this down to four main factors: a pricing framework which has lacked transparency and in many cases would not have enabled an efficient competitor to enter the market; a regulatory framework which incentivised companies to invest in their own supplies rather than deal with deficits through water trading; uncertainty about the gains from investigating the potential for selling water; and the economics of the water industry, including high transport costs and limited availability of new resources.

However, faced with a the supply/demand challenge resulting from the twin pressures of climate change and population growth, the government believes competition in upstream activities could help by promoting more efficient use of a scarce resource and more innovation.

In evaluating whether markets should be promoted, Mogford said benefits must exceed costs.

Economic consultancy Oxera has compared potential upstream competition in water against parallels in other sectors including energy, communications and rail. Benchmarking in this way, Craig Lonie, partner at Oxera, said: “the benefits in water are just as big, but the challenges are greater due to a cocktail of circumstances”. In economic terms, the upstream activities in water are comparable with those of other competitive industries. In the cocktail though are the RCV allocation issue, the fact that water is heavy and difficult to move, and that asset lives in the industry tend to be long.

Lonie said Oxera’s observation for Ofwat was: “To establish net benefit, it should focus its efforts in areas where benefits are near term and obvious – water trading or new build where there is a supply imbalance or assets have expired.” Oxera added: “Similarly, sludge treatment and disposal activities might be more conducive to competition in the short- to medium-term as there are likely to be fewer interoperability issues and asset lives tend to be shorter.”