UK Water – Making Waves

By Nigel Hawkins

Executive summary

UK Water – making waves

- Over the past year, UK utility share prices have been volatile, especially within the electricity sub-sector. The combination of the war in Ukraine and the associated impact of fluctuating gas prices, along with sharply higher inflation and the consequential rise in interest rates, have destabilised much of the sector. Indeed, most sector constituents have seen their share pieces fall (although not seriously), while Centrica, the UK's leading gas company, has bucked the trend, with a near 50% rise over the past year, albeit from a very low base.

- The two largest quoted water companies have announced their full-year results in recent days (the announcement of Pennon's full-year results post-dates the compilation of this publication). The results of the two leading water stocks, Severn Trent and United Utilities, contained few surprises; but the latter's revenues fell by over 2%. The impact of surging inflation has seen a sharp spike in those interest payments associated with index-linked bonds, a funding mechanism to which United Utilities, in particular, is exposed; consequently, its adjusted EPS for 2022/23 was negative.

- Considerable interest also focused on two specific sector issues that have generated extensive media coverage of late: first, leakage levels, although still too high, are at least falling; secondly, the water sector generally is – eventually – recognising the controversy surrounding storm overflow issues. Disposing of untreated sewage into rivers is intended to be a concession in quite exceptional cases, but, in recent years, it has become commonplace, and Ofwat is adamant that, given the environmental harm that it undoubtedly causes, especially to water quality, such a situation cannot continue.

- At the financial level, the lead-up to AMP8 is well under way, with business plans for the five-year regulatory period – beginning in April 2025 – being drafted. It seems clear that a substantial increase in capital expenditure will be prescribed; how this will be financed, given the pronounced impact on consumer bills, is far from clear.

- As expected, full-year dividends for Severn Trent and United Utilities rose – both by 4.6%. These annual dividend increases are linked to movements in CPIH. As inflation falls, future dividend increases, despite the time lag, are expected to be pared back in nominal terms.

- In terms of share price movements over the last five years, those of Severn Trent and United Utilities have risen by 38% and 29%, respectively. Both were "safe havens" for investors during the COVID-19 period, when many cyclical stocks plunged. By contrast, despite its rally, Centrica's share price is down by almost 20% since late May 2018.

Background

The rush to private equity

In 1989, the 10 largest water and sewerage companies in England and Wales were privatised; however, the water sector in Scotland was excluded from this process, and remains – to this day – publicly owned. Only three of the original 10 privatised companies – Pennon, Severn Trent and United Utilities – retain a public quotation.

Over the near 34-year intervening period, a heavy capital expenditure programme has been undertaken by the sector. Consequently, net debt figures have risen very sharply, especially for the many privatised companies that are now owned by private equity interests. In the case of Thames Water, for example, net debt at September 2022 exceeded £13.7bn.

AMP8 and the prescribed WACC

Every five years, price controls for the sector are set by Ofwat; the next review, AMP8, will be implemented in April 2025. The allowed capital expenditure figures and the Weighted Average Cost of Capital (WACC) will, as always, be pivotal. Valuations will also be driven by dividend growth expectations that may give rise to greater involvement by Ofwat, especially under a changed political environment.

Latest results

Revenue growth disparities

Although the announcement of Pennon's 2022/23 full-year results post-dates the compilation of this publication, both Severn Trent and United Utilities – the two FTSE-100 stocks in the sector – recently announced their full-year results for 2022/23. There were no major surprises, although United Utilities' 2022/23 revenues fell by 2.1% when compared with 2021/22; Severn Trent, by contrast, reported that its 2022/23 regulatory revenues were up by over 10% when set alongside its 2021/22 figure.

The pronounced downside of index-linked bonds

However, the impact of using index-linked bonds as an integral element of their funding policy was clearly demonstrated, with the double-digit inflation that the UK has experienced – until very recently – having a major negative impact. There are, though, substantial offsets via the inflation-linked consumer price formula and tax savings.

United Utilities' near £541m index-linked finance expense at a 10%+ premium on the 2.2% effective interest rate on its other debt

United Utilities was particularly exposed in this respect, with a finance expense of over £541m on its index-linked debt. United Utilities confirmed, too, that its effective interest rate on its index-linked debt was 12.4%, a premium of over 10% on the 2.2% effective interest rate on its other debt. As a result, its 2022/23 adjusted EPS was negative.

Severn Trent's index-linked debt exposure is considerably less, with just 28% of its £7.2bn net debt being index-linked; 67% is fixed and 5% is floating.

Falling inflation should markedly lower finance expenses for index-linked bonds

Of course, with sharply declining inflation, these payments should fall appreciably, but they do illustrate the adverse impact that high inflation can have when index-linked debt instruments are widely deployed.

Further capex rises

Looking forward, capital expenditure projections for the sector will remain key, especially during the AMP8 period, beginning in April 2025. In the short term, Severn Trent's figures indicated continued upward momentum in terms of investment. In 2022/23, a figure of £737m was reported. For 2023/24, Severn Trent has "flagged" a rise to between £850m and £1bn – a pronounced increase.

Industry issues

Aside from AMP8, two industry issues continue to be widely debated, by both politicians, at a general level, and by industry experts.

Leakage, leakage, leakage – Ofwat eventually gets tougher

First, the leakage issue remains an abiding concern for the sector. To be sure, the figure is coming down, but from a very high base, given the low priority accorded to this issue by Ofwat since privatisation in 1989. In Severn Trent's case, it is on track to meet its target of a 15% decrease by 2025 (over the 2020 figure). In the long term, a 50% cut by 2045 is envisaged. In United Utilities' case, its leakage figures have fallen by ca.6% since 2020; this trend is expected to continue.

Ofwat is assessing South West's and Dwr Cymru's leakage data

It should be added that Ofwat has recently announced that it is reviewing the accuracy of the leakage figures submitted by both South West, part of the Pennon Group, and by Dwr Cymru.

The storm overflow concession – not designed for everyday use

Secondly, there has been considerable media interest in storm overflow levels. Previously, untreated sewage was allowed to be discharged to rivers in exceptional circumstances, such as in a "flash-flood" situation. In recent years, though, this concession has been abused, with regular such disposals. Consequently, environmental concerns have been raised, especially with regard to preserving water quality levels.

Ofwat has recognised the importance of this issue. Not only has it tightened the monitoring requirements undertaken by the companies, but it has also confirmed that storm overflow projects will become a more integral part of the AMP8 process than has been the case to date.

Investor returns

Reliable dividends in recent years – in marked contrast to Shell's 66% cut

Compared with other quoted utility stocks, shares in both Severn Trent and United Utilities have been relatively stable in recent years. As might be expected, given their assured revenues, they performed very robustly during the COVID-19 pandemic, as many growth-orientated stocks seriously struggled. And their dividend payments were more reliable than those of most other stocks during the pandemic – compare this with Shell's 66% dividend cut in 2020, its first since the end of World War 2 in 1945.

Shareholder expectations met – even during COVID-19

As such, over a five-year period, dating back to late May 2018, both Severn Trent and United Utilities have met shareholder expectations, with share price increases, as noted earlier, of 38% and 29%, respectively. Of course, the post-pandemic recovery in more cyclical stocks has seen some underperformance. Indeed, this scenario may be repeated if adverse political trends affect the sector.

General Election permutations

A General Election is widely expected in late 2024, and a change of government – whether a majority or minority Labour government, or an official Labour/Liberal Democrat Coalition – is a real possibility. While renationalisation is an unlikely scenario, enhanced intervention in the level of dividend payments, or even changes to ownership requirements, are certainly possible.

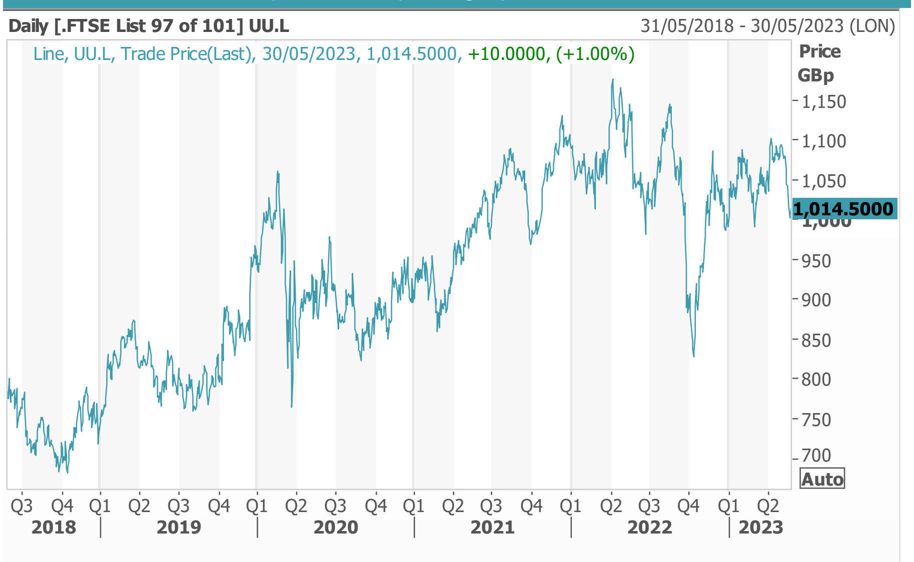
Increased volatility going forward

The two graphs below show how the share prices of Severn Trent and United utilities have performed over the last five years. Given the current political situation, and the lead-up to AMP8 and Ofwat's final determination in December 2024, more – rather than less – volatility should be expected.

Severn Trent – five-year share price graph

Source: Hardman & Co Research

United Utilities – five-year share price graph



Source: Hardman & Co Research

Conclusion

Challenges afoot

As solid defensive stocks, Severn Trent and United Utilities have undoubtedly met investor expectations in recent years. However, over the next two years, major challenges await. They include AMP8, Ofwat's prescribed – and pivotal – WACC figure, as from April 2025, fluctuating interest rates and what may prove to be a very contentious General Election.

The water sector is unlikely to lack challenges on several fronts.

About the author

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Nigel Hawkins is the Infrastructure and Renewables Specialist at Hardman & Co.

Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, in both the UK and overseas, about which he has written several reports assessing the sector's finances. He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe. He has also written many feature articles for Utility Week magazine since the mid-1990s. Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham, and is a senior fellow of the Adam Smith Institute.

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