SES WATER

APPENDIX SES115

EXTERNAL ASSURANCE - NERA

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Board of Directors
SES Water

NERA Assurance Letter on Financeability and Financial Resilience of the PR24 DD response

Dear Sir or Madam

SES Water ("SESW") requested NERA to provide assurance in relation to its financeability over PR24, including a review of its actual financial models prepared for SESW's response to Ofwat's PR24 Draft Determination (DD) and assessment of its financeability and financial resilience over PR24.

This letter summarises our scope of work, our findings, and our opinion on SESW's actual financeability and financial resilience over PR24.

1. Scope of Work

Our review covered the following work items:

- **Item 1:** Review and verification of the results of the financeability and financial resilience modelling undertaken by SESW, and subsequent assessment of its financeability and financial resilience on an actual basis, drawing on SESW's actual financial model.
- **Item 2:** In addition, we have reviewed and verified the results of SESW's notional financeability, drawing on SESW's completed PR24 notional model.
- **Item 3:** Review of 3 SESW's PR19 reconciliation models which result in adjustments to SESW's RCV. These adjustments are inputs to the PR24 financial models.

Our completion of these work items relied on our knowledge of Ofwat's regulatory calculations, gained through our work on financial modelling and financial issues at successive reviews and due diligence assignments, including assurance for SESW's PR24 business plan.

The next sections summarise our findings for each of the work items set out above.

2. Assessment of Financeability and Financial Resilience

In this section, we assess whether SESW achieves an investment grade credit rating and complies with SESW's bond covenants on an actual basis.

2.1. SESW's Assumptions on RCV run-off and PAYG

As explained in SESW's response to Ofwat's DD, in its PR24 business plan SESW proposed an RCV run-off rate of 7 per cent, broadly consistent with the rate allowed by Ofwat at PR19. In its PR24 DD, Ofwat has instead adopted a run-off rate of 4.5 per cent for SESW water resources (WR) price control and a rate of 4.15 per cent for water networks plus (WNP) price control. Ofwat's rationale for adopting these levels is to ensure consistency with Ofwat's view of asset lives and ensure that SESW does not recover the costs of service improvements from current consumers.[1]

SESW considers that Ofwat's intervention on the RCV run-off is not justified. SESW explains that its RCV run-off is relatively high compared to Ofwat's proposed intervention and the wider sector because SESW's PAYG excludes the costs associated with infrastructure renewal expenditure (IRE) with such costs instead recovered through the RCV run-off rate.

Alternatively, if SESW were to adopt a (lower) RCV run-off that did not allow for the recovery of IRE, then it would correspondingly need to increase the PAYG rate.

In other words, when the RCV run-off of 7 per cent is considered jointly with the PAYG rate, SESW recovers the costs of maintaining the current asset base and levels of service. By contrast, Ofwat's proposed RCV run-off rate would lead to insufficient costs being recovered from current customers to maintain the asset base, to the detriment of future customers.

SESW's plan therefore retains its an RCV run-off rate of 7 per cent and its proposed pay-as-you-go (PAYG) based on the natural rate, and this is the basis for our assessment of its financeability. Alternatively, SESW has also identified an alternative scenario where its PAYG rate includes the recovery of IRE, with a correspondingly lower RCV run-off rate of 5 per cent, where the RCV run-off rate is determined to allow for the same level of revenue. As the alternative scenario provides for the same level of revenues, the implications for financeability are unchanged and our conclusions on actual financability are the same.[2]

2.2. Actual Financeability

We assess financeability on an actual basis, using SESW's actual gearing and debt costs as projected in its financial model over PR24. SESW also considers a suite of downside scenarios, based on a modified version of the scenarios that Ofwat previously prescribed in its Final Methodology, such as totex underperformance (10 per cent of totex); or ODI penalty (3 per cent of RoRE) in one year.[3]

In line with Ofwat's guidance, we assess financeability with reference to target credit ratings, using the methodology used by Moody's and S&P.[4]

In addition, we assess the financeability of SESW against the financial covenants it faces on its senior secured bond. Compliance with the financial covenants requires SESW to achieve gearing of at most 80 per cent, an interest cover ratio (ICR) of at least 1.3x.[5]

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1 Ofwat (2024) PR24 Draft Determinations, Aligning Risk and Return, Appendix 1, p. 46. Link: https://www.ofwat.gov.uk/wp-content/uploads/2024/07/PR24-draft-determinations-Aligning-Risk-and-Return-Appendix-1.pdf

2 In the alternative scenario, total revenues remain the same as in the base case; however, the revenue profiling over the years differs. This means that while the ratio results may vary in any given year, the average ratios over PR24 remain consistent with those in the base case. Moreover, the alternative case does not involve any significant worsening in ratios in any given year relative to the base case. Consequently, the conclusions regarding financeability are unchanged.

3 Ofwat (December 2022), PR24 final methodology, Appendix 10 – Aligning risk and return, p.59.

4 Moody's and S&P are the two credit rating agencies covering SESW and hence we have applied their methodologies to assess the financeability of SESW.

5 Based on information from SESW.

Moody's

As part of our model review, we have reviewed the Moody's scorecard functionality in the SESW actual financial model against the latest (i.e., August 2023) rating methodology published by Moody's.[6]

Table 2.1 summarises Moody's scorecard approach to calculating the overall credit rating based on different sub-factors and sets out SESW's modelled sub-factor ratings over PR24. The table shows the five financial ratios considered by Moody's (i.e., Capex/RCV, AICR, Gearing, FFO/Net debt, RCF/Net debt) calculated assuming SESW's actual financial structure and allowed revenues as per its PR24 business plan submission. Combining these credit ratio scores with the qualitative factor scores Moody's assigned to SESW in its latest ratings report,[7] implies an overall credit rating of Baa2 over PR24 on average based on the actual financing structure, as shown in Table 2.1. The overall credit rating score of 9.0 implies a strong Baa2 rating, only slightly below the threshold required for a Baa1 rating (and indeed a Baa1 rating is achieved in Year 2 of PR24, as set out in Table 2.2).

[6] Moody's Investor Service (18 August 2023), Regulated Water Utilities Rating Methodology.

[7] As reported in SES_Model_v.3.21_Base (1).xlsm, sheet "Moody's scorecard".

Table 2.1: We calculate a Baa2 credit rating from Moody's for PR24 assuming SESW actual financial structure and its PR24 business plan

Category	Ratio result	Rating	Numerical Score	Penalty	Total Score
Factor 1: Business Profile (50%)					
Stability and Predictability of Reg. Env't (15%)	-	Aa	3	1	0.33
Asset Ownership Model (5%)	-	Aa	3	1	0.11
Cost and Investment Recovery (15%)	-	A	6	1	0.66
Revenue Risk (5%)	-	Aa	3	1	0.11
Scale and Complexity of Cap. Programme, i.e., Capex / RCV (10%)	9.9%	Baa	9	1.15	0.76
Factor 2: Financial Policy (10%)					
Financial Policy (10%)	-	Ba	12	2	1.76
Factor 3: Leverage and Coverage (40%)					
AICR (12.5%)	1.38	Ba	12	2	2.20
Gearing (10%)	75.0%	Ba	12	2	1.76
FFO/Net debt (12.5%)	11.1%	Baa	9	1.15	0.95
RCF/Net Debt (5%)	9.4%	Baa	9	1.15	0.38
Total Moody's Grid Score & Implied Rating		**Baa2**			**9.00**

Source: NERA analysis of SESW actual PR24 financial model.

As shown in Table 2.2, SESW's plan implies a slight deterioration of ratios over PR24, with AICR decreasing to 1.26 and Gearing increasing to 77 per cent by the end of PR24. A minimum investment grade rating of at least Baa2 is nevertheless retained throughout PR24.

Table 2.2: Moody's ratios slightly deteriorate by end of PR24, but Baa2 investment grade rating is retained throughout PR24

	2026	2027	2028	2029	2030
AICR	1.38	1.54	1.36	1.36	1.26
Gearing	72.3%	73.3%	75.5%	76.5%	77.2%
Overall rating	Baa2	Baa1	Baa2	Baa2	Baa2

Source: NERA analysis of SESW actual PR24 financial model.

S&P

We have also assessed the financeability of SESW's plan against the rating methodology applied by S&P. S&P assesses companies' credit rating along two dimensions: First, it considers its Business Risk profile which it determines through an assessment of country risk, industry risk, and the competitive position of the company. Second, it considers the Financial Risk profile of the company, for which it considers a range of financial ratios including the "core ratios" FFO/debt and debt/EBIDTA and "supplementary ratios" which include FFO/cash interest, EBITDA/interest, and others.

We understand that S&P's latest (November 2022) rating report for SESW reports its Business Risk profile as "Excellent", which is the highest possible score from S&P.[8]

Table 2.3 below sets out the ratios that go into S&P's assessment of the Financial risk, calculated assuming SESW's actual financial structure. Unlike Moody's, S&P does not have a prescribed approach of combining the different financial ratios in a final score for its Financial risk assessment. We understand that S&P focusses primarily on the "core ratios" FFO/debt and debt/EBITDA to determine companies' Financial risk profile. Although it focuses on these two ratios, our experience is that S&P tends to place greater weighting on FFO/debt in the case of water companies. We calculate an FFO/debt ratio of 9.3 per cent and a debt/EBITDA ratio of 6.3x on average over PR24, which supports a "Significant" to "Aggressive" / "Highly leveraged" financial risk profile for the actually financed SESW based on S&P's methodology.[9]

Table 2.3: Key S&P ratio FFO/debt supports "Significant" Financial risk profile for actually financed SESW

	PR24 average	S&P assessment
Core ratios		
FFO/debt	9.3%	Significant
Debt/EBITDA	6.3x	Aggressive / Highly leveraged

Source: NERA analysis of SESW actual PR24 financial model.

Combining an "Excellent" Business risk profile and "Significant" to "Aggressive"/"Highly leveraged" Financial risk profile supports an overall a- to bbb-/bb+ rating on average over PR24 from S&P based on its rating matrix.[10] We understand that in the case of water utilities S&P typically places greater weight on FFO/debt which would support a "Significant" Financial risk profile and an overall a- rating from S&P. We also note that the debt/EBITDA ratio remains stronger than a threshold of 9x that S&P mentioned could result in a downgrade to SESW's current BBB rating, again supporting a conclusion that SESW's plan remains firmly investment grade over PR24.

As shown in Table 2.4, SESW's plan implies broadly constant S&P core ratios over time. FFO/debt improves slightly in Year 2, moving above the 9.0 per cent minimum threshold for a "Significant" Financial risk profile implying a rating of a- if the rating is determined by FFO/debt. Debt/EBITDA slightly breaches the 6.0x maximum threshold for an "Aggressive" Financial risk profile over PR24, implying a bbb-/bb+ credit rating based on this ratio. However, as mentioned above, our view is that S&P will place most weight on FFO to net debt and our analysis shows that on this basis S&P will

8 S&P Global Ratings (10 November 2022), Research Update: Sutton and East Surrey Water PLC 'BBB' Rating Affirmed; Outlook Remains Negative, p.5.

9 S&P Global Ratings (19 November 2013), Corporate Methodology, p.34.

10 S&P may also apply a number of upward or downward modifiers to the credit rating determined on the basis of the Business risk and Financial risk, to reflect the effects of diversification, capital structure, financial policy, liquidity, management governance and comparable rating analysis. In its latest ratings update on SESW, S&P makes no upward or downward adjustment based on any of these factors but considers these are "neutral". We assume that the effect of these modifiers will remain neutral over the PR24 period, so that the overall rating is determined by the Business risk and Financial risk assessment. See S&P Global Ratings (10 November 2022), Research Update: Sutton and East Surrey Water PLC 'BBB' Rating Affirmed; Outlook Remains Negative, pp.5-6.

maintain an a- rating on average over PR24. Debt/EBITDA also remains well above the threshold of 9x that S&P mentioned could result in a downgrade to SESW's current BBB rating.[11]

Table 2.4: S&P ratios remain broadly constant over PR24 under SESW's plan, with FFO/debt improving slightly towards the beginning

	2026	2027	2028	2029	2030
FFO / debt	8.6%	9.3%	9.4%	9.6%	9.4%
Debt / EBITDA	6.4	6.2	6.3	6.3	6.4
Implied rating	bbb (FFO/debt) bbb-/bb+ (Debt/E.)	a- (FFO/debt) bbb-/bb+ (Debt/E.)	a- (FFO/debt) bbb-/bb+ (Debt/E.)	a- (FFO/debt) bbb-/bb+ (Debt/E.)	a- (FFO/debt) bbb-/bb+ (Debt/E.)

Source: NERA analysis of SESW actual PR24 financial model.

Bond covenants

We have also reviewed whether SESW complies with its bond covenants given its actual financial structure. This included checking the conceptual and arithmetic accuracy of the two covenant ratios calculated in the SESW actual financial model against the covenants set out in the original bond agreement.

As shown in Table 2.5, SESW complies with its two bond covenants (gearing and ICR) throughout the PR24 period under its expected financing plan.[12]

Table 2.5: SESW complies with bond covenants under its actual financing plan and PR24 business plan revenues

	Threshold	2025/26	2026/27	2027/28	2028/28	2029/30
Gearing	max. 80%	71.0%	71.6%	73.8%	74.7%	75.3%
ICR	min. 1.3	1.40	1.42	1.43	1.40	1.41

Note: Gearing is based on "Gearing (all cash)" measure in model, which considers total available cash in calculation of net debt.
Source: NERA analysis of SESW actual PR24 financial model.

Stress-testing

In its Final Methodology, Ofwat requested companies to model the impact of a number of scenarios on their actual financeability.[13] Ofwat did not ask companies to model these scenarios at Draft

[11] S&P states that it could lower the rating from the current BBB if We could also lower the rating if "*the company's credit metrics do not recover beyond our downside threshold over fiscal 2025: that is, FFO to debt of 7%, and debt to EBITDA below 9x*". See S&P Global (27 January 2024), Sutton and East Surrey Water PLC Rating Outlook Revised To Stable; Affirmed At 'BBB', available at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3114885.

[12] At business plan submission, SESW covenants also included and adjusted interest cover ratio (AICR) but we understand from SESW that this covenant no longer applies.

[13] These scenarios were i) totex underperformance (10 per cent of totex) over 5 years; ii) ODI underperformance payment (3 per cent of RORE) in one year applied in year 2; iii) inflation below the assumption for the base case in the business plan (2 per cent below), to be applied in each year of the price review period; iv) deflation of -1 per cent for 2 years, followed by a return to the long-term inflation target; v) high inflation: a 10 per cent spike in inflation with a 2 per cent increase in wedge between RPI and CPIH, followed by two years at 5 per cent and a 1

Determination. Nevertheless, SESW modeled the following modified version of Ofwat's Final Methodology scenarios under its updated plan:

1. Totex underperformance of 10 per cent in each year or PR24 and in the last year of PR19;
2. An ODI penalty equivalent to 3 per cent of RoRE in Year 2 of PR24;
3. Inflation at 1 per cent above the base assumption throughout PR24;
4. Inflation at 1 per cent below the base assumption throughout PR24;
5. Inflation at 7.5 per cent above the base assumption in Year 5 of PR19 and 3 per cent above the base assumption in Years 1 and 2 of PR24;
6. An increase in bad debt levels, modeled as an increase in financing costs by GBP 3.4m in Year 5 of PR19 and GBP 22.0m over PR24;
7. Refinancing at interest rates at 2 per cent above the base assumption;
8. A 3 per cent revenue penalty in Year 2 of PR24.

SESW also considered a number of company specific scenarios, which we set out in Appendix A.

We have reviewed the modified Ofwat and company specific scenarios in SESW's actual financial model, with a focus on whether these result in expected variations in financial ratios relative to the base case.

Table 2.6 summarises the results of the modelling of the Ofwat scenarios, focusing on the impacts of the different scenarios on SESW's key financial ratios and overall Moody's and S&P credit ratings (we focus on the S&P rating implied by the FFO/net debt, given S&P typically places greater weight on this ratio as explained above). As shown, most scenarios still support at least a Baa2 credit rating from Moody's over PR24. The modeled rating falls to Baa3 or below in a limited number of cases. However, in practice the downside impact in these cases is significantly mitigated as the modellign does incorporate regulatory mitigation mechanisms (e.g., revenue indexation and totex underperformance sharing). In the event that these mechanisms do not restore an investment grade credit rating, we would expect SESW to rely on the draw-down of liquidity facilities, the triggering of cash-lock up provisions and/or ultimately equity provision, to restore financial viability.

SESW retains an investment grade rating of at least Baa2 under all but one of the company specific scenarios (see Appendix A). In one scenario (i.e., the high inflation scenario), the modeled rating falls below Baa3 but this again does not incorporate relevant regulatory mechanisms which significantly mitigate the negative impact in practice (i.e., revenue indexation).

per cent increase in wedge; vi) increase in the level of bad debt (20 per cent) over current bad debt levels applied in years 2 and 3; vii) debt refinanced as it matures, with new debt financed at 2 per cent above the forward projections of interest rates; viii) financial penalty equivalent to 6 per cent of one year of Appointee turnover applied in year 2.

Table 2.6: Modified Ofwat actual financing scenario model results (impact on average ratios for PR24)

Scenario	Gearing (Moody's)	AICR (Moody's)	FFO/debt (S&P)	Implied Rating - Moody's	Implied Rating - S&P FFO/debt	Comment
Totex underperformance (10%) over 5 years	83.1%	0.97	6.8%	Ba2	bbb	Moody's rating drops below Baa3, S&P FFO/debt drops below 9 per cent, supporting bbb rating. However, modelling overstates downside impact as it does not incorporate risk mitigation in regulatory framework (i.e., sharing of overspend at the end of PR24)
ODI penalty (3% RoRE in Year 2 of PR24)	75.4%	1.35	9.1%	Baa2	a-	Slight deterioration in ratios, continuing to support Baa2 (Moody's) and a- based on S&P based on FFO/debt
High inflation (1% above base throughout PR24)	77.7%	1.13	7.1%	Baa3	bbb	Deterioration in ratios, dropping to Baa3 (Moody's) and bbb based on S&P based on FFO/debt. However, modelling does not fully account for indexation of revenues in regulatory framework, which mitigate adverse impact of high inflation in practice
Low inflation (1% below base throughout PR24)	71.9%	1.68	11.9%	Baa1	a-	Slight improvement in ratios, supporting Baa1 (Moody's) and a- based on S&P based on FFO/debt. However, modelling does not fully account for indexation of revenues in regulatory framework, which reduces upside of low inflation in practice
High inflation (+7.5% in Year 5 of PR19, and +3%, in years 1 and 2 respectively)	84.8%	0.56	3.5%	Ba2	bbb-/bb+	Deterioration in ratios, dropping below Baa3 (Moody's) and to bbb-/bb+ on S&P based on FFO/debt. However, modelling does not account for indexation of revenues, hence significantly overstating downside impact

Bad debt increase	76.0%	1.24	8.6%	Baa2	bbb	Moody’s rating retained at Baa2; S&P FFO/debt drops slightly below 9% target implying bbb
Refinancing at 2% above forecast rate	75.9%	1.27	8.7%	Baa2	bbb	Moody’s rating retained at Baa2; S&P FFO/debt drops slightly below 9% target implying bbb
Financial penalty (3% of Appointee turnover in Year 2 of PR24)	75.0%	1.39	9.3%	Baa2	a-	Moody’s rating retained at Baa2; S&P FFO/debt retained at a-

Source: NERA analysis of SESW actual PR24 financial model.

2.3. Notional financeability

We also assess SESW's notional financeability on the basis of Ofwat's notional financial model, which uses financing assumptions for a notional company (gearing, cost of debt, and share of ILD).

As in the case of our financeability assessment on an actual basis, we assess notional financeability with reference to the credit ratings assigned by Moody's and S&P. Ofwat requires companies to target a notional credit rating of at least two notches above the minimum required for investment grade or Baa1 on Moody's rating scale.[14]

Moody's

Ofwat's notional model does not include Moody's scorecard, e.g. it does not contain a module to calculate the sub-ratings for all financial ratios, and when combined with qualitative factors, the overall Moody's rating, as included within SESW's actual model (as summarised in Table 2.5 above).

In the absence of scorecard module, we have considered Moody's notional rating in two ways. First, at PR19, Moody's published specific guidance for the UK water sector which sets out target ranges for the gearing and AICR which take into account the effect of qualitative factors on the required thresholds for achieving a certain rating, as shown in Table 2.7 below.[15]

As shown, Moody's requires an AICR of >=1.5x and gearing =< 75 per cent for Baa1 rating. SESW's notional gearing is around 55 per cent and the Moody's AICR is 1.96, and therefore both of these ratios are comfortably above the Baa1 rating (where thresholds are gearing less than 72 per cent and AICR greater than 1.5).

Table 2.7: Moody's specific guidance for UK water sector on gearing and AICR

Moody's ratio guidance for the UK water utilities

Issuer Rating	Maximum RCV gearing (previous)	Maximum RCV gearing (new)	Minimum AICR (previous)	Minimum AICR (new)
A2	≤ 60%	≤ 55%	≥ 1.8x	≥ 2.0x
A3	≤ 68%	≤ 65%	≥ 1.6x	≥ 1.7x
Baa1	≤ 75%	≤ 72%	≥ 1.4x	≥ 1.5x
Baa2	≤ 85%	≤ 80%	≥ 1.2x	≥ 1.3x

Source: Moody's (May 2018), Regulated Water Utilities – UK Regulator's proposals undermine the stability and predictability of the regime, p.5.

Second, we have calculated the "theoretical AICR" based on its underlying economic form, which can be calculated independently of any financial modelling. Noting that AICR is equal to FFO less regulatory depreciation divided by cash interest, the AICR reduces to the real allowed return over cash interest, where cash interest is based on notional nominal rate and indexed-linked debt.[16] Ofwat also considered the theoretical AICR at PR19.

Table 2.8 sets out the theoretical AICR for PR24 based on Ofwat's PR24 draft determination values. This shows that the AICR is 1.74, implying a notional rating comfortably above Baa1 given Moody's guidance in Table 2.7. The AICR is higher than the equivalent for PR19 of 1.32, as reported by Ofwat

14 Ofwat (December 2022), PR24 final methodology, Appendix 10 – Aligning risk and return, p.39.

15 Given UK water companies achieve comparatively higher scores on the qualitative factors, the rating thresholds in Moody's specific guidance are less demanding compared to the general methodology.

16 Ofwat (2019) PR19 final determinations: Aligning risk and return technical appendix, p. 82

and reproduced below. The improvement in the AICR at PR24 is mainly explained by the full switch to CPI indexation which increases the estimate of the Appointee WACC in real CPIH terms and the reduction in notional gearing from 60 to 55 per cent.

Table 2.8: Theoretical AICR at PR24 above 1.5 Baa1 threshold

		PR19 FD	PR24 DD
A	Appointee WACC (real)	2.52%	3.72%
B	Notional gearing	60%	55%
C	Proportion of ILD	33%	33%
D	Allowed cost of debt (RPI ILD)	1.15%	1.84%
E	Inflation	3.00%	3.00%
F	Allowed cost of debt (nominal) =(1+D)*(1+E)-1	4.18%	4.90%
	AICR = A/[B*(C*D+(1-C)*F)]	**1.32**	**1.74**

Source: NERA calculations based on: Ofwat (2019) PR19 final determinations: Aligning risk and return technical appendix, p. 82. Ofwat (2024) PR24 draft determinations – Aligning risk and return – Allowed return appendix, pp.7-9.

S&P

Ofwat's notional model includes functionality to calculate the two core S&P ratios FFO/debt and debt/EBITDA. As shown in Table 2.9, the model indicates an FFO/debt of 15.1 per cent and debt/EBITDA of 5.4x on average over PR24, which supports at least a "Significant"/"Aggressive" Financial risk profile for the notionally financed SESW based on the core ratios,[17] and could be interpreted to marginally support an "Intermediate" financial risk profile based on the FFO/debt which S&P tends to place greater weight on.

Table 2.9: S&P core ratios support at least "Significant" Financial risk profile for notionally financed SESW

	PR24 average	S&P assessment
FFO/debt	15.1%	Weak "Intermediate" or at least "Significant" (see Figure 2.1)
Debt/EBITDA	5.4	"Significant" (see Figure 2.1)

Note: S&P's "Intermediate" Financial risk profile is supported by an FFO/debt between 13-23 per cent and a Debt/EBITDA of 4-5x. The "Significant" Financial risk profile is supported by an FFO/debt between 9-13 per cent and Debt/EBITA of 4-5.
Source: NERA analysis of SESW's completed Ofwat PR24 financial model.

Combining the FFO/debt ratio results with the "Excellent" Business risk profile S&P assigned to SESW in its latest rating report (see Section 2.1) supports an overall S&P rating over PR24 of at least a- (see Figure 2.1).

[17] This does not consider any potential Financial risk profile uplift S&P may apply on the basis of its supplementary ratios, which are not included in Ofwat's financial model.

Figure 2.1: S&P Guidance Supports at Least a- Notional Rating Based on SESW Core Ratio Results

Cash Flow/Leverage Analysis Ratios--Low Volatility

	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	35+	Less than 2	More than 8	More than 13	More than 30	20+	11+
Modest	23-35	2-3	5-8	7-13	20-30	10-20	7-11
Intermediate	13-23	3-4	3-5	4-7	12-20	4-10	3-7
Significant	9-13	4-5	2-3	2.5-4	8-12	0-4	0-3
Aggressive	6-9	5-6	1.5-2	1.5-2.5	5-8	(10)-0	(20)-0
Highly leveraged	Less than 6	Greater than 6	Less than 1.5	Less than 1.5	Less than 5	Less than (10)	Less than (20)

Combining The Business And Financial Risk Profiles To Determine The Anchor

	--Financial risk profile--					
Business risk profile	1 (minimal)	2 (modest)	3 (intermediate)	4 (significant)	5 (aggressive)	6 (highly leveraged)
1 (excellent)	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
2 (strong)	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
3 (satisfactory)	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
4 (fair)	bbb/bbb-	bbb-	bb+	bb	bb-	b
5 (weak)	bb+	bb+	bb	bb-	b+	b/b-
6 (vulnerable)	bb-	bb-	bb-/b+	b+	b	b-

Source: S&P Global Ratings (15 December 2021), Corporate Methodology, available at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/8314109.

<u>Overall conclusion on notional rating</u>

Overall, our analysis shows that SESW is rated at least Baa1 on Moody's rating and a- on S&P, and therefore is consistent with Ofwat's guidance that the notional company should be two notches above the minimum investment grade threshold.

3. Assurance of PR19 Reconciliation Models

Ofwat has published a series of models that set out how Ofwat will reconcile companies' performance in 2020-25 for a range of revenue, cost, ODIs, and other factors, and how these will feed into revenue and RCV adjustments over PR24. Ofwat has also published a PR19 reconciliation guidebook for completion of the models.[18]

We have been asked to review the following three models which impact the calculation of the PR24 RCV in a material way and therefore have a potential impact on financeability. These are:

- Cost sharing model which reconciles actual performance against the totex allowance at PR24
- RPI-CPI wedge, which reconciles difference between assumed wedge at PR19 and the realised wedge

[18] Ofwat (August 2023) PR19 Reconciliation Rulebook: Guidance Document. L

- Land sales, which calculates the requires adjustment to the RCV for any disposal of land

The remaining PR19 reconciliation models are subject to assurance by others.

We have reviewed the inputs against Ofwat's own PR19 DD models and where necessary Ofwat's model guidance and we have provided comments where the input were not aligned with Ofwat's DD model and/or guidance.

We have not reviewed the mechanics of the models themselves as these are Ofwat's industry-wide models. However, we have reviewed the outputs of the models – in terms of the RCV adjustments over PR24 – to ensure that that these are consistent with expectations given our understanding of the inputs and the intention of the reconciliation.

Overall, following our review and revision, we have not identified any issues that would affect our assessment of financeability.

4. Summary - Our Opinion on Notional and Actual Financeability

In our opinion, SESW's actual financial model shows that SESW achieves a strong Baa2 credit rating from Moody's on average over PR24 in the base case, only slightly below the threshold required for a Baa1 rating. Overall, SESW demonstrates an investment grade credit rating on an actual basis.

The achievement of a Baa2 rating depends on SESW totex spend in line with allowances and a stable macro-environment, with poor cost or ODI performance or adverse changes in interest rates or inflation leading to a weaker Baa2 rating and more extreme scenarios showing further downgrades. In such scenarios, we would expect SESW to draw on liquidity facilities, cash-lock up provisions and ultimately further shareholder equity, to restore financial viability.

The achievement of a strong Baa2 rating is also predicated on equity support of £20m over the current year of AMP7 and £25m over AMP8.

Ofwat's notional model as populated by SESW/CEPA and our calculation of the theoretical AICR also indicate that SESW is financeable on a notional basis and achieves a notional rating of at least Baa1 (Moody's) and a- (S&P) based on Ofwat's own notional model and metrics.

Yours sincerely

James Grayburn
Managing Director

Appendix A. SESW company specific scenario results

SESW Scenario	Gearing (Moody's)	AICR (Moody's)	FFO/debt (S&P)	Implied Rating (Moody's)	Implied Rating (S&P FFO/debt)
CS1 – Cyber attack (GBP 0.3m reduction in Year 5 PR19 revenue, GBP 0.2m reduction in revenue over PR24)	75.4%	1.40	9.3%	Baa2	a-
CS2 – Water quality failure (GBP 4.8m increase in opex in Year 5 of PR19)	75.8%	1.39	9.2%	Baa2	a-
CS3 Loss high quality staff (GBP 1m increase in opex in Year 5 of PR19 and each year of PR24)	75.7%	1.33	8.9%	Baa2	bbb
CS4 Totex underperformance (+10% in PR19 Year 5, +5% in Year 1 and 2 of PR24)	78.5%	1.28	8.5%	Baa2	bbb
CS4a Totex underperformance (+5% in Year 1 and 2 of PR24)	76.4%	1.38	9.1%	Baa2	a-
CS5 Cost of Living- bad debt (+GBP 14m financing costs in Year 5 of PR19)	78.0%	1.36	8.8%	Baa2	bbb

CS5 Cost of Living- bad debt (+GBP 1.4m financing costs in Year 5 of PR19)	76.5%	1.29	8.6%	Baa2	bbb
CS6 not meeting OE	75.6%	1.40	9.2%	Baa2	a-
CS7 climate 2.5% capex (GBP 1m capex overspend in each year of PR24)	75.6%	1.40	9.2%	Baa2	a-
CS8 Additional pension deficit payment (GBP 2m additional financing cost in Year 5 of PR19)	75.3%	1.40	9.3%	Baa2	a-
CS10 inflation increase (+2% inflation increase over base over PR24)	80.5%	0.86	5.0%	Ba2	bbb-/bb+

Source: NERA analysis of SESW actual PR24 financial model