Southern Water's £1.6 Billion of Swaps Threaten Rating

Fitch says downgrade partly reflects super-senior derivatives
The utility pursued 'borrowing through swaps': Fitch analysts

Water companies' derivative liabilities are coming under increased scrutiny as the sector faces economic challenges. *Photographer: Chris J. Ratcliffe/Bloomberg*

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Fitch Ratings sees an increasing risk to creditors from Southern Water Ltd's outsize swap portfolio, which is creating liabilities that outrank the claims of even senior bondholders.

The ratings agency downgraded the UK utility to one step above junk status with a negative outlook on Tuesday, citing "challenging funding conditions" and the risk of default should it fail to maintain two investment-grade ratings. The water company said its turnaround plan is progressing and it has “strong liquidity” through May 2026, according to a statement after the rating was issued on Tuesday.

It also said Southern Water’s long-dated derivatives portfolio, which created £1.6 billion ($2 billion) of super-senior liabilities on the utility as of March, was an increasing drag on its creditworthiness.

Derivatives are commonly used as a hedge by companies whose revenues are tied to inflation. A typical deal for one of the firms in the UK water industry involves drawing up an agreement with a bank that effectively swaps the fixed-rate coupon on one of its bonds for an inflation-linked coupon, transferring the risk from price fluctuations from the firm to the lender.

Crucially, however, Fitch doesn’t see all of Southern Water’s swaps as akin to the typical hedges pursued by other water providers. Instead, the ratings agency says the company effectively used them as tools to borrow through the derivatives market. Southern Water’s swap liabilities are far higher than the average across the sector, reflecting about 23% of its regulatory capital value.

“We see increasing risk posed by super senior swaps, which rank ahead of the Class A debt,” Fitch analysts including Elliot Ryan wrote. Southern Water “may no longer benefit from above-average sector recovery for its senior secured debt.”

Under Scrutiny

Water companies' derivative liabilities are coming under increased scrutiny as the sector faces economic challenges. Swap counterparties to Thames Water hired advisers to negotiate with Thames separately from other creditors.

In Southern Water's case, Fitch said it pursued so-called swap restructuring transactions in 2018-19 that resulted in additional cash inflows on some of its inflation swaps over subsequent years. This improved the company's headroom under its interest-cover covenants.

However, these benefits were partly achieved through tenor extensions on out-of-money swaps — contracts where the water company owed money to the bank following moves in inflation and interest rates. That's created longer-term liabilities for Southern Water, with the ratings agency adding an additional £187 million to the firm's net debt due to this practice, which it describes as "borrowing through swaps."

Fitch expects Southern Water to maintain adequate liquidity over the next 12 months, with focus on a debt maturity of £350 million and about £500 million in swap accretion payments due in March 2026. The utility was downgraded to junk status by Moody's Ratings last week.