

Research Update:

# Dwr Cymru (Financing) UK Senior Issue Rating Lowered To 'A-'; Outlook Stable; Subordinated Issue Rating Lowered To 'BBB'

February 7, 2020

## Rating Action Overview

- On Jan. 31, 2020, Dwr Cymru (Financing) UK PLC (Welsh Water) announced that it will not ask Ofwat to refer its determination for 2020-2025 to the Competition and Markets Authority.
- We now have more certainty about the conditions under which the company will operate over the next regulatory period starting April 2020, and believe that Welsh Water's credit metrics will be at a level that we don't view as commensurate with the previous issue ratings.
- As a result, on Feb. 7, 2020, S&P Global Ratings downgraded the senior secured (class B) debt issued by Welsh Water to 'A-' from 'A'. At the same time, we lowered our issue rating on the subordinated (class C) debt to 'BBB' from 'BBB+'.
- We also affirmed the 'AA' issue rating with a stable outlook on the four senior secured class A bonds issued by Welsh Water and guaranteed by Assured Guaranty Europe PLC (AA/Stable).
- The stable outlook on Welsh Water's senior secured (class B) debt reflects our views that the company will maintain its adjusted funds from operations (FFO) to debt significantly above 6% and debt-to-EBITDA ratio significantly below 9x, with adequate operating performance over the next regulatory period.

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## Rating Action Rationale

The downgrade reflects our expectations that the company's credit metrics will not be in line with the levels we see as commensurate with 'A' and 'BBB+' issue ratings over the next regulatory period, AMP7, starting in April 2020, that is an FFO-to-debt ratio consistently below 7% and debt to EBITDA above 8x.

### **Tougher operating conditions will be challenging for Welsh Water over the next regulatory**

**period.** On Dec. 16, Ofwat, the U.K. water utility regulator, completed the final stage of the price review process (PR19) for the next regulatory period (lasting through March 2025) by publishing its final determination for water companies in England and Wales. On Jan. 31, 2020, Welsh Water

announced that it will not ask Ofwat to refer its final determination price control, services, and incentive package for 2020-2025 to the Competition and Markets Authority. Therefore we now have greater visibility about the conditions under which the company will operate from April 2020 onward.

Based on the elements in the company's business plan, we believe that Welsh Water, along with the rest of the sector, will operate under tougher conditions starting in April 2020, which will ultimately weaken its credit quality. This relates to the regulator's chief goal for the next regulatory period to provide customers with better service at lower costs. Welsh Water will face an average 9% reduction (in real terms) in customer bills over the next regulatory period, while earning lower returns, with a reduced allowed cost of capital of 1.92% (assumed retail price index [RPI] of 3%), versus 3.53% in the previous regulatory period.

The greater focus on operational performances and environmental impact also means that Welsh Water will be subject to a challenging set of performance commitments. These include--among others--at least a 15% leakage reduction from the PR14 level, a 58% reduction in water supply interruptions by 2024-2025 to five minutes, and a reduction in internal and external sewer flooding incidents by 2024-2025 (33% and 25% reduction per 10,000 connections, respectively). Overall, the likely range of returns from the outcome delivery incentive package in the final determination equates to a return on regulatory equity range of negative 1.03% (P10) to 0.61% (P90). We believe Welsh Water's operating performance against its regulatory targets is currently average, and expect the company to achieve a neutral-to-small net penalty position in its outcome delivery incentives (ODIs) for the current regulatory period (AMP6). In light of the more stringent performance commitments, we expect the next regulatory period to be challenging for the company and don't rule out the possibility that the company may end up in a net penalty position during AMP7.

**Credit metrics will remain below our current targets.** We expect Welsh Water's credit quality to weaken over the next regulatory period. We project FFO-to-debt and debt-to-EBITDA ratios to be markedly below the levels under which the company operated at the start of the current regulatory period (at 9% and 7.5x, respectively) and to remain below our current targets for the 'A' and 'BBB+' issue ratings on its senior secured (class B) and subordinated (class C) debt. This would result from a tougher regulatory period for Welsh Water following three years of marked deterioration in its credit metrics (with average FFO to debt about 6% and average debt to EBITDA about 9x).

We also believe that Welsh Water has a relatively high cost of embedded debt, mainly due to relatively long-dated high-rate fixed debt issuances and the relatively large proportion of RPI-linked debt in its capital structure. This has resulted in a large increase in (non-cash) interest costs in the past years on the back of rising inflation rates. While we project that Welsh Water will be able to take advantage of the current low interest rates to attract cheaper funding, we continue to believe that indexation accruals, which we incorporate into our FFO calculations, will remain sizable and limit any material reductions in the company's cost of debt. This is therefore unlikely to significantly bolster its credit metrics, in our opinion.

**Low gearing and unique ownership structure still support the group's overall credit quality.** We believe that Welsh Water's lower balance-sheet leverage compared to the rest of the sector and plan to keep on deleveraging over the next regulatory period are positive factors for its credit quality. We project reported debt to remain significantly below 60% of the company's regulated capital value (RCV) during this period. This is in part because Welsh Water has a longer RCV run-off rate compared to peers, which keeps customers' bills down and insures a long-term build-up of the RCV, hence limiting the upward pressure on its gearing, but at the same time leading to lower

revenue in the short term. However, this is also the result of its unique ownership structure as a nonprofit company, which eliminates the pressure to increase leverage through shareholder distributions.

## **Outlook**

The stable outlook on Welsh Water's senior secured debt reflects our view that the company benefits from sufficient headroom over the next regulatory period to keep its FFO to debt significantly above 6% and debt to EBITDA significantly below 9x. Welsh Water currently doesn't have subordinated debt outstanding. Should the company decide to issue debt that we would classify as subordinated (class C), the assigned outlook on its issue rating would be stable.

## **Downside scenario**

We could lower the ratings on Welsh Water's senior secured class B debt and subordinated debt if its FFO-to-debt ratio doesn't maintain enough headroom above 6% and debt-to-EBITDA below 9x on a prolonged basis. This could occur during the next regulatory period if Welsh Water does not deliver on its business plan or if it were to incur a significant level of penalties on its ODIs; or could be linked to the company rebate policy.

## **Upside scenario**

We would consider raising the ratings on Welsh Water's senior secured class B debt and subordinated class C debt if FFO to debt markedly exceeded 7% consistently and debt to EBITDA was significantly below 8x, with the company demonstrating an above-average operating performance at the same time.

## **Company Description**

Welsh Water is the sixth largest of the 10 regulated water and sewerage companies in England and Wales, according to its RCV, which was £5.7 billion as of March 31, 2019. It supplies water and wastewater services to 1.4 million properties and 3 million people across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing) Ltd. is a financing vehicle that is ultimately owned by Glas Cymru, a Welsh nonprofit company. Glas Cymru is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers and, to a lesser extent, debtholders, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates pressure to pay dividends and other shareholder returns.

## **Our Base-Case Scenario**

### **Assumptions:**

- RPI assumptions as per our in-house projections. We forecast inflation as measured by RPI in the U.K. of 2.6% in 2020, 2.9% in 2021, and 3.1% in 2022.

- EBITDA margins of about 50% in 2020 and 52%-56% in AMP7.
- Lower capital expenditure (capex) of about £300 million per year in AMP7 from FY2021.
- Dividends (social tariff contributions) of an average of £11 million per year over AMP7, leading to an annual reduction in revenues of a similar amount.
- No outperformance in the form of underspending of total expenditures against regulatory allowances.
- A neutral rewards/penalties position based on the company's ODIs for AMP6 and AMP7.

Based on these assumptions, we arrive at the following credit measures for 2020-2022:

- FFO to debt of about 5.8% in 2020, rising to an average of 6.5% in 2021 and 2022;
- Debt to EBITDA of about 9x in 2020, declining to an average of 8.5x in 2021 and 2022; and
- Gearing, measured as debt to RCV, to remain below 60% over AMP7.

## Liquidity

We assess Welsh Water's liquidity position as adequate, supported by our view that the company's liquidity resources will exceed its funding needs by more than 1.2x in the next 12 months. Our liquidity assessment is further underpinned by Welsh Water's high standing in the capital markets and its good relationship with banks. We note that it is working on refinancing both its March 2021 £325 million class B notes and its £170 million revolving credit facility.

Principal liquidity sources in the next 12 months from Oct. 31, 2019:

- A cash balance of about £249 million;
- FFO of about £210 million; and
- Access to £90 million of undrawn credit facilities.

Principal liquidity uses in the next 12 months from Oct. 31, 2019:

- Upcoming short-term debt maturities of approximately £62 million; and
- Expected capex of approximately £400 million.

## Ratings Score Snapshot

### Senior secured (class B) debt

Issue Rating: A-/Stable

Business risk: Excellent

Country risk: Low

Industry risk: Very low

Competitive position: Excellent

Financial risk: Aggressive

Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

Diversification/Portfolio effect: Neutral (no impact)

Capital structure: Neutral (no impact)

Financial policy: Neutral (no notch)

Liquidity: Adequate (no impact)

Management and governance: Satisfactory (no impact)

Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Structural enhancements (+1 notch)

### **Subordinated (class C) debt**

Issue rating: BBB

Business risk: Excellent

Country risk: Low

Industry risk: Very low

Competitive position: Excellent

Financial risk: Aggressive

Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

Diversification/Portfolio effect: Neutral (no impact)

Capital structure: Neutral (no impact)

Financial policy: Neutral (no impact)

Liquidity: Adequate (no impact)

Management and governance: Satisfactory (no impact)

Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Risk of interest deferral (-1 notch)

### **Related Criteria**

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

### Downgraded

|                                   | To        | From       |
|-----------------------------------|-----------|------------|
| <b>Dwr Cymru (Financing) Ltd.</b> |           |            |
| Senior Secured (SPUR)             | A-/Stable | A/Negative |
| Senior Secured                    | A-        | A          |
| Senior Secured                    | A-/Stable | A/Negative |
| Subordinated                      | BBB       | BBB+       |

### Ratings Affirmed

|                                   |           |
|-----------------------------------|-----------|
| <b>Dwr Cymru (Financing) Ltd.</b> |           |
| Senior Secured                    | AA/Stable |

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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