S&P Global
Ratings

RatingsDirect®

Dwr Cymru (Financing) UK PLC

Primary Credit Analyst:
Gustav B Rydevik, London + 44 20 7176 1282; gustav.rydevik@spglobal.com

Secondary Contacts:
Massimo Schiavo, Paris + 33 14 420 6718; Massimo.Schiavo@spglobal.com
Emeline Vinot, Paris + 33 014 075 2569; emeline.vinot@spglobal.com

Table Of Contents

Dwr Cymru (Financing) UK PLC

Issue Ratings	
Class A*	AA/Stable
Class B	A-/Stable
Class C	BBB/Stable

*Guaranteed.

Credit Highlights

Overview	
Key strengths	**Key risks**
Focus on low-risk, U.K. water regulated monopoly activities, in a transparent, credit-supportive five-year regulatory framework ending in March 2025.	High capital intensity, leading to negative free operating cash flows and limiting debt reduction prospects over the current regulatory period.
Greater financial flexibility provided by the nonprofit status of its parent company, and lower leverage than industry peers' (with debt to regulated capital value [RCV] expected to remain at about 60% during the current regulatory period).	Challenging operating efficiency targets under the current regulatory period, potentially leading to financial penalties and greater cash flow volatility.
Various structural features designed to increase cash flow certainty for debtholders.	

Dwr Cymru (Financing) UK PLC (Dwr Cymru) has a natural monopoly in its service area and operates under a transparent regulatory framework that we think provides the group with a strong regulatory advantage. As a result, Dwr Cymru benefits from stable and predictable cash flows from its low-risk regulated water business under the current five-year regulatory framework ending in March 2025.

The current framework, which began in April 2020, has resulted in lower allowed return over the period. Since the start of the new period (AMP7), Dwr Cymru Cyfyngedig (Welsh Water) has been operating under tougher conditions than in AMP6, with an average 9% reduction (in real terms) in customer bills and a reduced allowed cost of capital of 1.92% versus 3.53% in the previous period. This change related to the regulator's chief goal to provide customers with better service at lower costs. However, the first year of the regulatory period (ending in March 31, 2021) showed that Dwr Cymru managed to secure EBITDA of £351 million, only slightly lower than AMP6's average of £370 million, after the group reduced investments to support the metrics. Dwr Cymru's FFO to debt reached 6.0% in March 2021 from 4.8% in March 2020. We expect FFO to debt to remain at about 6%-7% over our forecast period, in line with our expectations and in line with current credit rating requirements.

High investment requirements reduce Dwr Cymru's deleveraging prospects. Since 2017, Dwr Cymru has invested about 150% of its operating cash flows on average. We expect the group to maintain its investments at about 130% of its operating cash flows, effectively reducing its ability to reduce its S&P Global Ratings-adjusted debt, which we forecast at about £3.5 billion-£3.8 billion in the medium term through FY2025.

The current high inflation will put some water utilities under short-term pressure, but with long-term benefits. Inflation in the U.K. could help support water companies' financial positions in the long term because the water tariff is linked to the consumer price index (CPI) and retail price index (RPI). However, in the short term, inflation could have a negative effect because large inflation-linked debt balances and, occasionally, derivatives exposure, will increase annual accrued payments and weigh on our adjusted credit metrics. Furthermore, although asset bases may increase, this will not immediately translate into higher income. Ofwat adjusts RCV and allowed revenue by the inflation that was current in the November of the previous fiscal year. This risk is more pronounced for some U.K. water utilities than others. For example, about 80% of Dwr Cymru's reported debt as of March 2021, including its index-linked inflation swaps, was linked to an inflation index. It also has higher inflation accruals, which we incorporate in our calculation of funds from operations (FFO).

Dwr Cymru benefits from structural features within the group that protects debtholders further. Dwr Cymru operates under financial and nonfinancial covenants that support the group's overall credit quality. The ratings on the debt also reflect various structural features. These are designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should enable Dwr Cymru to manage temporary cash flow shocks, in our opinion.

Outlook

The stable outlook on Welsh Water's senior secured and subordinated debt reflects our view that the group has sufficient headroom in the current five-year regulatory period (AMP7; April 2020-March 2025) to keep its FFO to debt at or above 6% on a consolidated basis and at least at 7% based on its senior secured debt.

Downside scenario

We could lower the ratings on Welsh Water's senior secured class B debt and subordinated class C debt if the group's FFO-to-debt ratio falls significantly and for a prolonged period, to below 7% for its senior debt and 6% for subordinated debt. This could occur during AMP7 if Welsh Water does not deliver on its business plan or incurs significantly more penalties on its outcome delivery incentives than we currently project.

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 and consistently exceeded 8% and 7% for each debt class, respectively, with the group also demonstrating above-average operational performance.

Our Base-Case Scenario

Assumptions

- RPI and CPI assumptions as per our projections. We forecast RPI in the U.K. of 8.5% in 2022, 4.0% in 2023, and 2.2% in 2024, and CPI of 6.3%, 2.4%, and 1.6% in the same years.
- Revenue based on approved tariffs until the end of the current regulatory period, AMP7 (March 31, 2025).
- Adjusted EBITDA margins of approximately 53%, over AMP7, lower at the start of the period due to the COVID-19 pandemic limiting the delivery of cost efficiencies, and revenue under collection.
- No outperformance on total expenditure against an already tight regulatory allowance, as per the group's track record.
- A backloaded capital expenditure (capex) program averaging about £370 million a year on average over the AMP7.
- A neutral rewards/penalties position on outcome delivery incentives (ODI) at this stage.
- Average dividends (social tariff contributions) of £15 million per year over AMP7. These contributions are customer rebates and represent revenue foregone by the group by not applying the full price cap on charges available to it.
- Debt to RCV to remain at about 60% for AMP7.

Key Metrics

Dwr Cymru (Financing) UK PLC--Key Metrics*

	--Fiscal year ended Mar. 31--			
	2021a	**2022e**	**2023f**	**2024f**
EBITDA	350.5	385-395	420-440	410-430
Funds from operations (FFO)	217.9	235-245	255-265	235-255
Capital expenditure	304.2	300-320	310-330	270-290
Free operating cash flow	(58.9)	(100)-(110)	(70)-(90)	(50)-(30)
Debt	3,607.5	3670-3710	3760-3800	3690-3720
Debt to EBITDA (x)	10.3	9-10	8.5-9.5	8.5-9.5
FFO to debt (%)	6.0	6-7	6.5-7.5	6.5-7.5

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Company Description

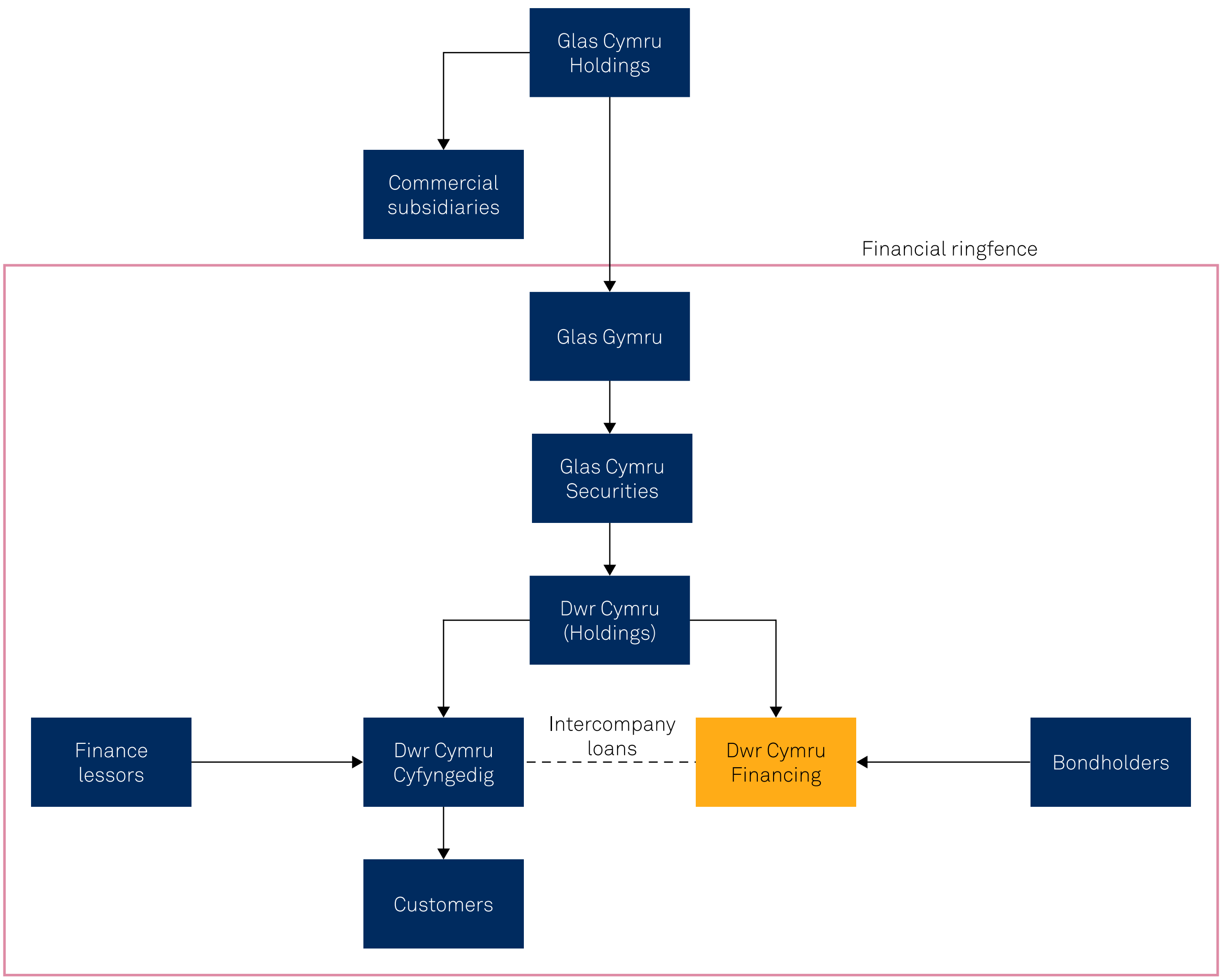
Welsh Water is the sixth largest of the 10 regulated water and sewerage companies in England and Wales, based on its

RCV (regulatory capital value), of about £6 billion as of March 31, 2021. It supplies water and wastewater services to 3.1 million people across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing) UK PLC is a financing vehicle ultimately owned by Glas Cymru Holdings Cyfyngedig (Glas Cymru), a Welsh nonprofit company. Glas Cymru is controlled by members with no financial interest in the company and the financial beneficiaries of outperformance are primarily the customers through social tariffs and rebates and reinvestments of profits into the asset base and, to a lesser extent, investors, 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 forms of shareholder returns.

Chart 1

Dwr Cymru (Financing) UK PLC -- Ownership Structure



Source: S&P Global Ratings.

Liquidity

We assess Welsh Water's liquidity position as adequate, supported by our view that the group's liquidity sources will exceed its funding needs by approximately 1.9x 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. Its liquidity sources over uses would stay positive even if EBITDA declined by 10%. Covenants would not be breached if EBITDA declined by 15%.

Principal Liquidity Sources	Principal Liquidity Uses
Principal liquidity sources in the 12 months from March 31, 2022: • Cash balance of about £544 million; • Access to £200 million of undrawn credit facilities; and • Cash FFO of about £650 million.	Principal liquidity uses in the 12 months from Dec. 31, 2021: • Upcoming short-term debt maturities of approximately £66 million; • Negative working capital outflows of about £30 million; and • Expected capex of approximately £315 million.

Covenant Analysis

Dwr Cymru has an internal target to maintain debt at or close to 60% of the RCV, reflecting significant headroom to its covenant structure, which sets the default level at 95% and trigger level at 85%. Other default covenants include keeping senior interest coverage pre-capital maintenance above 1.6x. Dwr Cymru has a good degree of headroom under its leverage ratio and cash flow coverage ratios.

Environmental, Social, And Governance

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

As one of the U.K.'s main water and wastewater companies, Welsh Water provides a key service with a significant social impact. This could expose the operator to additional scrutiny from the regulator or Welsh government to ensure not only high quality and reliability of its network and services, but also affordable costs for customers. However, we consider the unique structure and governance of the group as limiting these risks and positively contributing to our social and governance factors assessment. This is because Welsh Water is owned by its customers, via its ultimate parent Glas Cymru, a Welsh nonprofit company. As a result, we judge its financial policy as significantly more flexible than the rest of its peers, in terms of not being influenced by shareholder considerations, which has led to significant leverage reduction over the past twenty years. Income generated, when not used to reduce leverage, may be returned to customers by way of investments to the existing asset base or through tariff rebates, ultimately resulting in lower customer bills. In addition, Welsh Water has about 130,000 vulnerable customers on reduced tariffs, far more than any of its peers.

In response to ongoing political pressure and negative press coverage, Welsh Water undertook a restructuring to close its Cayman Islands incorporated financing subsidiary Dwr Cymru (Financing) Ltd. in 2019 and replace it with the U.K.-based Dwr Cymru (Financing) UK PLC. Although we view the transaction as neutral to the group's overall credit quality, with all outstanding obligations transferred from one financing vehicle to the other and without affecting creditors' rights, we expect it to simplify the capital structure in the group and enhance its transparency.

Issue Ratings - Subordination Risk Analysis

Structural features

We rate the debt issued by Welsh Water's financing vehicle, Dwr Cymru (Financing) UK PLC, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published on Feb. 24, 2016. Dwr Cymru operates under financial and nonfinancial covenants that support the group's overall credit quality. The ratings on the debt also reflect various structural features. These are designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should enable Dwr Cymru to manage temporary cash flow shocks, in our opinion.

In particular, debtholders benefit from:

- Ringfencing of the financing entity, which is achieved through Dwr Cymru's special-purpose status.

- Significant independent representation on the Dwr Cymru board (six of the nine members), and some business, legal, and regulatory restrictions.
- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control over Dwr Cymru at an early stage of financial or operational difficulty, or following material changes in business circumstances. The covenants minimize the probability of default and create an additional credit cushion.
- Liquidity facilities of £135 million available to cover a standstill, provided by suitably rated counterparties. These facilities are sufficient to cover finance charges, and are dedicated to drawings if the group enters a standstill. The facilities remain undrawn and the amounts available are unchanged.
- A strong covenant package, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.
- Subordination of the class C debt, the nonpayment of which cannot create an event of default for the class A debt.

Dwr Cymru issues three types of debt: class A (guaranteed by Assured Guaranty UK Ltd., class B (senior secured, ranking at the same level as class A), and class C (junior and subordinated to class A and B).

- We equalize our rating on the class A debt with that on its guarantor, Assured Guaranty UK Ltd., rated 'AA/Stable'.
- The class B debt is rated 'A-' based on credit metrics excluding the subordinated debt, and including one notch of uplift for various structural features, in particular the additional protection from the deferral of the subordinated debt interest and principal if the financing group had insufficient cash to make the payments due.
- The class C debt is rated 'BBB' based on credit metrics including senior and subordinated debt.

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 (low volatility table)

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Structural enhancements (+1 notch)

Senior secured (class C) debt

Issue Rating: BBB/Stable/--

Business risk: Excellent

- Country risk: Low
- Industry risk: Very Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive (low volatility table)

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Risk of interest deferral and structural subordination: (-1 notch)

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019

- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings Detail (As Of May 17, 2022)*	
DWR Cymru (Financing) UK PLC	
Senior Secured	A-
Senior Secured	A-/Stable
Senior Secured	AA/Stable
Subordinated	BBB
Subordinated	BBB/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.