Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades Welsh Water to A3, stable outlook

07 Feb 2020

London, 07 February 2020 -- Moody's Investors Service (Moody's) has today downgraded to A3 from A2 the corporate family rating (CFR) of Dwr Cymru Cyfyngedig (Welsh Water) as well as the senior secured debt ratings of Dwr Cymru (Financing) UK Plc. The A2 ratings of those bonds that are subject to a financial guarantee by Assured Guaranty (Europe) plc (A2 stable) of timely payments of scheduled interest and principal will continue to reflect the insurance financial strength rating of the guarantor and are unaffected by this action. All ratings have a stable outlook.

A full list of affected ratings is attached at the end of the press release.

These rating actions conclude the rating review initiated on 20 December 2019, following publication by the Water Services Regulation Authority (Ofwat), the economic regulator for water companies in England and Wales, of its final determination for the forthcoming five-year regulatory period commencing on 1 April 2020 (AMP7).

RATINGS RATIONALE

Today's rating actions follow Welsh Water's announcement, on 31 January 2020, that it will not ask Ofwat to refer its final determination to the Competition and Markets Authority. The downgrades to A3 from A2 take into account (1) Welsh Water's exposure to a significant cut in allowed wholesale returns to ca. 2.42% real in cash terms from 2020, compared with 3.6% in the current period; (2) a reduction in total expenditure allowances compared with the company's requests; and (3) challenging performance targets, which Moody's expects to result in financial penalties for Welsh Water during the next regulatory period. Specifically, the rating actions reflect that, under Moody's projections, the final determination will result in Welsh Water's key financial metrics falling outside guidance for the previous A2 ratings.

In its final determination, Ofwat set an allowed cash return of circa 2.42% for wholesale activities (or 2.46% when including the margin for household retail activities), which incorporates the regulator's decision to link half of the regulatory assets to the Consumer Prices Index adjusted for housing costs (CPIH), with the remainder linked to the Retail Prices Index (RPI). As the share of regulatory assets linked to CPIH grows over time, Moody's estimates that Welsh Water will have an average allowed cash return of around 2.5% over AMP7. On an RPI-stripped basis, for comparison with the current period, allowed returns will fall to 1.92% (1.96% including retail margin) from 3.6% (3.74% including the retail margin), a nearly 50% cut. The low returns put particular pressure on companies, like Welsh Water, with relatively expensive debt.

In addition, Welsh Water faces significant efficiency challenges of GBP171 million (or 22.5%) on enhancement and GBP25 million (or 10.9%) on household retail expenditure. However, on base operating and maintenance expenditure, the company received roughly GBP10 million more than its business plan request and management expects to be able to offset the remaining efficiency challenge on enhancement and retail expenditure through additional savings on base costs.

Stringent performance targets set by the regulator could lead to performance penalties for Welsh Water in the range of GBP30-40 million over the AMP7 period. While management anticipates rewards on some performance measures, in particularly around customer service, Moody's considers a net penalty likely.

Moody's base case scenario is that Welsh Water's Adjusted Interest Coverage Ratio (AICR) will be around 1.5x over AMP7, albeit constrained below this level prior to the maturity of an expensive fixed-rate bond in March 2021. This is in line with the 1.5x guidance for Welsh Water's previous A2 rating but exposed to the risk of operational or financial underperformance.

On gearing, measured as net debt to regulatory capital value (RCV), Moody's expects Welsh Water to remain outside of the A2 guidance over most of AMP7. Gearing could fall to 55%, the maximum for an A2 rating, in the later years of the period if performance was better than Moody's base case assumptions, and excess cash was retained within the business rather than returned to customers, through bill reductions or additional investments over and above the current plan.

The above described financial metrics will place Welsh Water well within the A3 category but are insufficient to maintain the previous A2 ratings.

Moody's notes that Welsh Water remains one of the lowest geared companies in the sector and, due to its not-for-profit ownership structure, does not face any dividend pressures. It has shared previous outperformance with customers through reduced bills and increased investments but only plans to share GBP55 million in aggregate over the AMP7 period. Any additional so-called customer dividends remain at the company's discretion and cash retention will help offset financial pressure from a challenging review.

In this context, Moody's AICR guidance for Welsh Water is materially less demanding than for peers, given the benefit of the company's ownership and governance structure as well as the Welsh Government's more cautious stance toward competition.

The ratings continue to be supported by (1) Welsh Water's low business risk profile as the monopoly provider of essential water and sewerage services in Wales, with stable and predictable cash flows generated under a transparent and well-established regulatory regime; (2) the not-for-profit status of Welsh Water's ultimate parent company, Glas Cymru Holdings Cyfyngedig, which allows Welsh Water to manage the distribution of its profits in order to maintain the company's publicly stated gearing target of 60% net debt to RCV; and (3) the decision by the Welsh Government not to implement retail competition for incumbent water companies operating wholly or mainly in Wales in April 2017, which evidenced a cautious approach to market reform.

RATINGS OUTLOOK

The stable outlook reflects Moody's expectation that the company will be able to maintain financial metrics in line with guidance for its A3 CFR (as outlined below).

WHAT COULD CHANGE THE RATING

The ratings could be considered for an upgrade, if Welsh Water appeared likely to exhibit a ratio of net debt to RCV consistently at or below 55% and an AICR comfortably above 1.5x. Any upgrade would also have to take into account the evolution of the regulatory and business risks at that point in time.

Conversely, the ratings could be downgraded if Welsh Water's financial metrics was likely to deteriorate, such that gearing, measured by net debt to RCV, would increase above 65%, and AICR remain persistently below 1.35x.

In addition, downward rating pressure could result from (1) diversification away from Welsh Water's core regulated water and wastewater business that would result in an increase of the overall business risk, or credit risk implications for Welsh Water from future developments of the wider Glas Cymru group; and/or (2) a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a reduction in the stability and predictability of regulatory earnings, which in each case are not offset by other credit-strengthening measures; or (3) or the company facing unforeseen funding difficulties.

LIST OF AFFECTED RATINGS

Downgrades:

..Issuer: Dwr Cymru (Financing) UK Plc

....Underlying Secured Regular Bond/Debenture, Downgraded to A3 from A2

....Senior Secured Regular Bond/Debenture, Downgraded to A3 from A2

..Issuer: Dwr Cymru Cyfyngedig

.... Long Term Corporate Family Rating, Downgraded to A3 from A2

Outlook Actions:

..Issuer: Dwr Cymru (Financing) UK Plc

....Outlook, Changed To Stable From Rating Under Review

..Issuer: Dwr Cymru Cyfyngedig

....Outlook, Changed To Stable From Rating Under Review

The principal methodology used in these ratings was Regulated Water Utilities published in June 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Dwr Cymru Cyfyngedig is the sixth-largest UK water utility by RCV, providing water and sewerage services to approximately 3 million people in a region that covers most of Wales and certain adjoining areas of England.

Welsh Water's ultimate parent company is Glas Cymru Holdings Cyfyngedig (Glas Cymru), a not-for-profit organisation. In the financial year ending 31 March 2019, Welsh Water had a RCV of just under GBP5.7 billion, and the Glas Cymru group reported revenues of GBP782 million and operating profit of GBP69 million, primarily attributable to Welsh Water.

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