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Research Update:

Outlook On U.K. Water Utility Dwr Cymru (Financing) UK PLC's Debt Revised To Negative On Inflationary Pressure

November 1, 2022

Rating Action Overview

- High inflation is weighing on the credit metrics of U.K. water and wastewater services provider Dwr Cymru (Financing) UK PLC (Dwr Cymru). In particular, it is increasing accretion on the company's inflation-linked financing instruments, which make up roughly 80% of its debt stock, above the sector average of about 50%.
- This, together with a large capital expenditure (capex) program, leads us to project that Dwr Cymru's S&P Global Ratings-adjusted credit metrics will remain below our thresholds for the rating for the fiscal years ending in March 2023 and 2024.
- We project that Dwr Cymru's financial metrics will gradually recover, leaving it with some headroom above our rating thresholds by the end of the current regulatory period (AMP7) in March 2025. However, there is uncertainty around this projection due to the sensitivity of the company's credit metrics to movements in inflation.
- We therefore revised our outlook on the class B and class C debt issued by Dwr Cymru to negative from stable. At the same time, we affirmed our 'A-' issue rating on the class B debt and 'BBB' issue rating on the class C debt.
- The negative outlook indicates that we could lower the ratings on the class B and C debt if we do not see a path for Dwr Cymru's adjusted funds from operations (FFO) to debt to recover to levels commensurate with the rating by the end of AMP7, specifically, 7% for the senior debt (class A and class B) and 6% for the consolidated debt.
- Finally, we affirmed our 'AA' issue rating on the class A debt issued by Dwr Cymru and guaranteed by Assured Guaranty Europe PLC. The outlook on this debt remains stable.

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Rating Action Rationale

Inflationary pressures will erode the rating headroom for Dwr Cymru's debt for most of AMP7 on the back of rising noncash financing costs. Inflation typically benefits regulated water companies like Dwr Cymru, since both its future allowed revenue and its regulatory capital value (RCV) rise in line with the average increase in prices measured by the consumer price index (CPI), including owner occupiers' housing costs (CPIH). That said, significantly higher inflation than we anticipated is weighing on water companies' operating and financing costs, temporarily causing significant operational challenges for the sector. Financing costs in particular are having a significantly negative short-term effect on the sector's credit metrics, notably FFO to debt, because of the accrual of a large amount of noncash inflation that we incorporate into our adjusted metrics, and because water companies in the U.K. tend to have part of their financing linked to inflation. Dwr Cymru uses a significant amount of inflation-linked financing instruments, accounting for about 80% of its total debt. This is higher than the sector average of 50%. We expect annual inflation to remain high in fiscal 2023 and fiscal 2024, before gradually normalizing in fiscal 2025. As a result, we expect that inflation will push up Dwr Cymru's financing costs significantly in fiscal 2023 and fiscal 2024 via an increase in its noncash accretion.

We believe that high inflation will also affect operating conditions throughout the rest of the regulatory period. We foresee pressure on Dwr Cymru's operating margins in the short term, and uncertainty around the macroeconomic environment until the end of the regulatory period. This is in a context of high energy costs that are outpacing average inflation, coupled with an increase in other operating costs, such as labor and chemicals, on top of the COVID-19 pandemic's lingering effects on supply chains. However, Dwr Cymru's wholesale energy costs are hedged for roughly 80%-90% of its power needs for the rest of AMP7, including 30%-35% of self-generation. In line with many of its peers, Dwr Cymru's capex will peak in the last three years of AMP7, on the back of a significant increase in its enhancement expenditure on things such as drought resilience. Capex will rise to an average of about £430 million annually in the last three years of AMP7 from about £340 million in the first two years. As a result, we consider that Dwr Cymru's capital intensity will be high for the rest of AMP7, which will prevent deleveraging since capex will exceed our projection of operating cash flows for fiscal 2023 and fiscal 2024.

We see pressure building on Dwr Cymru's credit metrics for fiscal 2023 and fiscal 2024. We forecast that Dwr Cymru's adjusted FFO to debt will remain below our 7% threshold for the senior debt and 6% for the consolidated debt until March 2025, before likely recovering toward a level we see commensurate with the rating by fiscal 2025. The recovery in metrics hinges on a gradual normalization in inflation by 2025. However, there is significant uncertainty around this assumption due to the sensitivity of the company's credit metrics to movements in inflation.

Low leverage and a unique ownership structure still support Dwr Cymru's overall credit quality. We believe that the company's lower balance-sheet leverage than the rest of the sector is positive for its credit quality. We project that reported debt will remain around 60% of the company's RCV during the rest of AMP7, supported by significant RCV growth. We also believe that Dwr Cymru's unique ownership structure as a nonprofit entity can benefit its financial resilience, as it eliminates the pressure to increase leverage through shareholder distributions.

Outlook

The negative outlook indicates that Dwr Cymru's credit metrics--specifically its adjusted FFO to debt--are likely to remain below levels we see as commensurate with the rating until the end of the current regulatory period, because of inflationary pressures and despite our expectation of a gradual normalization of inflation over the next two years. We forecast that FFO to debt will remain below 6% based on the consolidated debt and below 7% based on the senior debt only for much of AMP7.

Downside scenario

We could lower our rating on the debt issued by Dwr Cymru if the company is unable to mitigate the negative effects of the highly inflationary environment, preventing FFO to debt from recovering above 6% on a consolidated basis and above 7% based on the senior debt only by the end of the current regulatory period. We could also lower the rating if Dwr Cymru's operational performance deteriorates significantly compared with our base case, resulting in a net penalty position for the company on its outcome delivery incentives for the rest of this regulatory period.

Upside scenario

We could revise the outlook to stable if we were to observe a gradual easing of inflationary pressures, leading to a quicker and more certain recovery in credit ratios to levels we consider commensurate with the rating, with FFO to debt consistently above 6% on a consolidated basis and 7% based on the senior debt only. This assumes that Dwr Cymru will not be subject to any form of regulatory intervention that limits its ability to increase bills in line with inflation for the rest of AMP7, and that the company will remain committed to maintaining the rating. It also assumes that Dwr Cmyru will not face tougher operating conditions as part of the 2024 price review.

Company Description

Dwr Cymru is the sixth largest of the 10 regulated water and sewerage companies in England and Wales based on its RCV of about £6.4 billion as of March 31, 2022. It provides water and wastewater services to 3.1 million people across most of Wales and some adjoining areas of England. Dwr Cymru 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, rebates, and reinvestments of profits in the asset base, and, to a lesser extent, investors, although they 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 return.

Our Base-Case Scenario

Assumptions

- Revenue growth in line with the regulatory assumptions, with the ability to pass through CPIH inflation in full for the 12 months to November 2022.
- RPI inflation in the U.K. of 12.6% as of March 31, 2023; 4.5% as of March 31, 2024; and 2.5% as of March 31, 2025.
- Adjusted EBITDA margins of approximately 49%-51% over the rest of AMP7.

- No outperformance on total expenditure against an already tight regulatory allowance, as per the company's track record.
- A backloaded capex program averaging about £430 million a year on average until the end of AMP7.
- A neutral rewards/penalties position on outcome delivery incentives.
- Average social tariff contributions of £12 million per year over AMP7. These contributions are customer rebates and represent revenue that Dwr Cymru has foregone by not applying the full price cap on charges available to it.
- Debt to RCV of about 60% for AMP7.

Key metrics

Dwr Cymru (Financing) UK PLC

	--Fiscal year ended March 31--			
(Mil. £)	**2022a**	**2023f**	**2024f**	**2025f**
EBITDA	419.8	400-420	430-480	440-490
Capital expenditure	274.4	430-480	400-450	370-420
Debt	3702.1	3,900-4,100	4,000-4,300	4,000-4,300
FFO to debt (%)	3.4	1-2	4-5	7-8
Debt to EBITDA (x)	8.8	9-10	9-10	8-9

a--Actual. F--Forecast. FFO--Funds from operations.

Liquidity

We assess Dwr Cymru's liquidity position as adequate, supported by our view that the company's liquidity sources will exceed its funding needs by more than 1.1x in the next 12 months. Our liquidity assessment is further underpinned by Dwr Cymru'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%, and it would not breach its covenants if EBITDA declined by 15%.

Principal liquidity sources in the 12 months from June 30, 2022:

- A cash balance of about £470 million;
- Cash FFO of about £150 million; and
- An undrawn revolving credit facility of £200 million.

Principal liquidity uses in the 12 months from June 30, 2022:

- Upcoming short-term debt maturities of approximately £60 million; and
- Capex of approximately £440 million.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

As one of the U.K.'s main water and wastewater companies, Dwr Cymru provides a key service with a significant social impact. This could expose it to additional scrutiny from the regulator or the Welsh government to ensure not only the high quality and reliability of its network and services, but also affordable costs for customers. However, we consider that the company's unique structure and governance limits these risks and contributes positively to our assessment of social and governance factors. This is because Dwr Cymru is owned by its customers, via its ultimate parent Glas Cymru, a Welsh nonprofit company. As a result, we judge Dwr Cymru's financial policy as being significantly more flexible than the policies of the rest of its peers, as it is not influenced by shareholder considerations. This has led to a significant reduction in leverage over the past 20 years. When it does not use the income it generates to reduce leverage, Dwr Cymru may return it to customers by way of investments in the existing asset base or tariff rebates, ultimately resulting in lower bills for customers. In addition, Dwr Cymru has about 130,000 vulnerable customers on reduced tariffs, far more than any of its peers.

Ratings Score Snapshot

Class B Debt

Issuer Credit Rating: A-/Negative/--

Business risk: Excellent

Country risk: Low

Industry risk: Very low

Competitive position: Strong

Financial risk: Aggressive

Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers:

Diversification/Portfolio effect: Neutral

Capital structure: Neutral

Financial policy: Neutral

Liquidity: Adequate

Management and governance: Satisfactory

Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Structural enhancements: +1 notch

Class C Debt

Issuer Credit Rating: BBB/Negative/--

Business risk: Excellent

Country risk: Low

Industry risk: Very low

Competitive position: Strong

Financial risk: Aggressive

Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers:

Diversification/Portfolio effect: Neutral

Capital structure: Neutral

Financial policy: Neutral

Liquidity: Adequate

Management and governance: Satisfactory

Comparable rating analysis: Neutral

Stand-alone credit profile: bbb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Outlook On U.K. Water Operator Affinity Water Finance PLC Debt Revised To Negative On Inflationary Pressure, Oct. 28, 2022
- Outlook On South East Water (Finance) Ltd.'s Debt Revised To Negative On Increasingly Inflationary Environment, Oct. 27, 2022
- U.K. Water Operator Anglian Water Services Ltd. Outlook Revised To Negative On Inflationary Pressure, Oct. 20, 2022
- United Utilities Water Rating Affirmed At 'BBB+', Parent United Utilities PLC Affirmed At 'BBB'; Outlook Stable, Oct. 13, 2022
- Northumbrian Water Ltd. And Northumbrian Water Group Ltd. Downgraded To 'BBB' From 'BBB+'; Outlook Stable, Oct. 12, 2022
- Severn Trent Water Ltd. 'BBB+' And Parent Company Severn Trent PLC 'BBB' Ratings Affirmed; Outlook Stable, Sept. 30, 2022
- Outlook On Southern Water Services (Finance)'s Debt Revised To Negative On Inflationary Pressure, Sept. 20, 2022
- Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable, Sept. 16, 2022
- Why We See England And Wales' Water Regulatory Framework As Strong, July 1, 2022

Ratings List

Ratings Affirmed; Outlook Change

	To	From
DWR Cymru (Financing) UK PLC		
Senior Secured*	AA/Stable	AA/Stable
Senior Secured	A-/Negative	A-/Stable
Subordinated	BBB/Negative	BBB/Stable
*Guaranteed by Assured Guarantee.		