



## RATING ACTION COMMENTARY

# Fitch Affirms Dwr Cymru's Senior Secured Debt at 'A'; Outlook Stable

Fri 17 Mar, 2023 - 2:01 PM ET

Fitch Ratings - London - 17 Mar 2023: Fitch Ratings has affirmed Dwr Cymru (Financing) UK Plc's (Dwr) senior secured class A and class B debt (both wrapped and unwrapped) at 'A' and its subordinated class C debt at 'BBB+'. The Outlooks are Stable.

The affirmation and Stable Outlook reflects Fitch's expectation that operating company Dwr Cymru Cyfyngedig's (Welsh Water, guarantor of Dwr) financial profile will remain commensurate with the ratings for the five-year price control ending March 2025 (AMP7).

Fitch expects Dwr to maintain comfortable gearing headroom against our negative rating sensitivities across class A and B, and class C debt. This headroom should also absorb weak average cash and nominal post- maintenance interest cover ratios (PMICR) for AMP7.

The ratings also consider operational and regulatory performance of Welsh Water, its target gearing of 60%, and the secured nature of the group's financing structure. The latter benefits from structural enhancements, including trigger mechanisms (gearing and interest coverage covenants) and debt service reserve liquidity.

## KEY RATING DRIVERS

**Inflation-linked Debt Offset Inflation Benefit:** Dwr has about 80% of its total debt inflation-linked (IL), higher than the Fitch-rated UK water sector average of about 60%.

While IL debt provides a hedge against regulated capital value (RCV) that grows with inflation over time, we expect the higher accretion to the IL debt from inflation to contribute to weak nominal PMICRs, reflecting the rising total cost of debt. Dwr's rating sensitivities for gearing were previously tightened in recognition of the extended weakness in PMICRs.

**Inflation Mismatch:** We expect higher inflation is to boost shadow RCV, which is 50% indexed each to the consumer price index (CPIH) and to the retail price index (RPI). Additions to RCV for AMP7 are indexed entirely to CPIH. However, all of Dwr's IL debt is indexed to RPI, which creates an inflation benchmark mismatch.

**Comfortable Gearing Headroom:** We forecast net debt/RCV for the class A and B notes at 52.5% and the class C notes at 65% by financial year ending March 2025 against our negative rating sensitivities of 65% and 74%, respectively.

**Depleted PMICR Headroom:** We expect depleted PMICR headroom for class A and B debt, with forecast average cash PMICR of about 1.2x and nominal PMICRs of about 1.7x for AMP7, against our negative rating sensitivities of 1.5x and 1.7x, respectively. We forecast average cash PMICR of about 1.3x and nominal PIMCR of about 1.5x for class C debt, which is commensurate with negative rating sensitivities of 1.2x and 1.5x, respectively, although with no headroom.

**Totex Under-performance Expected:** We expect Welsh Water to underperform its total expenditure (totex) allowance by 12.9% across AMP7 with operating expenditure (opex) and capex underperformance of 12.2% and 13.8% respectively. Welsh Water is investing about GBP100 million in combined storm overflows to improve environmental outcomes and reduce penalties. These investments, which are within our expectations, are aimed at improving performance in water supply interruptions, water quality (multi-stakeholder initiatives to reduce phosphate), and wastewater asset health.

**Energy Mostly Hedged for AMP7:** We assume the impact from higher-than-expected energy prices to be neutral on opex for AMP7, supported by the group's self-sufficiency in 24% of its power requirements, with the rest about 85% hedged for FY24-FY25. The rolling hedge position will contribute to overall higher energy costs but it is likely to be offset by regulatory cost-sharing and higher allowances through IL totex.

**Net ODI Penalties Assumed:** We forecast GBP35 million-GBP40 million of net cash outcome delivery incentives (ODI) penalties (nominal) related to operational performance in AMP7. In the first two years of AMP7, Welsh Water incurred penalties mainly in water supply interruptions and water quality. Despite its sector-leading performance for internal sewer flooding in 2022, Welsh Water lagged behind other

regulated UK water companies in Ofwat's (UK water service regulation authority) overall performance category.

## DERIVATION SUMMARY

Welsh Water could make discretionary customer distributions, reducing post maintenance cash flows, or reinvest its free cash flow into the business for the benefit of customers, making it unique among its peers. This is mitigated by the lack of need to pay dividends and by its long-standing conservative gearing policy of 60% which is among the lowest in the sector.

Dwr's senior secured (class A and class B) and subordinated (class C) ratings of 'A'/Stable and 'BBB+'/'Stable, respectively, reflect the company's more conservative gearing profile and its secured covenanted structure compared with the standard corporate structure of its peer United Utilities Water Limited (BBB+'/'Stable; senior unsecured debt: A-).

## KEY ASSUMPTIONS

- Allowed weighted average cost of capital in AMP7 of 1.92% (RPI-based) and 2.92% (CPIH-based)
- RCV is 50% RPI-linked and 50% CPIH-linked plus capital additions since FY21
- RPI of 10.8% for FY23, 8% for FY24 and 3.9% for FY25
- CPIH of 8.5% in FY23, 6% in FY24 and 2.8% in FY25
- Allowed totex of around GBP3.1 billion in nominal terms (net of grants and contributions) over AMP7
- Average pay-as-you go rate of 56% and average run-off rate of 4.77% for AMP7
- Totex underperformance of 12.9% over AMP7
- Cash ODI-related penalties of GBP35 million-GBP40 million over FY23-FY25

## RATING SENSITIVITIES

**Factors that could, individually or collectively, lead to positive rating action/upgrade:**

- For class A and B debt: forecast gearing comfortably and consistently below 57%, cash PMICR above 1.7x and nominal PMICR above 1.9x

-For class C debt: forecast gearing comfortably and consistently below 59%, cash PMICR above 1.4x and nominal PMICR above 1.6x

### **Factors that could, individually or collectively, lead to negative rating action/downgrade:**

- A marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework
- For class A and B debt: forecast gearing approaching 65%, cash PMICR below 1.5x and nominal PMICR below 1.7x
- For class C debt: forecast gearing approaching 74%, cash PMICR below 1.2x and nominal below 1.5x
- Insufficient forecast gearing headroom to compensate for weak cash and nominal PMICRs

### **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

### **LIQUIDITY AND DEBT STRUCTURE**

**Strong Liquidity:** As at 30 September 2022, Welsh Water had cash and cash equivalents of GBP511 million and access to GBP200 million of undrawn revolving credit facilities. Fitch expects negative free cash flow of around GBP166 million for FY23 with no bond maturities within AMP7.

### **ISSUER PROFILE**

Welsh Water is a not-for profit organisation and does not pay dividends to external shareholders. It is the sixth-largest of 10 regulated water and sewerage companies in England and Wales based on its RCV of about GBP6.5 billion as of end-March 2022. It

provides water and wastewater services to 3.1 million people across most of Wales and parts of Herefordshire and Cheshire.

Dwr is a financing vehicle for Welsh Water ultimately owned by Glas Cymru Holdings Cyfyngedig (Glas Cymru).

### Criteria Variation

Leases of about GBP396 million were included in the debt figure to reconcile it with the investor report and regulatory treatment. This is a criteria variation from the corporate rating criteria's treatment of leases where we exclude it for most sectors, including utilities.

### SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest reconciled with investor reports
- Statutory total debt reconciled with investor reports
- Infrastructure renewal expenditure reclassified as opex from capex

### REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

### ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg)

### RATING ACTIONS

**ENTITY / DEBT** ⚡

**RATING** ⚡

**PRIOR** ⚡

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Dwr Cymru (Financing)

UK Plc

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subordinated	LT	BBB+ Rating Outlook Stable		BBB+ Rating Outlook Stable
		Affirmed		

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senior secured	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable
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[VIEW ADDITIONAL RATING DETAILS](#)

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## **APPLICABLE CRITERIA**

[Corporates Recovery Ratings and Instrument Ratings Criteria \(pub. 09 Apr 2021\)](#)  
(including rating assumption sensitivity)

[Sector Navigators: Addendum to the Corporate Rating Criteria \(pub. 28 Oct 2022\)](#)

[Corporate Rating Criteria \(pub. 28 Oct 2022\)](#) (including rating assumption sensitivity)

## **APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

## **ADDITIONAL DISCLOSURES**

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Dwr Cymru (Financing) UK Plc

UK Issued, EU Endorsed

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