FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Dwr Cymru's (Welsh Water) Senior Secured Debt at 'A'; Outlook Stable

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Fitch Ratings - London - 11 Mar 2024: Fitch Ratings has affirmed Dwr Cymru (Financing) UK Plc's (DWR) senior secured class A and B debt (both wrapped and unwrapped) at 'A' and its subordinated class C debt at 'BBB+'. The Outlooks are Stable.

The affirmation reflects Fitch's expectation that the financial profile of the operating company Dwr Cymru Cyfyngedig (Welsh Water), which guarantees DWR's debt, will remain commensurate with the ratings for the five-year price control ending March 2025 (AMP7) and includes a provisional overview of the trend expected for AMP8 (price control April 2025 to March 2030).

Fitch expects DWR to maintain adequate net debt/regulated capital value (RCV) headroom against its negative rating sensitivities across class A and B, and class C debt in AMP7. This headroom is sufficient to offset expected weak average cash and nominal post-maintenance interest cover ratios (PMICRs).

The ratings also consider the sound operational and regulatory performance of Welsh Water, its conservative target net debt/RCV of 60%, and the secured nature of the group's financing structure.

KEY RATING DRIVERS

Large Gearing Headroom in AMP7: We forecast net debt/RCV for the class A and B notes at about 52% and the class C notes at about 63% for financial year ending March 2025 (FY25) 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 PMICRs 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 1.2x and nominal PMICR of about 1.6x for class C debt, which is commensurate with negative rating sensitivities of 1.2x and 1.5x, respectively, although with no headroom.

Ambitious AMP8 Business Plan: Welsh Water's draft AMP8 business plan (for price review 2024 (PR24)) includes a GBP5 billion (real 2022/2023) total expenditure (totex) programme targeting significant environmental improvements and operational efficiencies, which is almost 70% higher than that of AMP7. This plan is based on Ofwat's early view weighted average cost of capital (WACC) of 3.3% and a notional company gearing of 55%. Funding for the plan is expected to come from higher customer bills, retained earnings and additional debt.

Inflation-linked Debt Offsets Inflation Benefit: DWR has 84% of its total debt linked to inflation (IL), higher than the Fitch-rated UK water sector average of about 60%. While IL debt provides a hedge against RCV that grows with inflation over time, we expect the higher accretion to IL debt from inflation to contribute to weak nominal PMICRs, reflecting the rising total cost of debt.

Inflation Mismatch: The entirety of DWR's IL debt portfolio is indexed to the retail price index (RPI), which creates an inflation mismatch when compared with its RCV. AMP7 RCV indexation is 50% RPI-linked and 50% plus capital additions linked to the consumer price index (CPIH), moving to 100% CPIH-linked in AMP8.

Net ODI Penalties Assumed: We forecast around GBP40 million of cumulative net cash outcome delivery incentives (ODI) penalties (nominal) related to operational performance across FY24 and FY25. In the first three years of AMP7, Welsh Water incurred penalties of cumulatively GBP30 million, mainly in water supply interruptions, water quality and leakage. Despite its sector-leading performance for internal sewer flooding in 2023, Welsh Water lagged behind other regulated UK water companies in Ofwat's overall performance category.

Self-Reported Incorrect Regulatory Findings: Fitch has not assumed any additional penalties in FY24 and FY25 relating to Welsh Water's incorrect regulatory reporting for leakage and per capita consumption (PCC) announced in May 2023. We acknowledge management's announced GBP29 million redress package, with GBP15 million refunded to customers in FY24 and GBP14 million to reduce the RCV at the start of AMP8 through the midnight adjustment.

Totex Under-performance Expected: We expect Welsh Water to underperform its totex allowance by 12.2% across AMP7 with operating expenditure (opex) and capex underperformance of 14.5% and 9.3%, 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, with about 85% hedged for FY25. Welsh Water benefits from self-generating about 22% of its power requirements in FY23 with the target to reach 35% by FY25.

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 (IDR BBB+/Stable; senior unsecured debt: A-). DWR benefits from structural enhancements, including trigger mechanisms (gearing and interest coverage covenants) and debt service reserve liquidity.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

-Ofwat's final determinations financial model and PR24 business plan used as a main information source

-Allowed WACC in AMP7 of 1.9% (RPI-based) and 2.9% (CPIH-based)

-Broadly 50% of the RCV RPI-linked and another 50% plus capital additions CPIH-linked from FY21 to FY25;100% CPIH-linked for AMP8

-RPI of 8.3% for FY24 and 4.1% for FY25

-CPIH of 6.2% in FY24 and 2.8% in FY25

-Allowed totex of around GBP3.4 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 4.8% for AMP7

-Totex underperformance of 12.2% over AMP7

-Net cash ODI-related penalties of around GBP40 million cumulatively over FY24-FY25

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- For class A and B debt: net debt/RCV comfortably and consistently below 57%, combined with cash PMICR above 1.7x and nominal PMICR above 1.9x

-For class C debt: net debt/RCV comfortably and consistently below 59%, combined with 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: net debt/RCV approaching 65%, combined with cash PMICR below 1.5x and nominal PMICR below 1.7x

- For class C debt: net debt/RCV approaching 74%, combined with cash PMICR below 1.2x and nominal below 1.5x

- Insufficient net debt/RCV headroom to compensate for weak cash and nominal PMICRs

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: As at 30 September 2023, Welsh Water had cash and cash equivalents of GBP306.5 million and access to GBP200 million of undrawn revolving credit facilities (RCF) maturing in November 2024. We expect its RCF will be extended, consistent with the company's past record. Fitch expects negative free cash flow of around GBP109 million for FY24 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 GBP7.1 billion as of end-March 2023.

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

SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest reconciled with investor reports

- Statutory total debt reconciled with investor reports

- Infrastructure renewal expenditure reclassified to capex from opex

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

For more information on Fitch's ESG Relevance Scores, visit

https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Dwr Cymru (Financing) UK Plc				
subordinated	LT	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
senior secured	LT	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 03 Nov 2023)

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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dwr Cymru (Financing) UK Plc	UK Issued, EU Endorsed

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