MOODY'S
RATINGS

Rating Action: Moody's Ratings places Welsh Water's ratings on review for downgrade

13 Nov 2024

London, November 13, 2024 -- Moody's Ratings (Moody's) has today placed Dwr Cymru Cyfyngedig's (Welsh Water's) A3 Corporate Family Rating (CFR) and Dwr Cymru (Financing) UK Plc's A3 senior secured, backed senior secured and underlying senior secured debt ratings and Baa2 subordinate debt ratings on review for downgrade. The outlook on both entities was previously stable.

Dwr Cymru (Financing) UK Plc's backed senior secured A1 ratings continue to reflect the unconditional and irrevocable guarantee of scheduled principal and interest from Assured Guaranty UK Limited (AG, A1 stable) and are unaffected by today's action.

RATINGS RATIONALE / FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Today's rating action reflects a deterioration in the sector's business risk profile. In particular, it takes into account the risk that Welsh Water will not be able to maintain financial metrics commensurate with our tightened guidance for the current rating category in the five year regulatory period starting in April 2025, known as AMP8. This risk appears likely to crystallise unless Ofwat's final determination is materially more supportive of credit quality than the regulator's draft decision.

In the face of continuing public scrutiny and heightened political and regulatory focus, there has been a material and sustained weakening of credit quality for nearly all companies. Across the sector, past decisions including to prioritise affordability and shareholder distributions (albeit to a much lesser extent for Welsh Water given the non-for-dividend status of the ultimate parent company, Glas Cymru Holdings Cyfyngedig), have contributed to underinvestment and exacerbated the sector's exposure to changing weather patterns, population growth and shifting expectations. Regulatory targets have become more demanding and penalties for those that fall short have continued to grow. With widespread investigations, fines for UK water companies breaching environmental legislation are likely to increase further.

In addition, a perception that the water sector is "broken" has prompted a governmentinitiated strategic review that aims to improve the regulatory environment and create a stable backdrop to attract investment. However, until completed and any potentially credit positive recommendations are successfully implemented, this review also brings increased near-term uncertainty.

Taking account of the above we have changed our assessment of stability and predictability of the regulatory environment for the UK water sector under our rating methodology to A from Aa.

The risk that public concern over environmental, social or affordability issues could drive adverse regulatory or political intervention is a key aspect of demographic and societal trends that are assessed under the social risk considerations of our framework for assessing Environmental, Social and Governance (ESG) risks. The unique not-for-dividend status and aims of the devolved Welsh government partially alleviates this risk, resulting in an S-3 for social risk (compared to the water companies in England who face elevated S-4), and G-1 governance risk. However, we feel the balance of risks is shifting further towards environmental and social considerations, and have reduced Welsh Water's overall impact score to CIS-3 from CIS-1, reflecting the potential for greater negative impact over time.

The economic regulator, Ofwat, assessed Welsh Water's business plan for the AMP8 regulatory period as 'Standard' (the second best out of four designations) but ineligible for a financial reward. In its draft determinations, Ofwat provisionally granted expenditure allowances approximately 12% below the company's request, with reductions weighted towards enhancement expenditure. The reduction when compared to the company's request is slightly better than the industry average, which we calculate at a 15% reduction.

We view the largest risk from the draft determinations as Welsh Water's leakage Outcome Delivery Incentive (ODI). Welsh Water was under investigation for its leakage reporting during the current AMP7, which was ultimately settled in May 2024 with Ofwat accepting the company's undertakings in lieu of a fine. Welsh Water has restated its historic leakage numbers and for 2023-24, the most recent year available, has reported 251.6Ml/day. The draft determination sets a target of 176.2Ml/day for 2025-26, and when combined with significantly more high powered incentive rates, could result in a penalty of £45 million even if the company is able to deliver the leakage reduction in its business plan. If the company is unable to reverse the currently increasing trend in leakage, penalties may be significantly higher.

Welsh Water, along with the rest of the industry, has made representations against the draft determinations. Ofwat is currently considering these and we understand that Ofwat intends to review its performance incentive regime, which should improve the risk-reward balance. Ofwat's final determinations is scheduled for 19 December 2024, although the regulator has made provisions for a delayed release in January 2025.

The rating review will consider any improvement in the risk-return profile after final determinations, or ultimately through an appeal to the Competition and Markets Authority (CMA). We expect to conclude the review once the final outcome of Ofwat's regulatory review is known.

Welsh Water's rating continues to be supported by: (1) its position as a monopoly provider of essential water and sewerage services; (2) its low level of gearing at 60%; (3) the not-for-dividend status of Glas Cymru Holdings Cyfyngedig without pressure for shareholder dividends; and (4) a more cautious approach to market reform in Wales compared to England. However, the rating is constrained by: (1) the aforementioned challenges in the draft determination; and (2) high cash interest costs as a result of inflation-linked derivatives and interest coverage ratios which may not meet revised guidance.

Commensurate with the reduction in stability and predictability of the regulatory environment, we have tightened our guidance for the A3 rating to Net Debt to RCV less than or equal to 60% for the entire industry, and Adjusted Interest Coverage Ratio (AICR) greater than or equal to 1.6x which is issuer specific for Welsh Water and reflects its unique characteristics.

Given the review for downgrade, an upgrade is not currently envisioned. The rating could be confirmed if: (1) Ofwat's final determination reduced the scope for financial penalties, particularly resulting from leakage levels; (2) following the final determination, we expect AICR to remain above 1.6x on average across the regulatory period; and (3) Ofwat were to increase totex allowances or Welsh Water were otherwise able to reduce its planned expenditure, avoiding significant overspends and consequential increases in gearing given the company's inability to raise equity injections from shareholders.

The ratings could be downgraded if: (1) the final determination does not improve the risk-return balance, in particular with regards to leakage penalties; (2) there is a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a further reduction in the stability and predictability of regulatory earnings; (3) we forecast that Welsh Water will be unable to achieve an AICR above 1.6x on average and gearing under 60%; (4) a change in corporate strategy towards higher-risk non-regulated activities; or (5) unforeseen funding difficulties.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Regulated Water Utilities published in August 2023 and available at https://ratings.moodys.com/rmc-documents/406788. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

Dwr Cymru Cyfyngedig is the sixth-largest of the ten original water and sewerage companies in England and Wales, with an RCV of around £7.5 billion as of March 2024. It serves a population of approximately 3.1 million domestic customers and

110,000 business customer sites in a region that covers most of Wales and parts of Herefordshire and Cheshire.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

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At least one ESG consideration was material to the credit rating action(s) announced and described above.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824 .

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