FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Dwr Cymru's Senior Secured Class A and Class B Debt to 'A-'; Outlook Stable

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Fitch Ratings - London - 17 Feb 2025: Fitch Ratings has downgraded Dwr Cymru (Financing) UK Plc's (Dwr) senior secured class A and B debt (both wrapped and unwrapped) to 'A-' from 'A'. Its subordinated class C debt is downgraded to 'BBB' from 'BBB+'. The Outlooks are Stable.

The downgrade is due mainly to tightened rating sensitivities for AMP8 (the five-year price control period ending March 2030), following Fitch's sector review. This means that Dwr's expected ratios no longer align with the previous ratings. Fitch now combines all classes of debt at Dwr into a unified set of stricter rating sensitivities. Additionally, we believe that net outcome delivery incentives (ODI) penalties, assumed fines, and increased interest costs from substantial funding needs for AMP8 investments, would weaken Dwr's post-maintenance interest coverage ratios (PMICRs).

The Stable Outlook is underpinned by Dwr's comfortable net debt/regulatory capital value (RCV) headroom, which offsets forecast cash and nominal PMICRs that are around their negative sensitivities for AMP8.

KEY RATING DRIVERS

Rising Sector Risk: Fitch believes that the final determination has provided a reasonable outcome for most UK water companies, especially compared with the draft determination, and is in line with our expectations. However, we still see moderately higher business risk in AMP8, mainly driven by heightened exposure to environmental risk, increasing public scrutiny, and higher clawback risk, which is linked to the price control deliverables (PCDs) mechanism. Further uncertainties may arise from the Cunliffe review, the most significant regulatory reform since privatisation.

The sector also faces a heightened risk of fines related to operational and environmental under-performance, and a pressing need to rebuild trust with the public, government, and regulatory bodies. At the same time, we would expect the sector to enhance its assets to accommodate population growth and extreme weather conditions.

Constrained PMICRs Forecast: We forecast PMICRs at their negative rating sensitivities, with Dwr's cash PMICR at 1.5x and nominal PMICR at 1.8x. These ratios are weaker than those of peers at the same rating, due to 85% of its debt being inflation-linked, significantly above our calculated sector average of 52%. Additionally, Dwr's embedded cost of debt is among the highest in the sector. Plans to shift towards fixed-rate issuance is expected to weaken cash PMICRs in AMP8, limiting rating headroom. Our forecasts assume an average cost of new debt at 5.6%, broadly in line with the sector average.

Comfortable Gearing Headroom: Fitch forecasts ample total net debt/RCV rating headroom for Dwr against our tightened negative sensitivity of 70%. We forecast net debt/RCV to remain stable at 63% by end-AMP8, consistent with FY24's (financial year-end-March). This stability is supported by dividend retention due to the parent company, Glas Cymru Holdings Cyfyngedig, maintaining a non-dividend policy.

Neutral Total Expenditure (Totex) Performance: AMP8 totex is GBP6 billion (2022-2023, real terms), excluding Ofwat's adjustments, sharply up from GBP3.6 billion in AMP7. Totex allowances are aligned with Dwr's request. AMP8 enhancement totex is nearly 4x higher AMP7's, with 90% under the PCD mechanism; storm overflows represent 46% of suchg investments. Under PCD, investments need to achieve the Ofwat benchmarks of allowance and timeline to mitigate the risk of a clawback. PCD ensures that funding is ringfenced and unspent allowances are returned to customers.

Net ODI Penalties Assumed: We forecast cumulative net in-period ODI penalties of GBP150 million for AMP8. Since the cash impact of these penalties materialises with a two-year lag, we expect cash ODI penalties of GBP156 million in AMP8, including amounts from AMP7's final two years. In AMP8, we expect Dwr to incur penalties mainly for leakages, water supply interruptions, storm overflows and main repairs.

Regulatory Fines Forecast: Fitch forecasts GBP37 million in total fines as baseline cash outflows, due to heightened regulatory scrutiny and stricter controls on wastewater networks. We have assumed fines across all companies operating wastewater networks and will adjust this assumption to reflect actual fines or a perceived reduction in risk, accordingly.

DERIVATION SUMMARY

Dwr's senior secured class A and class B debt is rated in line with Anglian Water Services Financing Plc's class A debt. It is rated higher than Yorkshire Water Services Finance

Limited's (YWS) class A debt rating of 'BBB+'/Stable. This is due to YWS's class A debt rating no longer benefitting from a one-notch uplift for sector-specific recovery, as a result of its large super senior mark-to-market (MtM) liabilities at well above 10% of its RCV. For Dwr's class A and class B and Anglian Water's class A debt ratings, we still apply the uplift for sector-specific recovery.

Dwr's class A and class B debt rating is three notches above SW (Finance) I PLC's (Southern Water) class A debt rating of 'BBB-'/Rating Watch Negative. Similar to YWS, Southern Water also has substantial super senior MtM liabilities, which led to the same removal of the sector-specific recovery uplift, in addition to its higher leverage.

KEY ASSUMPTIONS

- Ofwat's final determination financial model used as the principal source of information

- Neutral totex performance

- Net cash ODI penalties of GBP156 million in AMP8

- Fines totalling GBP37 million in AMP8

- Nominal cost of new debt averaging 5.6%

- CPIH averaging 2.8% (starting at 3.3% in FY26 and decreasing to 2.5% by 2030). RPI averaging 3% (starting at 3.5% in FY26 and trending down to 2.5% by 2030)

- No cash tax payments or pension-deficit recovery payments

- No dividends or equity injections

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Adjusted total net debt/RCV above 70%, cash PMICR below 1.5x and nominal PMICR below 1.8x

- Deterioration in operational and environmental performance, resulting in financial penalties and fines that exceed Fitch's rating case

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

- Adjusted total net debt/RCV below 65%, combined with cash PMICR above 1.7x and nominal PMICR above 1.9x

LIQUIDITY AND DEBT STRUCTURE

As at 30 September 2024, Dwr had cash and cash equivalents of about GBP690 million and access to GBP400 million of undrawn revolving credit facilities (RCF) maturing in November 2027. Fitch expects Dwr to access debt markets within the next 12 months to address upcoming debt maturities of GBP720 million, and expected negative free cash flow of about GBP180 million in FY26.

ISSUER PROFILE

Dwr is an Ofwat-regulated regional monopoly providing water and sewerage services in England and Wales with an RCV of about GBP7.5 billion as of FYE24. We forecast this to increase to about GBP11 billion by the end of AMP8.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest and total debt reconciled with investor reports

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.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

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 Downgrade	BBB+ Rating Outlook Stable
senior secured	LT	A- Rating Outlook Stable Downgrade	A Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporate Recovery Ratings and Instrument Ratings Criteria (pub. 02 Aug 2024) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 06 Dec 2024) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 06 Dec 2024)

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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