MOODY'S
RATINGS

Rating Action: Moody's Ratings downgrades Welsh Water's ratings to Baa1; outlook stable

18 Feb 2025

London, February 18, 2025 -- Moody's Ratings (Moody's) has today downgraded Dwr Cymru Cyfyngedig's (Welsh Water's) long-term Corporate Family Rating (CFR) and Dwr Cymru (Financing) UK Plc's senior secured, backed senior secured and underlying senior secured debt ratings to Baa1 from A3, and subordinate debt ratings to Baa3 from Baa2; the outlook for both entities is stable. Previously, the ratings were on review for downgrade.

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

Today's rating action reflects our view that Welsh Water will be unable to maintain average Net Debt to RCV less than or equal to 60% as commensurate with the previous A3 rating following the recent regulatory determination.

On 19 December 2024, the regulator Ofwat published its final determinations of tariffs, costs allowance and returns for the regulatory period running from 1 April 2025 to 31 March 2030 (known as AMP8)[1]. On 22 January 2025, Welsh Water became the first company to formally accept the determination[2].

Welsh Water's final determination was materially improved from the draft determination published in July 2024. Ofwat granted expenditure allowances of £5,997 million over the five years against the company's revised request of £6,021 million (in 2022-23 prices), a cut of 0.4% compared to 12.2% at the draft stage.

The package of Outcome Delivery Incentives (ODIs) has also improved, with less demanding performance targets and greater use of maximum penalty caps by Ofwat. In particular on leakage, Welsh Water will accrue £62 million of ODI rewards if it delivers its performance forecast, compared to a £112 million penalty for the same level of performance at the draft determination stage.

However, challenges remain for other incentives. Ofwat continued to reject Welsh Water's request for a bespoke harm-based storm overflows ODI – instead mandating a spills-based measure, albeit with less challenging targets than for Welsh Water's peers. Despite this, we expect the company to incur a £16 million penalty on this measure, which could worsen towards the maximum £60 million penalty if performance does not improve from 2023-24 levels. We note positively that the maximum penalty has been reduced to 0.5% of wastewater Return on Regulated Equity (RoRE) and is now in line with peers, whereas at the draft stage it was set at the higher level of 0.75% for Welsh Water only.

In addition, Welsh Water's expected performance under the mains bursts ODI (used as a proxy for asset health) has deteriorated since the draft determination, with the company now expecting to complete more work to achieve its leakage performance. We expect Welsh Water to incur a penalty of around £25 million on this incentive, close to the maximum of £32 million.

While overall we expect the company to achieve ODI rewards of approximately £10 million per annum, penalties from some of the ODIs may be higher than we expect, in particular if Welsh Water's service area is hit by severe weather events.

Moody's adjusted Net Debt to RCV was 60.4% as of March 2024, and we expect this to increase to 62-64% in March 2025. These levels, which we forecast will be maintained during AMP8, are above the 60% guidance for the A3 rating level, as revised in November 2024. If Welsh Water significantly overspends or incurs net ODI penalties, gearing will increase further absent measures to bolster balance sheet strength. In this regard, and given the nature of its ultimate parent, Welsh Water is unable to raise equity.

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 levels of gearing relative to the sector; (3) the not-for-dividend status of ultimate parent company 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) challenges remaining in certain areas of the final determination; and (2) high cash interest costs as a result of inflation-linked derivatives.

Regulatory risk is part of demographic and societal trends that are assessed under the social risk considerations of our framework for environmental, social and governance 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).

A comprehensive review of all credit ratings for the respective transaction has been conducted during a rating committee.

RATING OUTLOOK

The stable outlook reflects our expectation that Welsh Water will perform in line with its final determination and achieve key ratios commensurate with the current rating levels.

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

The ratings could be upgraded if we expect Moody's Adjusted Interest Coverage Ratio (AICR) to be above 1.6x on average across the regulatory period and Net Debt to RCV to be under 60%.

The ratings could be downgraded if: (1) we forecast that Welsh Water will be unable to achieve an AICR above 1.4x on average and Net Debt to RCV under 68%; (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); a change in corporate strategy towards higher-risk non-regulated activities; or (4) 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 .

For any affected securities or rated entities receiving direct credit support/credit substitution from another entity or entities subject to a credit rating action (the supporting entity), and whose ratings may change as a result of a credit rating action as to the supporting entity, the associated regulatory disclosures will relate to the supporting entity. Exceptions to this approach may be applicable in certain jurisdictions.

For ratings issued on a program, series, category/class of debt or security, certain regulatory disclosures applicable to each rating of a subsequently issued bond or note of the same series, category/class of debt, or security, or pursuant to a program for which the ratings are derived exclusively from existing ratings, in accordance with Moody's rating practices, can be found in the most recent Credit Rating Announcement related to the same class of Credit Rating.

For provisional ratings, the Credit Rating Announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating.

Moody's does not always publish a separate Credit Rating Announcement for each Credit Rating assigned in the Anticipated Ratings Process or Subsequent Ratings Process.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website https://ratings.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

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/rmc-documents/435880.

The Global Scale Credit Rating(s) discussed in this Credit Rating Announcement was(were) issued by one of Moody's affiliates outside the EU and is(are) endorsed for use in the EU in accordance with the EU CRA Regulation.

REFERENCES/CITATIONS

[1] Ofwat Final determinations in the 2024 price review 19-Dec-2024

[2] Welsh Water Dwr Cymru confirms acceptance of £6bn Business Plan for 2025-30 22-Jan-2025

Please see https://ratings.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the issuer/deal page on https://ratings.moodys.com for additional regulatory disclosures for each credit rating.

Matthew Brown
Vice President - Senior Analyst

Neil Griffiths-Lambeth
Associate Managing Director

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London, E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

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