MOODY'S INVESTORS SERVICE

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 22 Aug 2012

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	A3

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Key Indicators

Dwr Cymru Cyfyngedig[1][2]

	Mar-12	Mar-11	Mar-10	Mar-09	Mar-08
Net Debt / RCV	**63.0%**	**66.1%**	**70.3%**	**72.3%**	**70.3%**
Adjusted ICR	**1.5x**	**1.6x**	**2.1x**	**1.7x**	**1.7x**
FFO Net Interest Cover	**3.1x**	**3.2x**	**3.8x**	**3.1x**	**3.0x**
FFO / Net Debt	**11.1%**	**10.8%**	**12.0%**	**10.3%**	**10.5%**
RCF / Net Debt	**11.1%**	**10.8%**	**12.0%**	**10.3%**	**10.5%**
RCF / Capex	**113.0%**	**111.8%**	**90.8%**	**77.5%**	**96.0%**

[1] Ratios are calculated post payment of customer dividend [2] All ratios are calculated using Moody's Standard Adjustments; Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Dwr Cymru Cyfyngedig ("Welsh Water") is the sixth-largest UK water utility by regulatory capital value ("RCV"), providing water and sewerage services to approximately 1.4 million households and businesses in a region that covers most of Wales and certain adjoining areas of England. Welsh Water's ultimate parent company is Glas Cymru Cyfyngedig ("Glas Cymru"), a not-for-profit organisation. In the fiscal year 2011/12, Welsh Water had a Regulated Capital Value ("RCV") of GBP4,170 million and reported revenues of GBP695million and operating profit of GBP191 million.

Rating Rationale

Welsh Water's A3 corporate family rating (CFR) consolidates the legal and financial obligations of the company, its funding vehicle Dwr Cymru (Financing) Limited and the three holding companies that are in the ring-fenced group. In line with our approach towards similar structured transactions (such as Anglian Water, Thames Water or Yorkshire Water), Moody's rating assessment of Welsh Water is the result of the evaluation of (i) the company's low business risk profile, (ii) its financial leverage and (iii) the structural enhancements of the bond covenant and security package. In terms of the covenant and security package, we note that Welsh Water's A3 rating currently does not incorporate any significant uplift for credit-enhancing features, given that due to its moderate leverage, Welsh Water exhibits significant headroom in its financial metrics compared to the additional indebtedness trigger levels embedded in its financing structure.

Moody's also takes into account the not-for-profit status of Welsh Water's ultimate parent company, Glas Cymru, which has allowed Welsh Water to significantly reduce leverage since the initial financing structure was put in place in May 2001, and the company's stated policy of leverage around 70%.

DETAILED RATING CONSIDERATIONS

Moody's rating assessment is based on the application of the global Rating Methodology for Regulated Water Utilities, published in December 2009. Based on a three-year historical average, the methodology grid results in an indicative factor outcome of A2, one notch higher than the assigned A3 CFR. This score reflects the recent improvement in Welsh Water's financial metrics, particularly also with respect to the RCF/Capex ratio. The assigned A3 CFR, however, also takes into account the stated policy of leverage of around 70%, rather than the currently exhibited lower level.

The following factors are considered under the rating methodology for regulated water utilities:

FACTOR 1: REGULATORY ENVIRONMENT & ASSET OWNERSHIP MODEL

Welsh Water's factor scoring is representative of that of the UK water sector as a whole, which benefits from a very transparent, stable and predictable regulatory regime. We therefore assign a Aaa score to the UK regulatory framework based on the clearly defined risk allocation principles and their consistent application, which underpin the stability and predictability of the UK regulatory environment.

Ofwat, the economic regulator for the water sector in England and Wales, is currently reviewing the regulation and structure of the industry to ensure that it is best able to address current and future challenges. This work may lead to significant changes in the way the industry is structured and regulated, most likely from the start of the next regulatory review period in 2015. Ofwat published a consultation document on setting future price limits in November 2011, which sets out the regulators preferred options, including (i) moving to an outcomes-led approach with increased customer engagement, (ii) focusing on total expenditure rather than providing separate allowances for opex and capex, (iii) updating the existing incentive mechanism, particularly on water trading, and (iv) creating separate price limits for wholesale and retail services. This was followed by a statement of principles in May 2012, which restated the regulator's preferred options.

The UK Government also published a Water White Paper in December 2011 and a Draft Water Bill in July 2012, which broadly support Ofwat's proposals.

Moody's considers that both the government and regulator are mindful of the need to preserve investor confidence in the industry but also that credit risk will increase as companies face a tougher operating environment and could be squeezed between potential growth in the cost of capital and a regulator keen to demonstrate that competition has brought customer benefit (please see Moody's Special Comment - Ofwat's Future Price Limits and White Paper Increase Sector's Credit Risk).

The tariff formula applied under the UK regulatory framework allows for the recovery of operating expenditure and depreciation, which broadly reflects capital maintenance requirements, as well as a return on the regulated asset base set to cover the cost of funding through a combination of debt and equity. The return on capital also reflects the funding cost of capital investments that increase the company's asset base. There is a moderate degree of risk allocation to the water utilities as cost recovery (both operational and financial) is based on ex-ante allowances set by the regulator at five-yearly price reviews. We score the tariff regime in England and Wales at single A, reflecting the strict regulatory oversight of tariff increases and that operators can be subject to challenging efficiency targets.

Ofwat published its final price determination for the regulatory period from 1 April 2010 to 31 March 2015 ("AMP5") in November 2009. In the final determination, Welsh Water has been required to reduce prices over AMP5 by an average of 0.8% p.a. in real terms. This compares to an average annual price increase of 0.5% p.a. for the industry as a whole and a 0.7% increase proposed in Welsh Water's final business plan. The final determination also allowed a weighted average cost of capital of 4.5% (real, post-tax), below the company's final business plan assumptions of around 4.9%.

In terms of revenue volatility, Welsh Water has some exposure to potential volume risk in relation to its industrial and commercial customer base. However, the overall proportion of non-household revenues is around the industry's average, i.e. around 25%, a relatively low exposure. Furthermore, revenue risk for the UK water companies is mitigated to some extent through the revenue-adjusted price cap mechanism introduced in the 2009 price review. This mechanism will allow an ex-post adjustment at the following price review to adjust for any under- or over-recoveries in revenues during the preceding price review period. For AMP5, the regulator also allowed a notified item for increases in household bad debt, resulting from worsening economic conditions, which would allow companies to ask for an interim price determination if the increase in these costs breaches certain thresholds.

FACTOR 2: OPERATIONAL CHARACTERISTICS & ASSET RISK

Welsh Water's performance is generally in line with the targets set by the regulator. For 2010/11, the first year in which the new service incentive mechanism ("SIM") applied, Ofwat awarded Welsh Water a total SIM score of 58 (out of a total 100 achievable). We understand, following a re-classification of unwanted contacts to align with industry practice, Welsh Water considers a SIM score of 71 of being more representative of its performance. This revised score would have positioned the company in the mid-field of all 21 water companies. For 2011/12 Ofwat has not yet published the SIM scores for all companies, but Welsh Water reported an improvement to 78.

In terms of overall performance, Ofwat reported concerns with respect to Welsh Water's security of supply, leakage performance (the company was among six WaSCs not able to meet their leakage target in 2010/11 due to the cold winter) and sewerage pollution incidents. We understand that the company has measures in place to address these issues, and indeed met its leakage target for the year 2011/12.

At the last price review in 2009, the regulator also recognised Welsh Water's significant improvement in its operational performance over recent years, which resulted in an uplift of 0.1% to its price limits for AMP5. However, the company was facing challenging efficiency targets, requiring an overall reduction of operating costs by 20% over the five-year regulatory period. As a consequence, the company decided to bring certain operational activities that had been outsourced to United Utilities and Kelda Water Services back into Welsh Water in spring 2010. We understand that the efficiency programme is progressing well and the company has not been facing any particular issues since the activities have been brought in-house.

Overall, we score the company at Baa for its operational performance, i.e. in line with the sector average.

A risk faced by Welsh Water - in line with the UK water sector as a whole - remains related to the execution of a large capital programme and the associated financing and refinancing requirements. The total capex allowance (gross of grants and contributions) for AMP5 was set at GBP1.1 billion (according to Ofwat's final determination and in 2007/08 prices), which corresponds to real growth in the RCV of around 3% over AMP5. Broken down into five equal instalments, the annual investment over the AMP5 period compared to the average RCV equals around 6%, resulting in a single-A score for capital requirements. We also note that the main focus of capital investments will be on maintenance expenditure, and the company is expected to become free cash flow positive during the course of AMP5. This will ease the additional funding requirements associated with the large investment programme.

FACTOR 3: STABILITY OF BUSINESS MODEL AND FINANCIAL STRUCTURE

Welsh Water's scores reflect the additional event risk protection provided by the bond covenant and security package, which are designed to enhance the existing licence condition to ensure primary focus on the regulated activities. We score Aa for ability and willingness to pursue corporate activity and single-A for ability and willingness to increase leverage. For the targeted proportion of operating profit outside the core water activities, Welsh Water scores Aa.These scores reflect the contractual restrictions placed on Welsh Water's management by the company's long-term financial structure, and are in line with other water and sewerage companies that follow a similar highly leveraged funding approach.

FACTOR 4: KEY CREDIT METRICS

To assess the financial risk profile of a regulated water utility, Moody's uses four key credit metrics. However, the key focus remains on two particular ratios that have been applied to the credit analysis of UK Water companies in the past, namely Net Debt to RCV and the Adjusted Interest Cover (Moody's FFO Interest Cover adjusted for regulatory capital charges). Welsh Water's credit metrics is calculated on the basis of the consolidated financial statements of its parent Glas Cymru.

Welsh Water's A3 rating reflects the ongoing strengthening of the company's financial metrics since it adopted a highly leveraged structure in May 2001, resulting in an Adjusted Interest Coverage Ratio of around 1.6-1.7x. Whilst Welsh Water decided not to pay a customer dividend for the first two years of AMP5 to retain some headroom given the challenges in the final price determination, the payment of future customer dividends will be assessed on an annual basis. Gearing on the basis of Net Debt to RCV is around 65%, providing some headroom against management's target ratio of 70%. We understand, however, that Welsh Water expects to make some additional capex investments due to the adoption of private sewers as well as to rectify the weaknesses in its asset serviceability reflected by the company's leakage performance and number of pollution incidents in 2010/11. Nevertheless, we expect the company to continue to exhibit moderate leverage around the 65% level over the remainder of the AMP5.

Moody's notes that the not-for-profit nature of its parent company, with no shareholders and therefore no dividend pressures, would allow Welsh Water to retain excess cash flows. This should enable the company to retain some financial flexibility to counteract negative economic pressures and manage its operations, notwithstanding the challenging efficiency targets set by Ofwat. Welsh Water, along with its peers, will also have to manage its financial profile in light of the development in the Construction Price Index, which will influence the calculation of the RCV at the next price review.

Structural Considerations

Welsh Water's debt structure includes (i) the presence of a standby liquidity facility of GBP135 million covering 12 months of debt service, (ii) a first ranking fixed charge over the shares in the company, and (iii) the agreement by financial creditors to give up their individual rights to petition for insolvency proceedings, which could modestly improve recovery in a default scenario. Moody's notes that the protection provided by the financial covenants, particularly the limitations for additional indebtedness and permitted distributions (including customer dividends), is limited at Welsh Water's A3 rating level. We also add that Welsh Water's covenant structure is slightly different form the other transactions as the protection offered by certain financial covenants is less critical for a not-for-profit company without equity shareholders. Furthermore, the benefit of the security provided to bondholders remains limited by the regulated and essential nature of the services provided by Welsh Water as governed by its licence and the Water Industry Act 1991.

Therefore, unlike for comparable transactions (such as Anglian or Thames Water), Welsh Water's rating achieves no further uplift from structural considerations or creditor protection, as the company would have significant headroom under the existing covenants to increase leverage before additional creditor oversight would be triggered.

Liquidity

Welsh Water's liquidity profile is very strong, supported by (i) the absence of dividend requirements due to its not-for-profit status, (ii) the stable and predictable cash flows generated by its regulated utility activity, (iii) the existence of around GBP300 million of cash and cash equivalents, (iv) GBP140 million of undrawn committed bank facilities (of which GBP50 million will mature in May 2016 and GBP90 million will mature in May 2017), as well as (v) an undrawn amount of GBP75 million under an agreed EIB facility. Moody's regards Welsh Water's sources of funds as sufficient to cover the group's needs, including limited short-term debt repayments and capital investments, for at least the next 12-18 months.

We add that additional comfort is taken from the existence of the GBP135 million special liquidity facility which would be available to the company to service its debt in the event of a standstill being declared following a breach of financial covenants.

Rating Outlook

The stable outlook reflects Moody's expectation that the company will continue to exhibit leverage below 70% of Net Debt to RCV over the medium term, in line with its publicly communicated target.

What Could Change the Rating - Down

Negative pressure on the ratings could derive from:

- Serious underperformance in operating or capital expenditure;

- Significant increases in the sums rebated to customers resulting in the company failing to maintain its leverage at around 70%; and/or

- A materially unfavourable change in the regulatory framework for the UK water sector, leading to a significant increase in Welsh Water's business risk.

What Could Change the Rating - Up

Ongoing deleveraging, resulting in a further reduction of the ratio of Net Debt to RCV below 65% could result in positive rating pressure. We note, however, that positive rating pressure may be limited due to ongoing regulatory developments.

Rating Factors

Dwr Cymru Cyfyngedig

Global Regulated Water Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Regulatory Environment & Asset Ownership Model (40%)							
a) Stability and Predictability of Regulatory Environment	x						
b) Asset Ownership Model		x					
c) Cost and Investment Recovery (Ability & Timeliness)			x				
d) Revenue Risk			x				
Factor 2: Operational Characteristics & Asset Risk (10%)							
a) Operational Efficiency				x			
b) Scale and Complexity of Capital Programme & Asset Condition Risk			x				
Factor 3: Stability of Business Model & Financial Structure (10%)							
a) Ability and Willingness to pursue Opportunistic Corporate Activity (M&A, Disposals & Investments)		x					
b) Ability and Willingness to Increase Leverage			x				
c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities		x					
Factor 4: Key Credit Metrics (40%) [1][2]							
a) Adjusted Interest Coverage (3-year average)				x			
b) Net Debt / Regulated Asset Value (3-year average)				x			
c) FFO / Net Debt (3-year average)				x			
d) RCF / Capex (3-year average)				x			
Rating							
a) Indicated Factor-Rating from Grid				(A2)			
+ Rating Uplift for Additional Creditor Protection				--			
= Final Indicated Rating from Grid				A2			
b) Actual Rating Assigned (OpCo)				A3			

[1] All ratios are calculated using Moody's Standard Adjustments [2] 3-year average historical financial information as of 31 March 2012; Source: Moody's Financial Metrics