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Dwr Cymru Cyfyngedig and Southern Water Services Limited: Peer Comparison

Ownership structure can make a difference, but management is key to ensure good performance

RATINGS

Dwr Cymru Cyfyngedig

CFR	A3
Senior Secured	A3

Southern Water Limited

CFR	Baa2, neg.
Senior Secured	Baa1
Subordinated	Ba1

KEY INDICATORS

	March 2012	March 2011	March 2010
Adjusted Interest Cover			
Welsh Water	1.5x	1.6x	2.1x
Southern Water	0.7x	0.7x	1.1x
Net Debt/RCV			
Welsh Water	63.0%	66.1%	70.3%
Southern Water	83.9%	83.4%	84.9%
FFO/Net Debt			
Welsh Water	11.1%	10.8%	12.0%
Southern Water	7.5%	7.3%	9.6%
RCF/Net Debt			
Welsh Water	11.1%	10.8%	12.0%
Southern Water	6.9%	5.4%	9.0%
RCF/Capex			
Welsh Water	1.1x	1.1x	0.9x
Southern Water	0.5x	0.4x	1.2x

Source: Annual Reports, Moody's MFM

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Summary:

Dwr Cymru Cyfyngedig ("Welsh Water"), rated A3, stable, and Southern Water Services Limited ("Southern Water"), rated Baa2, negative, are two of the ten water and sewerage companies ("WaSCs") operating in England and Wales.

In this report, Moody's focuses on the credit profile of both companies that is driven, inter alia, by (i) a very different ownership structure, (ii) the focus and track record of management in ensuring performance under the licence, (iii) the recent developments in the regulatory environment and (iv) the specific financial policies adopted by management.[1] Key aspects of our assessment are summarised below:

» Welsh Water's unique ownership structure with a not-for-profit holding company and therefore no dividend pressures has allowed the company to significantly deleverage over the last decade, and provides significant financial flexibility to absorb regulatory or other economic pressures.

» Southern Water, on the other hand, has maintained leverage close to the distribution lock-up levels of its highly leverage financing structure, and operational cash flow shortfalls resulted in a weak financial profile in the current regulatory period.

» Focused management remains a key factor to ensure good operational performance and Southern Water's new management team have recently introduced a number of measures to improve the company's performance. Such improvements will be necessary to stabilise Southern Water's positioning within its current rating category.

» Both companies have, like other highly-leveraged utilities and infrastructure issuers, entered into inflation-linked derivative contracts. These can pose significant additional risks. Taking into account the size of the swap portfolio, existing financial flexibility and recent performance, Welsh Water is in a significantly stronger position than Southern Water to be able to accommodate any potential risk exposure within its current rating. However, we believe that the probability that particularly counterparty risks related to the swap contracts will materialise in the short term remains relatively low at this point in time.

[1] For a more detailed discussion on each individual company, please refer to the relevant company-specific research published on moodys.com.

The two companies are subject to [Moody's Rating Methodology for Regulated Water Utilities] and in line with other issuers under this methodology the key rating considerations in rating Welsh Water and Southern Water are (i) the stability, transparency and predictability of the regulatory regime under which the companies operate and receive their remuneration, and (ii) their financial performance indicators. In addition, we consider the companies operational performance and capital investment requirements as well as management's corporate and financial strategy. Appendix III includes a comparison with the main UK water peers under the methodology.

Ownership: Welsh Water's unique ownership structure creates financial flexibility…

Among the privately owned water utilities rated in the UK, Welsh Water is unique in that it does not have any shareholders. The company, which is ultimately owned by Glas Cymru Cyfyngedig ("Glas"), operates on a not-for-profit basis, solely for the benefits of its customers. Glas's constitution only permits it to act as a holding company and to ensure that Welsh Water performs its functions and responsibilities as required by the licence. Instead of shareholders, Glas has members chosen from a variety of backgrounds across the region in which Welsh Water operates.[2]

The not-for-profit nature of Welsh Water's ultimate parent has allowed the company to significantly deleverage since its highly-leveraged financing transaction closed in May 2001. Indeed, as the company pays no shareholder dividends it has been able to reduce leverage from initially above 90% to below 65% measured in terms of Net Debt to Regulatory Capital Value ("RCV"). Welsh Water has used some of its financial headroom in the past to pay customer rebates.[3] Historically, these payments amounted to less than other companies would have paid in terms of equity dividends. Therefore, absent any unforeseen shocks, Welsh Water is expected to enjoy increasing flexibility against the company's published gearing target of 70% Net Debt to RCV (this is also the maximum level, Moody's considers commensurate with Welsh Water's A3 rating). With current leverage around 65% Welsh Water remains strongly positioned in its current A3 rating category.

… whilst Southern Water shows no headroom within the current rating

Southern Water's ultimate parent company is Greensands Holdings Limited, which is in turn owned by a consortium of pension funds and specialist private equity and infrastructure funds, including IIF International SW UK Investments Limited (advised by JP Morgan) and UBS Global Asset Management (UK) Ltd. In line with similarly highly leveraged peers in the UK water sector, Southern Water's dividend policy is designed to maintain some, but relatively limited, financial headroom, with leverage generally maintained in excess of 80% of Net Debt to RCV (allowing the company to maximise cash distribution to shareholders). That being said we also note that during a time of stress, Southern Water's shareholders have provided financial support to the company by either foregoing their dividends (as is the case for the current regulatory period) or even injecting cash to offset short-

[2] Members are appointed by Welsh Water's management board based on the recommendation of an independent Membership Selection Panel. At the end of the annual general meeting ("AGM") in July 2011, 12 members stood down having served a maximum three terms of appointment, and a further 12 members will stand down for this reason after the 2012 AGM. Following recommendation by the Panel, the re-appointment of 19 members was approved whose term of office would otherwise have expired at the end of the 2012 AGM. At March 2012, Glas Cymru has 72 independent members, excluding the company's directors who are also members (falling to 58 after the 2012 AGM). The members are not entitled to receive any payments for services or dividend distribution from Glas and their liabilities are limited to £1 in the event of Glas being wound up.

[3] Instead of paying dividends, the company reduces the charges that its customers have to pay below the amount allowed by the regulator; this is also referred to as 'customer dividend' by the company.

term fluctuations in inflation (as seen in March 2009 when the shareholders injected additional equity into Southern Water's holding company Greensands Junior Finance Limited).

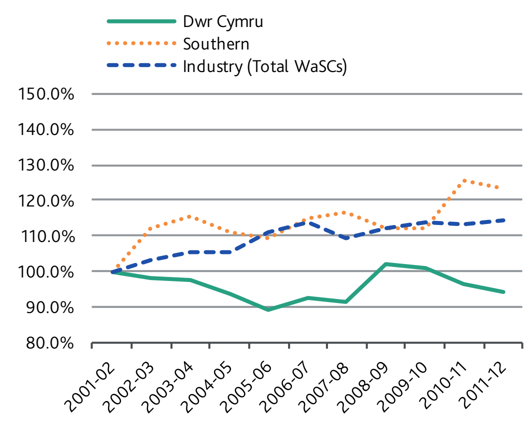
Appendix I includes the detailed group structures of Welsh Water and Southern Water.

Management Expertise: A focused management approach ensures that Welsh Water's flexibility can be maintained…

As we discuss further below, the covenant structure embedded in the financing arrangements of both Welsh Water and Southern Water restricts management's actions outside of the core business, and also limits general event risk in relation to the company's business and financial strategy. Nevertheless, Moody's believes that the presence and commitment of a capable and experienced management team remains an important factor for the long-term success of any company.

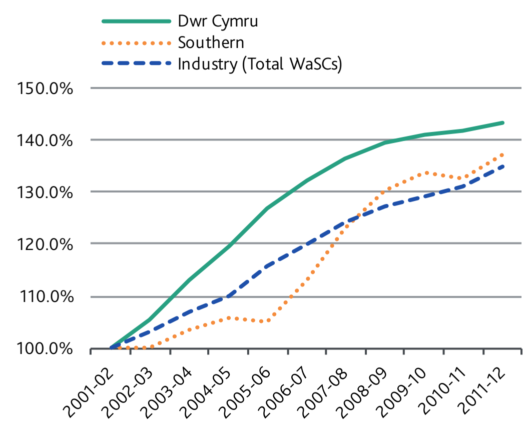
The quality of management has been a key distinguishing factor between Welsh Water and Southern Water in the recent past. Whilst Welsh Water's operational performance and overall cost structure has significantly improved since its mutualisation (see below chart), Southern Water's performance and apparent lack of management focus have resulted in a deterioration that led to a visible reduction in cash flow generation during the current regulatory period.

FIGURE 1
Real Opex Growth from 2001-02



Source: Ofwat

FIGURE 2
Real RCV Growth from 2001-02



Source: Ofwat

As the above charts show, Welsh Water's operating costs (in real terms) followed a declining trend over the past decade whilst the overall industry (we refer to the average across all 10 WaSCs) saw an increase, and Southern Water even increased its operating costs above the WaSC-average. This is despite Welsh Water exhibiting an above average real growth in RCV and therefore related opex from capital growth.

…whilst Southern Water's new management team needs to bring about further improvements to stabilise the current rating

During 2011/12, Southern Water's management team has seen a shake-up with a new Chief Executive Officer (CEO) and Chief Financial Officer (CFO) appointed in 2011. Matthew Wright, CEO since February 2011, and Michael Carmedy, CFO since November 2011, both have a strong utilities background with recent roles as asset management director and financial controller, respectively, at United Utilities. Since the change in Southern Water's management team we have perceived a renewed focus on the core operations of the water and sewerage business to tackle the more recent issues, such as leakage, asset serviceability, particularly in relation to sewerage infrastructure, and customer service.

Early successes have been achieved with a new strategic direction and focus introduced by the new management team. After renegotiating its leakage target with the regulator and implementing additional investments, Southern Water materially outperformed its leakage target for 2011/12 and achieved its lowest measure in its operating history. Following significant additional investments in the early years of the regulatory period, Southern Water also expects to have achieved stable serviceability for its sewerage infrastructure assets compared to the marginal score in 2010/11. There has also been an improvement in operating cost performance in 2011/12.

In terms of customer service, Ofwat awarded Southern Water a total score of 54 (out of a total 100 achievable) for 2010/11, the first year in which the new service incentive mechanism ("SIM") applied.[4] This score positioned the company towards the bottom of all 21 water companies. We understand, the poor SIM performance was partially driven by an increased level of customer contacts regarding changes to tariffs under the universal metering programme. For 2011/12, the company calculated a score of 65. Whilst this is a significant improvement, it remains materially below the 78 score Welsh Water reported, and continues to position the company at the lower end of all WaSCs in England and Wales. We understand, however, that particularly the customer satisfaction scores have improved and Southern Water is now closer to the overall industry average. The quantitative score seems to be based on inconsistent data provided by the companies so may be less comparable.

Despite encouraging signs of improvement, Southern Water's new management will have to build a track record of a more focused approach over the remainder of the regulatory period to stabilise the company's position within its rating category.

Regulatory Developments: Welsh Water is less exposed to regulatory changes…

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 will 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 regulator's 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.

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4 SIM consist of a quantitative element (out of 50), which is based on the number of written complaints and phone contacts a company receives (effectively measuring certain targets that were previously reflected in Ofwat's overall performance assessment), and a qualitative element (out of 50), which is derived from a consumer experience survey. The SIM includes household and non-household customers. The maximum total score achievable is 100.

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 benefits.

In a previous report[5] we considered the potential impact of retail competition for non-household customers, linked to the separate price limits proposal by the regulator. The overall conclusion so far has been that the impact may be modest, and indeed primarily linked to the way prices will be set for the non-contestable part of the business (as shown below).

FIGURE 3

Indicative Losses from Retail Competition

Potential losses as % of RCV	Losses from losing 25% non-household retail customers	household retail control losses from "cost to serve" challenges	Total potential retail control losses
	(a)	(b)	(c) = (a) + (b)
Dwr Cymru	0.00%	0.18%	0.18%
Southern Water	0.03%	0.35%	0.38%
WaSCs average	0.05%	0.17%	0.22%

Note: The above assumes a 10% gross margin or 1.5% EBIT margin, when calculating the impact of losing 25% of non-household customers. Please see Special Comment - Ofwat's Future Price Limits and White Paper Increase Sector's Credit Risk for detailed calculations.

Due to a different approach by the Welsh Government, with a higher threshold for non-household customers to choose their supplier, the consequences of regulatory changes to introduce competition are expected to be more limited in Wales than in England. The Welsh Government is currently working on its strategy paper for the water sector in Wales, which is expected to be published for consultation in early 2013. Based on its current stance, including maintaining the threshold for customers allowed to switch at 50Ml/day, the Welsh Government would seem to see less benefit for customers in increasing retail competition. This could create a less challenging environment for the two water companies mainly operating in Wales, i.e. Welsh Water and Dee Valley Water Plc (not rated).

Furthermore, due to its significantly lower leverage and ability to create additional headroom supported by its not-for-profit parent holding structure, Welsh Water has much greater financial flexibility to absorb and/or accommodate any adverse consequences of competition.

As shown in Figure 3, Southern Water may be affected primarily by potential challenges on the household retail cost price control, if the regulator decides to move to the average cost to serve approach. Non-household retail competition is expected to have a minimal impact as the company has the lowest proportion of non-household revenues among all WaSCs in England and Wales, and therefore any potential customer losses would have a relatively smaller impact on its overall revenues and cash flows. Nevertheless, given Southern Water's limited financial headroom, it may struggle to accommodate challenges implied by regulatory reform within its current ratings, if it cannot improve its cash flow generation.

[5] Please see Moody's Special Comment - Ofwat's Future Price Limits and White Paper Increase Sector's Credit Risk, published in February 2012.

… but both companies may be challenged by certain reforms

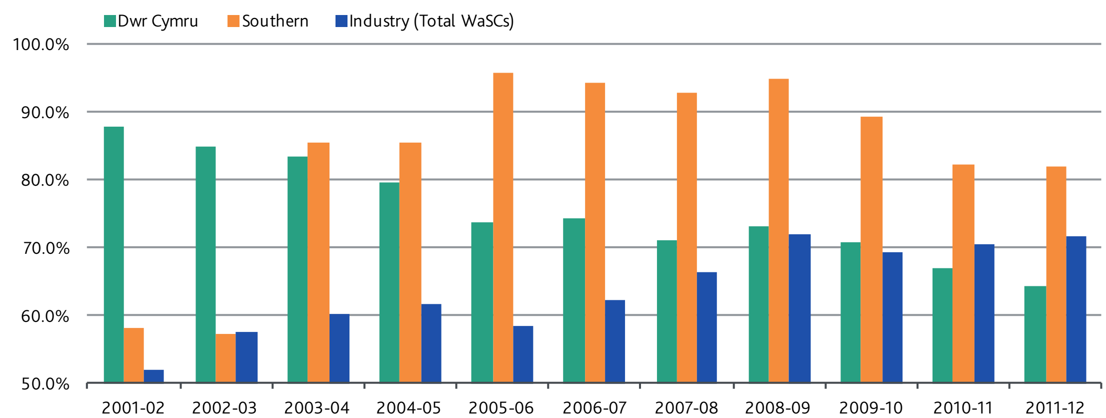
Both Welsh Water and Southern Water may be challenged by the regulator's proposed focus on outcomes rather than outputs and other planned changes, including a move to totex potentially from the start of the next regulatory period in 2015. The proposed switch to 'outcomes' from 'outputs' will represent something of a step change and one that may challenge companies unaccustomed to broader responsibilities and innovation. Management will need to adapt to a different skill set, and operational performance may become a more important rating driver than is currently the case.

Good management will therefore remain a key distinguishing factor going forward, more so than has been the case in the past, particularly, if the regulatory regime continues to evolve with higher focus on performance incentives as a driver of a company's ultimate return on capital.

Financing Structure: With both companies initially entering highly leveraged financing structures, Welsh Water's ongoing deleveraging resulted in significant financial flexibility…

Soon after privatisation of the water sector in England and Wales, a number of companies entered into highly leveraged financing structures. Welsh Water and Southern Water were among the first companies to do so in 2001 and 2003, respectively. As shown below, overall gearing across the industry (again overall average across the 10 WaSCs) continued to increase.

FIGURE 4
Gearing level since 2001-02



Note: Ofwat's gearing for Southern Water includes the mezzanine debt and preference shares that Moody's treats as quasi-equity.
Source: Ofwat

Given the highly-leveraged nature of their financing structures, certain contractual restrictions and credit-enhancing features were embedded in the financing terms, such as cash-trapping covenants, designated liquidity facilities, security over the shares held in the operating company and an agreement by all creditors to forego their independent enforcement rights in an event of default.[6]

Due to Welsh Water's moderate leverage, which leaves significant headroom compared to the additional indebtedness trigger level of 75% for senior debt and 86% for total debt (including any junior tranche that may be issued), we believe that the value of these covenants is currently limited at

[6] For further details, please see Moody's Special Comment entitled UK Water Sector: Highly-Leveraged Financing Structures – An Update, published in June 2010.

Welsh Water's A3 rating level. We also add that Welsh Water's covenant structure is slightly different from Southern Water's or other transactions as the protection offered by certain financial covenants is less critical for a not-for-profit company without equity shareholders.[7]

Welsh Water's current A3 ratings take into account the company's published dividend policy of maintaining leverage close to 70% of Net Debt to RCV, and we understand that some of the current headroom may be applied to additional capital investments to improve customer service, protect drinking water quality and improve cost efficiency (inter alia by looking at increased own power generation and other efficiencies). As the rest of the industry, Welsh Water will also use excess capital to cover the costs of the adoption of private drains and sewers in October 2011. The private sewer network nearly doubled Welsh Water's sewerage network and its condition remains largely unknown.

Southern Water's leverage, on the other hand, has been relatively constant at around 80-85%, close to the distribution lock-up trigger levels.

In addition the company has been suffering a reduction in operational cash flows due to challenging efficiency targets embedded in the cost allowances for the current regulatory period and its performance under the regulator's capex incentive scheme.[8]

Furthermore, Southern Water has been experiencing a significant reduction in revenues compared to the assumptions used in the final determination, partly related to a one-off accounting adjustment of around £23 million in 2010/11, as well as an ongoing revenue shortfall of in aggregate £150 million over the five-year regulatory period from April 2010-March 2015 (cumulative reductions over the first two years slightly exceeded £50 million). Whilst the revenue correction mechanism will ultimately compensate water companies for lower than anticipated consumption by "tariff basket" customers (which applies to Southern Water's revenue shortfall), the correction will be made only at the next price review, and Southern Water, therefore, remains exposed to the liquidity risk within the period.

All these factors affect Southern Water's cash flow generation and hence its related credit metrics. In addition, Moody's calculation of the Adjusted Interest Cover Ratio, the second of the two key ratios[9] we use in assessing the financial risk profile of a regulated water utility, also takes into account the specific risk associated with the structure of Southern Water's significant derivatives portfolio.[10]

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7 Please see company-specific Pre-Sale Reports and Analyses as listed in the Related Research Section.

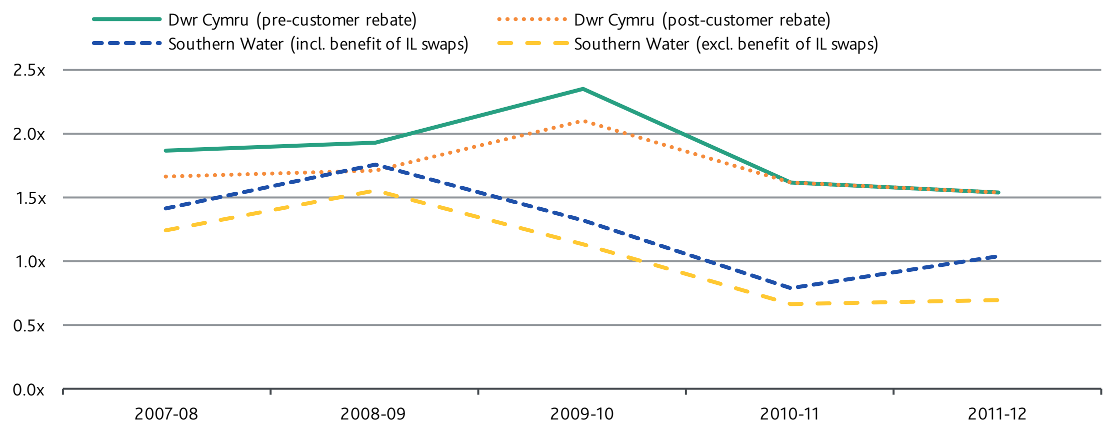
8 At the last price review in 2009, Southern Water achieved a CIS score of 131, meaning the company was planning to spend 31% in excess of what the regulator believed necessary to perform in line with its licence obligations. As a result, Southern Water had its allowed revenues reduced by an amount equivalent to approximately 0.1% p.a. of the average RCV, one of the highest penalties in the sector.

9 Please see Moody's Rating Methodology for Global Regulated Water Utilities, published in December 2009 and Moody's Special Comment entitled UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength, published in March 2006.

10 Please see Credit Analysis on Southern Water Services Limited, published in October 2011.

FIGURE 5

Adjusted Interest Coverage Ratio 2007-2012



Source: Companies' Annual Report, Moody's Financial Metrics

In assessing Southern Water's financial risk profile, Moody's considers the Adjusted Interest Cover without giving any benefit for the index-linked derivatives the company entered into, as we believe that the cash flow benefit achieved is only short-lived given that the company has to repay the accumulated inflation accretion every five years. However, we note, the despite Moody's calculation shows a ratio of below 1.0x, the company still maintains sufficient cash and liquidity to fulfil its payment obligations. Moody's ratio takes into account the annual inflation accrual as interest expense in each year, while the company will have to make the payment only every five years.

We believe that through the use of derivative instruments, Southern Water maintained its covenant compliance and as such has been in a position where it would be allowed to pay dividends when it should conserve cash (albeit noting that it currently is not paying equity dividends). As a consequence, Southern Water's Baa2 corporate family rating currently does not include a full notch of rating uplift. Whilst we consider that the covenant and security package still holds value for creditors, particularly due to the additional credit oversight, intercreditor arrangements and liquidity facilities, we believe that the value of the financial covenants, particularly the Adjusted Interest Cover Ratio has been reduced.

The current negative outlook on Southern Water's Baa2 corporate family rating also reflects the combination of (i) weak cash flow generation, (ii) a challenging settlement for the current regulatory, and (iii) additional pressures facing the UK Water industry as a whole (e.g. adoption of private sewers and extreme weather conditions).

… whilst Southern Water has little headroom to counteract additional risks, such as those created by its significant derivative exposure

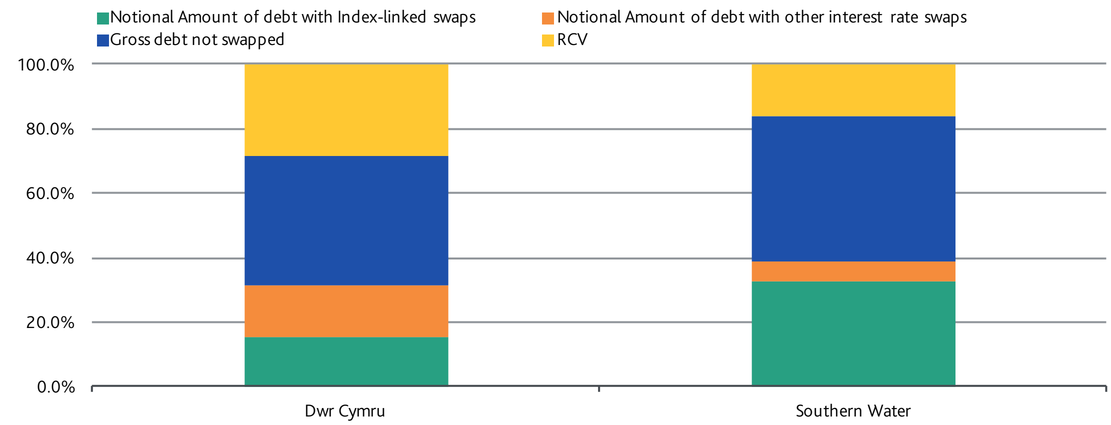
As discussed in previous publications[11], a number of UK regulated utilities and infrastructure issuers have used inflation-linked debt to match a portion of their debt service with their inflation-linked revenue stream. The increasing demand of issuers to create inflation-linked debt and limited availability in the bond market has led to the development of specific derivative instruments with numerous features and varying degree of potential additional risks.

[11] Please see Moody's Special Comment entitled UK Regulated Utilities: Why Index-Linked Swaps May not Provide the Same Cash Flow Benefit as Index-linked Bonds, published in February 2012.

Both Welsh Water and Southern Water issued straight index-linked bonds, but also entered into inflation-linked swaps, with a requirement to frequently pay down the inflation accretion.

FIGURE 6

Swap exposures as a percentage of RCV



Source: Companies' Annual Report

Welsh Water's swaps hedge its interest-rate exposure on floating-rate finance leases into a fixed-rate element and a floating element linked to the movement of the UK retail price index ("RPI"). We understand that the inflation indexation under these swaps with a notional amount of £528 million (as at 31 March 2012) is paid out annually and, therefore, is treated as a cash interest payment in the company's financial statements (a treatment that matches Moody's calculation of interest coverage ratios). In addition, the company has a long-term index-linked swap over a £120 million fixed-rate bond that is accreting inflation indexation over the life of the swap, which is aligned with the bond. Overall, the notional amount of inflation-linked swaps is at around 16% still of moderate size in comparison to the company's RCV (notional in the amount of 13% of the RCV is subject to annual accretion pay-down). The main risk of these swaps relates to counterparty exposure, which under certain circumstances could trigger a mark-to-market payment due to the counterparty. The counterparty risk is somewhat mitigated by the involvement of four major British banks with currently solid investment-grade ratings, albeit some concentration on one particular counterparty. However, with Welsh Water's strong rating positioning and financial flexibility (as discussed above) we believe that the company can accommodate the counterparty risk, if it were to materialise, within the current rating level. We, furthermore, note that due to Welsh Water's accounting treatment of its inflation-linked swaps with annual accretion paydown, a potential future loss of the related hedges may only have a limited impact on its financial metrics.

The situation for Southern Water is different. The company is already weakly positioned within its current rating category due to existing operational issues. In addition, its relative exposure to inflation-linked derivatives is more than double that of Welsh Water. Southern Water currently has a portfolio of inflation-linked swaps with a notional amount of around £1.3 billion, requiring five-yearly accretion paydown, commencing in 2016. Similarly to Welsh Water, and probably most of the highly leveraged UK water companies, the swaps are held with various bank counterparties, albeit again showing some concentration on one counterparty. And whilst counterparty risk is considered remote at this point in time, Southern Water's exposure is significantly higher than Welsh Water's and the company would be unlikely to accommodate any material mark-to-market payment at the current rating level, should such a payment materialise.

Moody's Related Research

Rating Methodology:

» Global Regulated Water Utilities, December 2009 (121311)

Industry Outlook:

» UK Water Sector Industry Outlook, October 2011 (136523)

Special Comments:

» UK Infrastructure and Utility Companies: Highly leveraged issuers largely insulated from weakened bank counterparty credit worthiness, July 2012 (143494)

» UK Regulated Utilities: Why Index-Linked Swaps May not Provide the Same Cash Flow Benefit as Index-linked Bonds, February 2012 (139368)

» UK Water Sector: Highly-Leveraged Financing Structures – An Update, June 2010 (123592)

» UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength, March 2006 (97010)

Pre-Sale Reports:

» Dwr Cymru Financing Plc, April 2001 (111735)

» Southern Water Services (Financing) Plc, June 2003 (78540)

Analyses:

» Anglian Water Services Limited, August 2010 (125277)

» Dwr Cymru Cyfyngedig, June 2010 (125709)

» Southern Water Services Limited, October 2011 (136656)

» Thames Water Utilities Limited, April 2012 (141728)

» Wessex Water Services Limited, May 2009 (117594)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

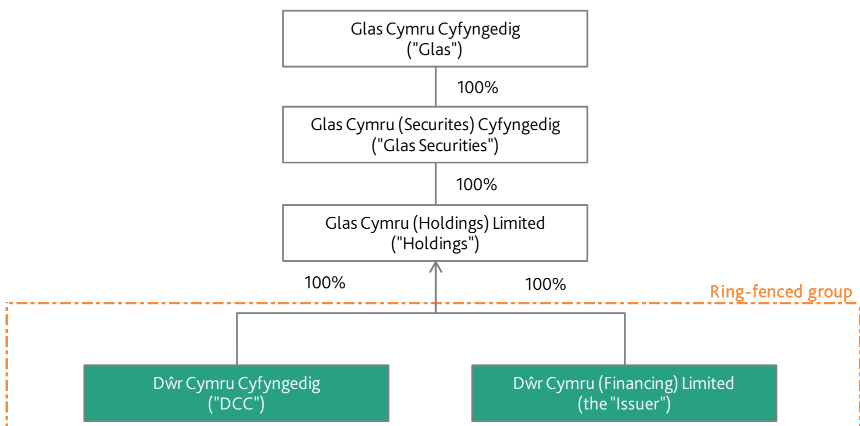
Appendix I – Group Structures

Dwr Cymru Cyfyngedig

The current group structure was put in place in May 2001, when Welsh Water executed its highly-leveraged financing transaction. Welsh Water's funding is arranged through secured loans from a bankruptcy-remote special purpose company, Dwr Cymru (Financing) Limited ("DCF"). DCF itself funds these loans to Welsh Water with the proceeds of ongoing capital market issuance under its £3.0 billion Multicurrency Programme for the issuance of Asset-Backed Bonds.[12]

FIGURE 7

Dŵr Cymru Cyfyngedig - Group & Debt Structure as at 30 June 2012



Senior Debt			
Finance leases	734.1		
		Class A bonds:	
		A1 notes	350.0
		A4 notes	364.7
		A5 notes	118.7
		A6 notes	121.3
		Class B bonds:	
		B1 notes	325.0
		B3 notes	177.0
		B4 notes	104.7
		B5 notes	60.6
		B6 notes	284.1
		EIB loan	220.0
KfW IPEX-Bank GmbH loan	35.0		
Local authority loans	1.5		
Total senior debt		**2896.7**	

Source: Company's Investor Report

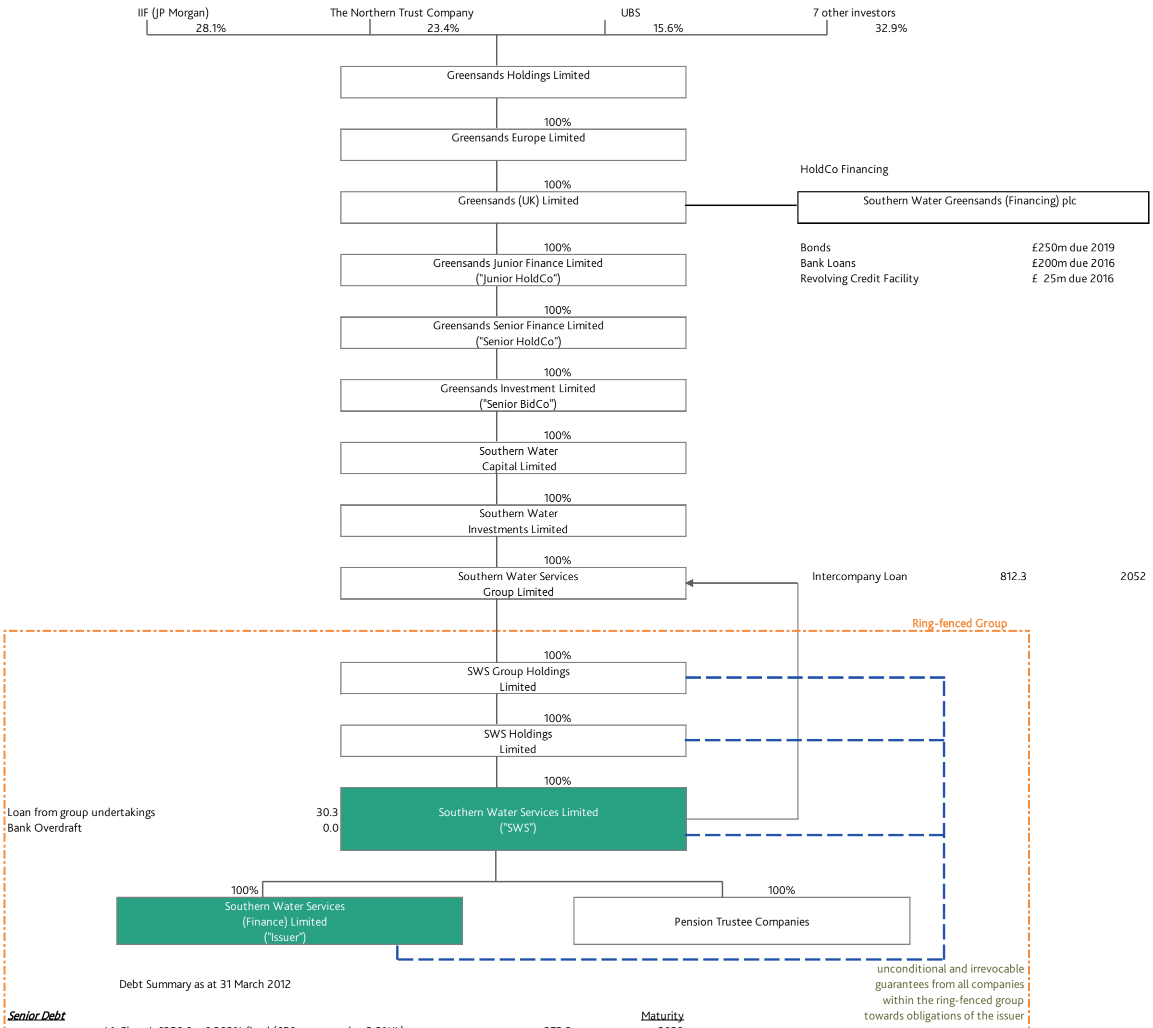
12 Senior Secured Bonds issued under Class A and Class B is ranking pari-passu amongst each other as well as the bank loans and finance leases. However, the interest and principal payment due on the Notes issued as Class A Debt have been unconditionally and irrevocably guaranteed by MBIA under a financial guarantee policy. The rating of these wrapped bonds reflects MBIA's financial strength rating at any given time, unless it falls below the underlying credit quality of such bonds. Due to a deterioration in MBIA's credit quality following the financial crisis, the underlying credit quality of the Class A Debt at A3 currently represents the credit profile of these bonds absent the MBIA financial guarantee. Welsh Water can also issue subordinated Class C Debt under the structure.

Southern Water Services Limited

In July 2003, SWS entered into a highly-leveraged financing transaction. Moody's rates the bonds issued by Southern Water's financing subsidiary Southern Water Services (Finance) Limited (SWSF) under a £6.0 billion bond programme. The bonds are issued either as part of a senior tranche ("Class A Debt") or a junior tranche ("Class B Debt") and are currently rated Baa1 or Ba1, respectively. The ratings of the different classes of debt reflect their debt protection measures and priority of claim in a default scenario.

FIGURE 8

Southern Water Services Limited - Group & Debt Structure as at 31 March 2012



Debt Summary as at 31 March 2012

			Maturity	
Senior Debt				
A1	Class A £350.0m 6.202% fixed (£50m swapped @ 3.2%IL)	372.2	2029	
A2a	Class A £150.0m 3.716% I-L	197.5	2034	
A2b	Class A £35.0m 3.716% I-L	46.7	2034	
A4	Class A £350.0m 6.650% fixed	357.6	2026	
A5	Class A £150.0m 3.826% fixed	197.6	2023	
A7	Class A £350.0m 5.010% fixed (£177m swapped @ 2.161% IL)	363.0	2021	
A8	Class A £150.0m 1.145% I-L (IL swap at 0.51%; step-up)	190.0	2041	
A9	Class A £200.0m 0.570% I-L (IL swap at 0.07%; step-up)	247.6	2052	
A10	Class A £300.0m 1.51% I-L (IL swap at 0.657%; step-up)	338.9	2056	
A11	Class A £300.0m 6.125% fixed	300.0	2019	
	Artesian £165.0m 4.086% I-L	217.3	2033	
	Artesian £156.5m 3.645% I-L	201.2	2032	
B1	Class B £250.0m 7.789% fixed	250.0	2038	interest rate fixed until 2014
B	Capex Facility £50m 6mths LIBOR + 3%	100.0	2013	
Total Senior Debt (as defined in covenant definition)		**3,379.6**		
	Debt issue costs		£(41.6) million, not removed from debt	
	Deferred gilt lock proceeds	5.5		
	Deferred bond premium	4.8		
Total Senior Debt (Moody's)		**3,389.9**		
Subordinated Debt				
	Mezzanine			
	Senior Mezzanine £127.2m 11.97% fixed	15.4	2038	£40m repaid in April 2009 & £20m in March 2009; £52m waived
	Junior Mezzanine £106.0m 16.01% fixed			fully repaid in April 2009
	Preference Shares			
	Class A1	32.6	2038	
	Class B	110.0	2038	
Total Subordinated Debt		**158.0**		

Source: Company's Annual Report

Appendix II – Key Financial Metrics

Dwr Cymru Cyfyngedig

In £ millions	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Revenue [1]	657	688	677	695
EBITDA	312	381	429	289
Net Interest Expense (incl. inflation indexation)	(166)	(104)	(176)	(192)
Net Income (after adjustment for unusual items)	(103)	65	139	(104)
Funds from Operations (FFO)	267	315	283	291
Dividends	0	0	0	0
Retained Cash Flow (RCF)	267	315	283	291
Capex	(345)	(346)	(253)	(257)
Working Capital	24	(18)	9	48
Free Cash Flow	(53)	(49)	39	82
Total Debt	2,760	2,912	2,761	2,990
Pensions	8	8	16	32
Operating Leases	0	0	0	0
Accrued Interest Removed	(42)	(44)	(46)	(92)
Cash	(139)	(249)	(98)	(301)
Net Debt	2,587	2,627	2,632	2,629
Regulatory Capital Value [2]	3,577	3,740	3,981	4,170
Regulatory Depreciation [3]	179	189	204	214
Indexation	41	(10)	48	52
Key Credit Metrics				
Net Debt/Regulatory Capital Value	72.3%	70.3%	66.1%	63.0%
Adjusted Interest Cover	1.7x	2.1x	1.6x	1.5x
FFO/Net Debt	10.3%	12.0%	10.8%	11.1%
RCF/Net Debt	10.3%	12.0%	10.8%	11.1%
RCF/Capex	0.8x	0.9x	1.1x	1.1x

Note: [1] revenues in March 2009 and March 2010 adjusted for customer dividends of £27 million and £28 million, respectively; [2] RCV adjusted for regulatory pension allowance in March 2009 and March 2010; [3] regulatory depreciation includes current cost depreciation and infrastructure renewals charge as published by the regulator

Source: Annual Reports, Moody's Financial Metrics

Southern Water Services Limited

In £ millions	31-Mar-09	31-Mar-10	31-Mar-11	31-Mar-12
Revenue	678	679	647	716
EBITDA	492	486	420	482
Net Interest Expense (incl. indexation) [1]	(191)	(156)	(219)	(233)
Net Income (after adjustment for unusual items)	100	105	15	84
Funds from Operations (FFO)	335	287	228	256
Dividends – Preference Shares & Mezzanine Debt	(44)	(16)	(24)	(19)
Dividends – Equity [1]	(79)	0	(36)	0
Retained Cash Flow (RCF)	212	271	168	237
Capex	(323)	(218)	(378)	(457)
Working Capital	(9)	26	83	108
Free Cash Flow	(121)	78	(127)	(112)
Total Debt	3,572	3,453	3,522	3,548
Pensions	116	109	60	96
Operating Leases	18	18	18	19
Mezzanine Debt removed	(473)	(289)	(289)	(158)
Cash	(360)	(289)	(172)	(96)
Net Debt	2,873	3,000	3,138	3,409
Regulatory Capital Value [2]	3,434	3,533	3,761	4,062
Regulatory Depreciation [3]	251	266	289	314
Indexation (Bond Indexation only)	38	(11)	37	41
Key Credit Metrics				
Net Debt/Regulatory Capital Value	83.7%	84.9%	83.4%	83.9%
Adjusted Interest Cover	1.5	1.1x	0.7x	0.7x
FFO/Net Debt	11.7%	9.6%	7.3%	7.5%
RCF/Net Debt	7.4%	9.0%	5.4%	6.9%
RCF/Capex	0.7x	1.2x	0.4x	0.5x

Note: [1] net interest and equity dividends exclude amount received as interest income under the intra-group loan that is also paid out as dividend; [2] RCV adjusted for operating leases and, in March 2009 and March 2010, also for regulatory pension allowance; [3] regulatory depreciation includes current cost depreciation and infrastructure renewals charge as published by the regulator as well as the capital element (i.e. 2/3) of the annual operating lease expense

Source: Annual Reports, Moody's Financial Metrics

Appendix III – Peer Comparison

Global Regulated Water Utilities	Welsh Water	Southern Water	Anglian Water	Thames Water	Yorkshire Water	Wessex Water
Factor 1: Regulatory Environment & Asset Ownership Model (40%)						
a) Stability and Predictability of Regulatory Environment	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa
b) Asset Ownership Model	Aa	Aa	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Ability & Timeliness)	A	A	A	A	A	A
d) Revenue Risk	A	A	A	A	A	A
Factor 2: Operational Characteristics & Asset Risk (10%)						
a) Operational Efficiency	Baa	Baa	Baa	Baa	Baa	A
b) Scale and Complexity of Capital Programme & Asset Condition Risk	A	Baa	A	Ba	A	Baa
Factor 3: Stability of Business Model & Financial Structure (10%)						
a) Ability and Willingness to pursue Opportunistic Corporate Activity (M&A, Disposals & Investments)	Aa	Aa	Aa	Aa	Aa	A
b) Ability and Willingness to Increase Leverage	A	A	A	A	A	Baa
c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities	Aa	Aa	Aa	Aa	Aa	Aa
Factor 4: Key Credit Metrics (40%)*						
a) Adjusted Interest Cover	Baa	Caa	Ba	Ba	Ba	A
b) Net Debt / Regulated Asset Base	Baa	Ba	Ba	Ba	Ba	Baa
c) FFO / Net Debt	Baa	Ba	Ba	Baa	Baa	Baa
d) RCF / Capex	Baa	Ba	Ba	Ba	B	Baa
Rating						
a) Indicated Rating from Grid	[A2]	[Ba2]	[Baa2]	[Baa2]	[Baa2]	[A2]
+ Rating Uplift for Additional Creditor Protection	+/-0	+/-0	+1	+1	+1	+/-0
= Final Indicated Grid Rating from Grid	A2	Ba2	Baa1	Baa1	Baa1	A2
b) Actual Corporate Family Rating Assigned (OpCo)	A3	Baa2	Baa1	Baa1	Baa1	A3

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