

## ISSUER IN-DEPTH

5 JUNE 2015

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## RATINGS

**Dwr Cymru Cyfyngedig**

Corporate Family Rating	A3
Outlook	Positive

**Dwr Cymru (Financing) Limited**

Senior Secured	A3
Backed Senior Secured	A3
Outlook	Positive

## KEY METRICS:

**Dwr Cymru Cyfyngedig**

	March 2014	March 2013	March 2012
Adjusted Interest Coverage	1.8x	1.7x	1.6x
Net Debt/RCV	61.9%	61.7%	63.0%
FFO/Net Debt	11.7%	11.6%	11.2%
RCF/Capex	0.9x	1.0x	1.1x

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UK Water Sector: Credit Implications of 2014 Price Review

## Dwr Cymru Cyfyngedig: Not-for-profit structure supports positive outlook

On 27 February 2015, Moody's affirmed Dwr Cymru Cyfyngedig's (Welsh Water's) A3 ratings and changed the outlook to positive from stable. The positive outlook reflects our expectation that unless it materially increases the spend on customer rebates and discretionary investment, the company's gearing will trend below its new target level of 60% net debt to regulatory capital value (RCV).

- » **Gearing will fall unless spending of equity returns increases materially:** Welsh Water's ownership by Glas Cymru Cyfyngedig, a not-for-profit company limited by guarantee means that the "equity" component of the allowed return set by Ofwat, the regulator for the sector in England and Wales, has historically been shared with customers via discounts on bills (the "customer dividend") and/or discretionary investments to improve service quality, rather than being paid to shareholders. In February 2015, Welsh Water reduced its target level of gearing to 60%, a level consistent with a strongly positioned A3 rating. While the company plans to spend more of its equity return, absent a significant increase, gearing will trend below 60%, potentially creating upward rating pressure.
- » **Cost of debt high versus peers; not-for-profit structure creates additional financial flexibility:** The low yield environment has prompted the regulator Ofwat to cut allowed returns for the sector driven, in particular, by a significant reduction in the assumed cost of embedded debt. Given that it fixed much of its debt long-term when rates were much higher, Welsh Water is relatively weakly positioned despite a moderate level of gearing. We consider, however, that Welsh Water can accommodate a lower Adjusted Interest Cover Ratio (Adjusted ICR) than peers for a given rating level, given the greater level of financial flexibility that its ownership structure affords it.
- » **Overall regulatory developments neutral over the next five years; Welsh Water insulated from the onset of competition:** Other than the allowed cost of capital, Welsh Water received a final price determination that was well aligned with the company's business plan submission, although it will face challenges over the next five years in relation to cost efficiency and customer service. Changes to the regulatory framework have included (1) separation of wholesale and retail price controls; (2) the move to a total expenditure assessment; and (3) focus on outcomes and specific outcome delivery incentives. The Welsh Government's recent decision not to implement competition in the sector in the near future means that Welsh Water is unlikely during the current regulatory period (AMP6) to be affected by the proposal to introduce competition for non-household retail activities in England.

- » **Accelerated cost recovery will flatter published financial metrics:** The company has chosen to use recently introduced regulatory levers to accelerate cost recovery and hence boost revenue, flattering interest cover metrics and creating additional headroom against financial covenant levels. However, the additional revenue may, in part, also result in a reduction in gearing and the risk of future penalties linked to operational performance (ODIs).

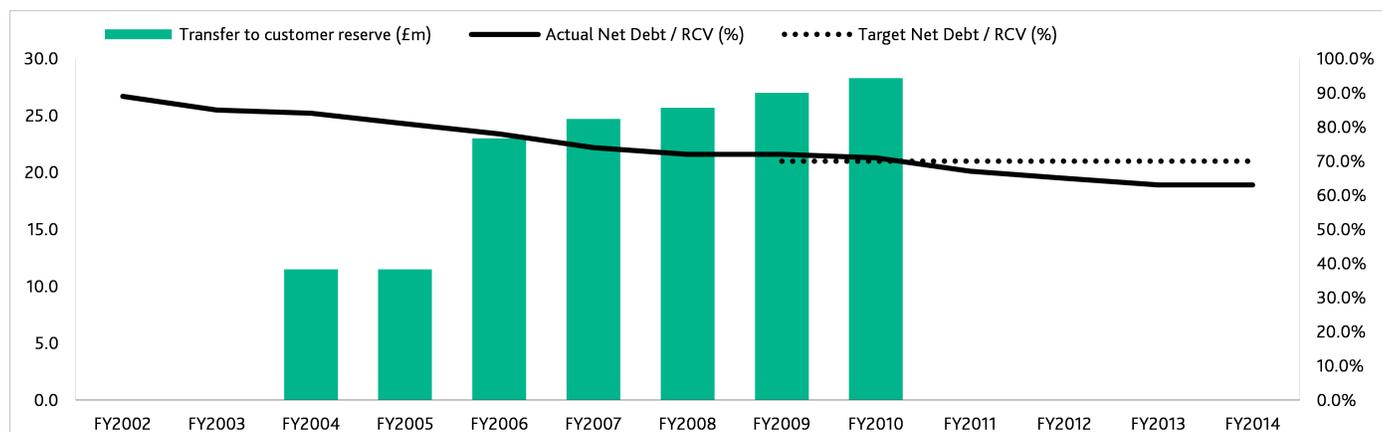
### Gearing will fall unless spending of equity returns increases materially

In February 2015, Welsh Water confirmed in its Investor Report for the period to 31 December 2014<sup>1</sup> that it intended to reduce the target gearing level (measured as net debt to regulatory capital value or "RCV") for the new AMP6 regulatory period, starting on 1 April 2015. The company announced that it would target gearing at around 60%, compared with a published target of 70% since the financial year to March 2009.

As illustrated in Exhibit 1 below, gearing trended below 70% over the last regulatory period to March 2015 (AMP5) despite a material investment programme. This was in part the result of a decision not to "pay" customer dividends with the aim of building financial headroom.

Exhibit 1

#### AMP5 gearing consistently below publicly-stated target Level of customer rebates one of the principal levers on achieved gearing



Notes: [1] Prior to FY2009, public statements of financial policy did not include a gearing target; [2] "Transfer to customer reserve" is a concept included within Welsh Water's financing documentation, which has historically be closely correlated with actual customer dividend.

Source: Welsh Water Investor Reports

In common with the rest of the industry, a key component of Welsh Water's revenues is the allowed return on the RCV. This is set by Ofwat in advance of each regulatory period by reference to a notional efficient company with a capital structure consistent with a solid investment grade credit rating<sup>2</sup>. The level of allowed return is set using the Capital Asset Pricing Model (CAPM) methodology and is expressed as a weighted average cost of capital. For privately-held companies, a portion of allowed returns accruing to equity is typically distributed to shareholders, with many companies using equity distributions as a lever to ensure certain financial policy objectives (often including a maximum gearing level) are met. Welsh Water does not face the same pressure to spend its "equity" returns because of its not-for-profit ownership structure.

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The Welsh Water financing group is ultimately owned by Glas Cymru Cyfyngedig (Glas Cymru), a not-for-profit company limited by guarantee and owned by around 70 members. As equity returns cannot be distributed to Glas Cymru members, they have historically been shared with customers via either (1) charging customers less than the amount allowed by Ofwat ("rebates") and/or (2) making discretionary investments not included in regulatory price determinations<sup>3</sup>. Exhibit 1 shows that gearing fell faster in AMP5 when the company did not "pay" rebates than during AMP4. The company took the decision in AMP5 to use its equity returns to increase financial headroom by reducing gearing and offset risk, in the context of a reduction in consumer bills in real terms.

Exhibit 2 below demonstrates that, relative to the industry, Welsh Water's AMP5 determination had already given customers some relief during a period of challenging macroeconomic conditions through a cut in bills in real terms. Through its determination, Ofwat may therefore have reduced the perceived need for Welsh Water to offer incremental reductions through the customer dividend.

Exhibit 2

#### Negative k factor may have obviated the need for customer rebates in AMP5

	FY2011	FY2012	FY2013	FY2014	FY2015	Average
Welsh Water AMP5 k factor	-1.3%	-1.3%	-0.4%	-0.4%	-0.6%	-0.8%
WaSC AMP5 average k factor	-0.8%	0.2%	1.7%	0.7%	0.5%	0.5%
Industry AMP5 average k factor	-0.6%	0.3%	1.6%	0.6%	0.4%	0.5%

"WaSC" = water and sewerage company

Source: Ofwat

The current gearing level of around 60% is commensurate with the company's strong positioning in relation to its A3 corporate family rating. Welsh Water's decision to reduce its gearing target for AMP6 reflects the fall in actual gearing levels in AMP5 and the desire to maintain financial headroom, given the fall in the allowed return and the company's relatively high embedded cost of debt. We estimate that the company will need to increase the level of customer dividend and/or discretionary investments by a material amount compared to the historic maximum in order to prevent gearing falling persistently below 60% during AMP6.

When the company announces its equity strategy later this year, we expect that it will supplement the social tariff scheme announced in November 2014<sup>4</sup> with a series of investments planned to de-risk its exposure to high value Outcome Delivery Incentive (ODI) penalties, such as unplanned interruptions to water supply and water discolouration in relation to which it could suffer a maximum penalty of around £20 million. However, if the scale of the company's ambitions in this area proves to be modest, upward ratings pressure could build as it would increase the likelihood of a gearing level below 60%.

#### Cost of debt high versus peers; not-for-profit structure creates additional financial flexibility

Despite a gearing level that is now one of the lowest in the sector and a higher-than-average proportion of inflation-linked debt, Welsh Water's Adjusted ICR is particularly exposed to the fall in the allowed return introduced as part of the PR14 price control. This is in part due to the fact that (1) it has the highest embedded cost of debt among peers; (2) despite a high level of inflation-linked debt, much of the accretion is paid down annually; and that (3) the nature of its financing structure means that Welsh Water has a relatively high proportion of debt fixed for the long-term and hence has had little opportunity to benefit from the recent low yield environment through refinancing. Exhibit 3 below shows that the cost, in particular, of Welsh Water's inflation-linked bonds ("average real cost of indexed debt"), mostly issued between 2001-2006, is significantly higher than that of peers and the 2.65% assumed by Ofwat as the real embedded debt cost of the notional company in relation to which the allowed return has been set.

Exhibit 3

## UK WaSC Debt Profile as at March 2014

Issuer	Gross Debt (GBP 'millions)	% of Debt Fixed (incl. IL debt)	% of Debt Index-Linked (incl. swap positions)	Average No. of Years over which Cost of Debt has been fixed	Average Nominal Cost of Fixed Debt	Average No. of Years over which Cost of Debt has been indexed	Average real cost of Indexed debt
Anglian Water Services Ltd.	6,186	91%	54%	10.2	5.7%	23.2	2.1%
Dwr Cymru Cyfyngedig (Welsh Water)	2,860	100%	67%	9	6.2%	22	3.6%
Northumbrian Water Ltd. [1]	2,630	96%	24%	15	5.9%	30	1.7%
Severn Trent Plc [2]	4,622	89%	27%	10.7	5.7%	35.4	1.9%
Southern Water Services Ltd.	3,587	91%	65%	6.1	5.9%	22.1	2.4%
Thames Water Utilities Ltd.	9,774	92%	52%	17.6	5.4%	26.2	1.5%
United Utilities PLC [2], [3]	6,069	97%	48%	5	5.0%	22.5	1.7%
Wessex Water Services Ltd.	1,930	80%	36%	13.5	5.0%	35.9	2.3%
Yorkshire Water Services Ltd. [4]	4,589	105%	58%	12.1	5.8%	32.7	2.4%
<b>Weighted average across rated WaSCs</b>		<b>94%</b>	<b>49%</b>	<b>11.6</b>	<b>5.6%</b>	<b>26.2</b>	<b>2.1%</b>

Notes: [1] including Kielder securitisation but excluding other debt at the wider group, which are taken into account to determine Northumbrian Water's rating; [2] excluding derivatives (FX and interest rate hedging); [3] based on UU Group Plc numbers; [4] company is currently overhedged.

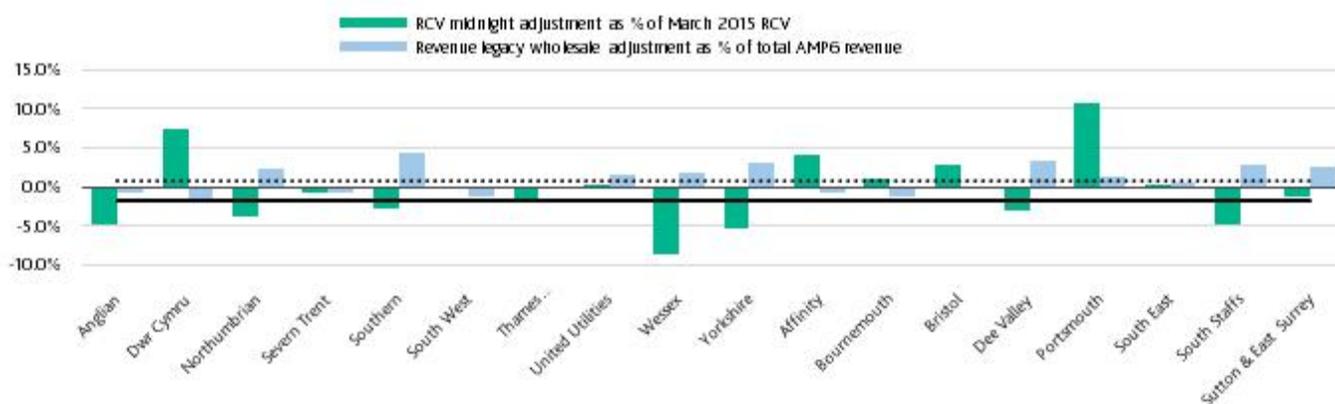
Source: Company Information; Annual Reports (statutory and regulatory accounts) & Investor Reports, Moody's

The main implication of an embedded cost of debt higher than the level allowed by the regulator is that there will be pressure on a company's interest coverage ratios. Furthermore, if, as we expect, RPI inflation starts to rise during AMP6, Welsh Water's Adjusted ICR will face further pressure through the impact on its inflation-linked swaps. As at 31 March 2014, Welsh Water had a portfolio of inflation-linked swaps with a notional value of around £650 million. Around £440 million is designed to hedge the floating interest payable in relation to its finance leases. On these, it receives a variable rate while paying a fixed real interest rate. However, as the inflation indexation under the swaps is paid out annually, it is treated as a cash interest payment under Welsh Water's covenant definitions, meaning that a rise in inflation will put further pressure on the Adjusted ICR.

Moreover, as illustrated in Exhibit 4 below, Welsh Water will also face certain negative adjustments to revenue in AMP6, which will impact the ICR. These adjustments total just over £50 million (2012/13 prices) and relate to overspend versus the regulatory allowance on its AMP5 capex programme.

Exhibit 4

## PR14 Legacy Adjustments for 2010-2015 performance



Source: Ofwat's Final Determination.

Unlike for other sector peers, Moody's does not publish guidance for the minimum Adjusted ICR that Welsh Water would need in order to maintain its A3 ratings. This is because we place less emphasis on the ratio when assessing the company's ability to meet its debt obligations, given the additional financial flexibility resulting from its ownership structure. However, in our base case estimate, we

expect that Welsh Water's Adjusted ICR (calculated in accordance with the Moody's methodology) will average around the 1.6x level, which we guide for peers United Utilities and Severn Trent in order to maintain an A3 rating.

We believe that the current low interest rate environment is unlikely to persist over the medium term. A rise in interest rates combined with the cost-competitive funding recently secured from the European Investment Bank would narrow the gap between Welsh Water's actual capital structure and the regulator's assumptions by the time of the 2019 price review. However, the long-term nature of Welsh Water's financing arrangements will continue to expose it to additional risks relative to peers, particularly if the low yield and hence, regulatory return environment, were to persist in the medium term.

### **Overall regulatory developments neutral over the next five years; Welsh Water insulated from the onset of competition**

Welsh Water's final determination was largely in line with its draft determination and final business plan submission. The principal changes in between the two relate to the household retail control, where it was successful in arguing for an adjustment to the Average Cost to Serve (ACTS) in relation to bad debt and debt management costs, although it was not successful in arguing for an adjustment for general cost inflation. Nonetheless, it will still face a meaningful efficiency challenge to reduce one of the highest ACTS in the industry to the industry average over a three-year period.

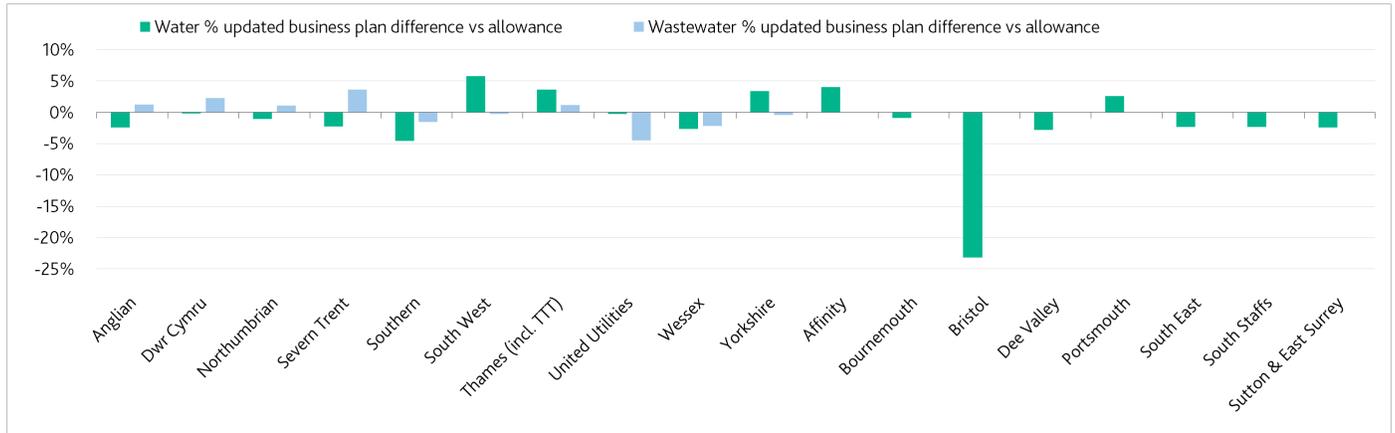
As with the rest of the industry, Welsh Water is subject to different price controls for wholesale and retail activities, with the following return assumptions:

- › Wholesale water and wastewater - allowed return on year-average RCV = 3.6% p.a.
- › Retail household: net retail margin 1% p.a.
- › Retail non-household: net retail margin 2.5% p.a.

Unlike its peers in England, Welsh Water will not be subject to competition in the non-household retail business from 2017. This is because the Welsh Government, to whom policy decisions on the water and waste sectors are devolved, has decided not to implement the relevant power introduced in the Water Act 2014<sup>5</sup> in the near term. The company's relative advantage in terms of business risk profile compared to companies based in England will be limited in AMP6 as revenues from the non-household business will typically only comprise around 2-3% of revenues for a WaSC. However, given that Ofwat has signalled its intention to explore options for introducing competition in the upstream part of the value chain from 2020, Welsh Water's relative advantage could widen, provided that there is not a change of approach from the Welsh Government following the 2016 election.

Welsh Water's total expenditure (totex) allowance, including operating and capital expenditure, for the wholesale activities was set at just under £2.6 billion (2012/13 prices) in aggregate over the next five-year regulatory period. The costs included in the company's final business plan submission for the water business were marginally higher than Ofwat's cost baseline, although Welsh Water's wastewater proposal was seen to be more efficient than the baseline. In this, as illustrated in Exhibit 5 below, the company was one of the best placed of those companies which did not achieve "enhanced" status in the process.

Exhibit 5  
**Relative difference between Regulatory Final Determination Totex Allowances and Companies' Final Business Plan Submission**

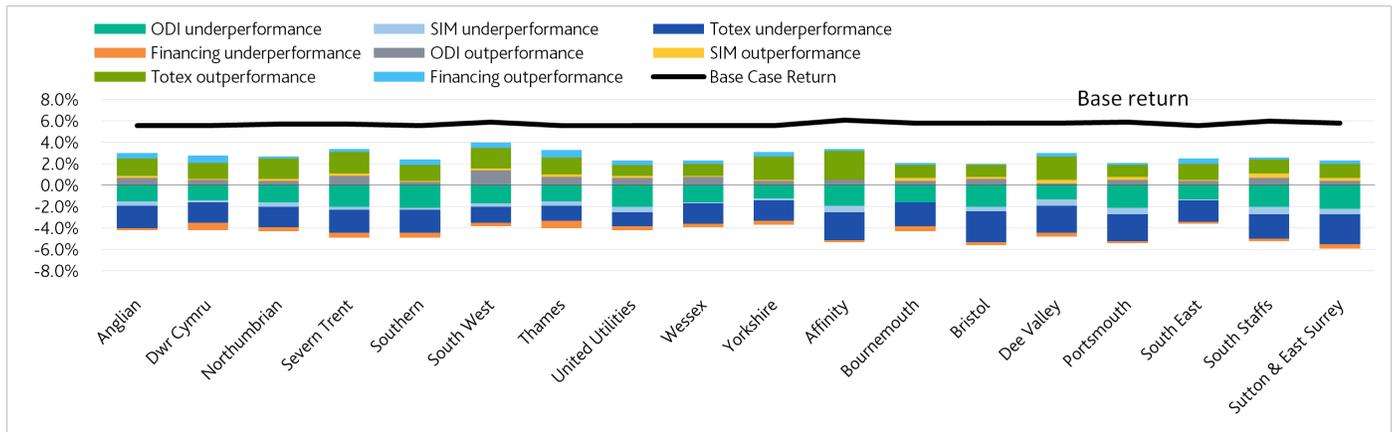


Source: Ofwat's Final Determination

While the company does retain some scope for outperformance, this will be challenging as Welsh Water has not historically been in the top quartile of the sector for cost efficiency.

Like the rest of the industry, Welsh Water has the potential to outperform its base return on regulatory equity (37.5% of RCV under the regulator's notional capital structure). Incentives under the ODI mechanism, which assess the company's performance against key measures that are important to Welsh Water's customers, provide larger scope for potential financial penalties than rewards, as illustrated in Exhibit 6 below. In line with most peers, ODI penalties and rewards will be carried forward into the next period<sup>6</sup>

Exhibit 6  
**Regulatory Return on Equity Skewed to the Downside**



Source: Ofwat's Final Determination

### **Accelerated cost recovery will flatter interest cover covenant ratio but will offset risk**

Welsh Water has, as with the majority of companies in the industry, sought to use new regulatory "levers", principally the total expenditure or "totex" mechanism, to accelerate cost recovery to a certain degree<sup>7</sup>. This means that it will receive (1) more revenue than it would have done had the old framework persisted; and (2) more in-period or PAYG revenue than the amount that it planned to spend on operating and infrastructure renewals expenditure (IRE), according to its final PR14 business plan. This will flatter the company's Post-Maintenance Interest Cover Ratio (PMICR) covenant compared with the previous regulatory framework, in which such regulatory levers were not available.

The availability of the new levers means that companies may make choices every five years, which boost the level of financial headroom, therefore meaning that covenants may be less effective in trapping cash in order to maintain rating stability. For Welsh Water, this will not have a material impact on our credit assessment as we do not factor in any particular benefit of the covenant and security package embedded in its financing structure. The company's significant headroom to covenant levels means performance would have to deteriorate very significantly to trigger additional creditor oversight.

Furthermore, while Welsh Water's PAYG revenue may flatter its interest cover covenant ratios, if not all "excess" fast money is used to fund an increased customer dividend, it either result in a fall in gearing and/or a reduction in risk associated with its ODIs.

Unlike companies such as Thames Water (Baa1 CFR, stable), Anglian Water (Baa1 CFR, stable) and Affinity Water (Baa1 CFR, stable), Welsh Water's interest cover covenants include a concept relating to actual capex spend<sup>8</sup> rather than current cost depreciation (CCD) and infrastructure renewals charge (IRC), which are regulatory concepts designed to reduce volatility as they based on the long-term average of the relevant categories of maintenance spend. Welsh Water has therefore not proposed any changes to its covenant package as a result of the introduction of Ofwat's totex approach.

## Appendix 1: Rating Grid and Peers

Exhibit 7

### Rating Grid & Peers

Issuer Name	Dwr Cymru (Welsh Water)	UU Water	Severn Trent Water	Wessex Water
Country	UK	UK	UK	UK
Rating / Outlook	A3 / positive	A3 / stable	A3 / negative	A3 / stable
<b>Factor 1: Regulatory Environment &amp; Asset Ownership Model (40%)</b>				
a) Stability and Predictability of Regulatory Environment	Aaa	Aaa	Aaa	Aaa
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Ability & Timeliness)	A	A	A	A
d) Revenue Risk	A	A	A	A
<b>Factor 2: Operational Characteristics &amp; Asset Risk (10%)</b>				
a) Operational Efficiency	Baa	Baa	Baa	A
b) Scale & Complexity of Capital Programme & Asset Condition Risk	A	A	Baa	Baa2
<b>Factor 3: Stability of Business Model &amp; Financial Structure (10%)</b>				
a) Ability & Willingness to Pursue Opportunistic Corporate Activity	Aa	A	A	A
b) Ability & Willingness to Increase Leverage	A	Baa	Baa	Baa
c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities	Aa	Aa	Aa	Aa
<b>Factor 4: Key Credit Metrics (40%), based on forward-looking consolidated financial profile of the group</b>				
a) Adjusted Interest Coverage	1.4-1.6x (Ba/Baa)	1.8x-2.0x (Baa)	1.4x-1.6x (Ba/Baa)	1.7-2.3x (Baa)
b) Net Debt/ Regulated Asset Value	58-63% (Baa)	58-62% (Baa)	65-70% (Baa)	65-70% (Baa)
c) FFO / Net Debt	9-11% (Ba/Baa)	12-14% (Baa)	10-14% (Baa)	11-13% (Baa)
d) RCF / Capex	0.5-0.7x (Ba)	0.5-1.0x (Ba)	0.5-1.0x (Ba)	0.5-1.0x (Ba)
Indicated Rating / BCA from Grid Factors 1-4	A3	A3	A3/Baa1	A3
Rating Uplift from Structural Features	0	0	0	0
<b>Actual Rating Assigned (OpCo)</b>	<b>A3</b>	<b>A3</b>	<b>A3</b>	<b>A3</b>

Source: Moody's

## Peer Group

- » [United Utilities Plc](#)
- » [Severn Trent Plc](#)
- » [Wessex Water Services Limited](#)

## Moody's Related Research

### 2015 Industry Outlook:

- » [UK Water Sector: Stable Outlook despite challenging regulatory review, October 2014 \(176291\)](#)

### Special Comments:

- » [UK Water Sector: Final determination remains challenging but in line with expectations, December 2014 \(1001995\)](#)
- » [UK Water Sector: Regulatory changes could weaken financial covenants for highly-leveraged structures, a credit negative, December 2014 \(1001364\)](#)
- » [UK Water Sector: Water Act 2014 provides basis for increased competition, a credit negative for the English water and sewerage companies, May 2014 \(170874\)](#)
- » [UK Water Sector: Speed of Money Cannot Address Potential Financeability Concerns, May 2013 \(150828\)](#)
- » [UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength, March 2006 \(97010\)](#)

### Issuer-In-Depth/Credit Focus:

- » [UK Water Sector: Credit Implications of the 2014 Price Review - Southern Water: Financial policy commitments and solid operating performance support credit profile, May 2015 \(1004459\)](#)
- » [UK Water Sector: Credit Implications of the 2014 Price Review - Yorkshire Water Services Limited: Credit quality weakened by risks of sizeable derivatives portfolio, April 2015 \(1004067\)](#)
- » [UK Water Sector: Credit Implications of the 2014 Price Review - Severn Trent Plc: Credit quality will weaken following challenging regulatory settlement, February 2015 \(1003016\)](#)
- » [UK Water Sector: Credit Implications of the 2014 Price Review - United Utilities Plc: Strong credit quality despite challenging environment, February 2015 \(1002795\)](#)
- » [Dwr Cymru Cyfyngedig and Southern Water Services Limited: Peer Comparison, October 2012 \(145812\)](#)

### Rating Methodology:

- » [Global Regulated Water Utilities \(December 2009\) \(121311\)](#)

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.

## Endnotes

- 1 The revised financial policy was published in February 2015 in [Welsh Water's Investor Report for the Quarter ended 31 December 2014](#).
- 2 The capital structure of the notional company considered by Ofwat during the PR14 review assumed that the RCV was financed using 62.5% debt and that 33% of that was inflation-linked.
- 3 As part of the recent PR14 price review, the sector's RCV was updated, *inter alia*, to reflect actual capex spend. From AMP6, there will no longer be a "true-up" of the RCV, as the link between RCV additions and actual capital expenditure has been weakened under the new totex model.
- 4 In November 2014, Welsh Water announced the "HelpU" social tariff scheme to start from April 2015. This tariff is expected to impact in excess of 100,000 customers and will offer savings of up to 55% on the average household bill
- 5 Please see [UK Water Sector: Water Act 2014 provides basis for increased competition, a credit negative for the English water and sewerage companies](#)
- 6 Anglian will have an in-period adjustment to revenues in relation to its three-year average performance under the leakage targets. Severn Trent Water will see annual revenue adjustments for drinking water quality, leakage, supply interruptions, low water pressure, sewer flooding events, pollution incidents, value for money and reduction of carbon footprints. South West Water will receive annual revenue adjustments for water quality, leakage, water restrictions, customer service, pollution incidents and deterioration in wastewater treatment compliance below 2014-15 standards.
- 7 Under the new totex model, revenues and RCV growth will reflect the depreciation rates, the PAYG ratio that each company has chosen and potentially rewards or penalties from outcomes, although these would have limited impact in-period. By choosing their PAYG ratios, companies can decide when they want to be remunerated for their expenditure. A high PAYG ratio means more cash flows up-front but conversely a smaller amount added to the RCV (and vice versa). Importantly, in the totex world, the economic value of the RCV will not be affected by how much a company actually spends on capex as there will be no true-up for actual capex versus RCV additions. Instead, only the totex capitalisation rate, i.e. (1-PAYG) and depreciation rates as defined at the final determination will drive RCV growth.
- 8 Welsh Water's covenant ratios are adjusted to deduct actual capital maintenance expenditure. Actual or planned capital maintenance expenditure is not defined.

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