

**Credit Opinion: Dwr Cymru Cyfyngedig**

Global Credit Research - 24 Feb 2016

Cardiff, United Kingdom

**Ratings**

Category	Moody's Rating
Outlook	Positive
Corporate Family Rating	A3

**Contacts**

Analyst	Phone
Paul Marty/London	44.20.7772.5454
Neil Griffiths-Lambeth/London	

**Key Indicators**

[1]Dwr Cymru Cyfyngedig	31/03/2015	31/03/2014	31/03/2013	31/03/2012
Adjusted Interest Coverage Ratio	1.8x	1.6x	1.6x	1.5x
Net Debt / Regulated Asset Base	59.0%	61.9%	61.7%	63.0%
FFO / Net Debt	11.7%	11.4%	11.6%	11.2%
RCF / Net Debt	11.7%	11.4%	11.6%	11.2%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

**Opinion**

**Rating Drivers**

- Stable cash flows from monopoly water and wastewater business supported by a well-established, transparent and predictable regulatory regime, although recently proposed changes could be credit negative
- Partially protected against increasing sector business risk by Welsh Government's current policy on competition
- Efficiency challenge remains following stretching determination
- Conservative financial policy

**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 3.2 million people 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 2014/15, Welsh Water had a Regulatory Capital Value (RCV) of GBP4.8 billion (after adjustments at the end of the regulatory period), reported revenues of GBP753 million and operating profit of GBP202 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.

The A3 rating reflects (1) the group's low business risk profile as monopoly provider of water and wastewater services operating under a well-established, transparent and predictable regulatory framework; (2) the protection provided against increasing business risk by the Welsh Government's opposition to increasing competition in the sector; and (3) 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 leverage target of 60%.

Given its moderate leverage, Welsh Water's A3 rating currently does not incorporate any significant uplift for credit-enhancing features.

## **DETAILED RATING CONSIDERATIONS**

### **TRANSPARENT AND WELL-ESTABLISHED REGULATORY REGIME SUPPORTS CURRENT CREDIT QUALITY, BUT PRESSURE FOR AMP6 AND BEYOND**

Welsh Water's A3 rating reflects its very low business risk as monopoly provider of water and wastewater services operating under a well-established, transparent and predictable regulatory regime.

Over the past five years, the economic regulator for the water and sewerage companies in England and Wales (Ofwat) has been reviewing the regulation and structure of the industry to ensure that it is best able to address current and future challenges. Building on this, Ofwat has introduced changes to its framework and methodology of setting price limits for the five-year period that started on 1 April 2015 (AMP6). Main changes include notably the introduction of retail competition for non-household customers in 2017.

Whilst we view the changes to the regulatory framework for PR14 as being largely neutral for the UK water sector as a whole, we believe that Ofwat's planned new approach to its 2019 price review, known as "Water 2020", and the government's proposed extension of retail competition to the household market in England, would increase credit risk for water companies if implemented altogether. Proposed changes include reforms relating to sludge treatment and disposal, a move towards CPI indexation of revenues and RCV, third party provision of new water resources, and a new approach to setting the cost of debt allowance.

We consider that both the government and regulator are mindful of the need to preserve investor confidence in the industry; nevertheless we see the business risk of the sector increasing over the medium to long term as more parts of the currently monopolistic value chain become subject to competitive pressures. In this respect, the decision of the Welsh Government, which has devolved powers in this area, to continue to use regulatory incentives (rather than competition) to encourage innovation, could partly protect Welsh Water's credit quality if business risk in the sector continues to increase.

### **PROPOSED INVESTMENTS WILL RESULT IN FURTHER RCV GROWTH AND ADDITIONAL FUNDING NEEDS**

As is the case for peers, Welsh Water faces some risk in the execution of its significant capital programme and the associated financing and refinancing requirements. For AMP6, Welsh Water has been allowed total expenditure (totex), which includes opex and capex of around GBP2.6 billion (in 2012/13 prices) for the wholesale part of the business. This will result in the RCV growing by just over 7% in real terms over AMP6, while the average bill will fall by 5% in real terms by the end of the period, in line with the industry average bill decline.

Welsh Water will have to maintain good access to capital markets, with net funding requirements (including refinancing needs) expected to be around GBP600 million over the five-year period that started on 1 April 2015. As the company's next bond maturity is in 2021, this principally relates to the financing of AMP6 investments, although the company will need to pay almost GBP200 million in scheduled amortisations and maturities of lease and bank facilities.

### **EFFICIENCY CHALLENGE REMAINS FOLLOWING STRETCHING DETERMINATION**

Welsh Water faces a meaningful challenge to deliver on its ambitious plan, especially in view of the fact that Ofwat has assessed the serviceability of its water infrastructure assets as "marginal" in four out of five years of AMP5, although it is now assessed as "stable". If it does not materially improve its performance in relation to certain Outcome Delivery Incentives (ODIs), in particular, interruptions to water supply and customer acceptability of drinking water, Welsh Water could face some financial exposure. However, as with the majority of its peers, we do not expect that any such exposure would crystallise until the PR19 price control. The task in the retail businesses is even more challenging, with Welsh Water being recognised as having one of the highest average cost to serve (ACTS) in the industry.

However, these risks are partially mitigated by the company's relatively strong (top quartile among WaSCs, second quartile across the industry) performance in relation to the Service Incentive Mechanism (SIM) in AMP5 and the fact that it will not face an increased scope of competition in the non-household retail segment. Furthermore, given the company's ownership by the not-for-profit Glas Cymru, it has significantly more financial flexibility than many peers, including that to make discretionary investments which could reduce the risk of underperforming in relation to ODIs.

#### CONSERVATIVE FINANCIAL POLICY

Welsh Water targets a gearing level of 60% in AMP6 - broadly in line with the current position. In order to maintain stable leverage, we estimate that Welsh Water would need to distribute or invest around GBP80-90 million per annum, which would be a step change compared to the long-term average of closer to GBP30 million per annum. We believe that the proposed creation of a new holding company as the parent of Glas Cymru, which would be able to make investments in new businesses funded by financial surpluses from Welsh Water, is unlikely to affect significantly Welsh Water's financial profile given the proposed aggregate cap on investments at GBP100 million (indexed).

#### LIMITED BENEFIT FROM STRUCTURAL PROTECTIONS AT CURRENT RATING LEVEL

Welsh Water's debt structure includes (1) the presence of a standby liquidity facility of GBP135 million covering 12 months of debt service; (2) a first-ranking fixed charge over the shares in the company; and (3) 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.

We believe that the protection provided by the financial covenants, particularly the limitations for additional indebtedness and permitted distributions (including customer dividends and distributions to the new holding company), is limited at Welsh Water's A3 rating level as the company would have significant headroom under the existing covenants to increase leverage before additional creditor oversight would be triggered. We also note that Welsh Water's covenant structure is slightly different from 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 Water or Thames Water), Welsh Water's rating achieves no further uplift from structural considerations or creditor protection.

#### Liquidity

Welsh Water's liquidity profile is strong, supported by (1) the absence of dividend requirements due to Glas Cymru's not-for-profit status; (2) the stable and predictable cash flows generated by its regulated utility activity; (3) a cash position of GBP55 million at 31 December 2015; and (4) around GBP250 million of undrawn credit facilities with the EIB, KfW and other banks at 31 December 2015. We view these 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 take additional comfort from the existing 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 positive rating outlook reflects our expectation that Welsh Water's gearing will continue to reduce below 60% net debt to RCV unless it materially increases the scope of customer rebates, distributions to the new holding company once it is created, and discretionary investments not funded by the regulator.

## What Could Change the Rating - Up

The ratings could be upgraded once there is greater clarity about Welsh Water's plans for the use of its equity returns and its actual performance compared with the level of expenditure allowed by the regulator and associated performance commitments. Positive rating pressure could arise if the company's gearing remains sustainably at or below 60%.

## What Could Change the Rating - Down

As the outlook is positive, we do not expect downward rating pressure. Negative pressure on the ratings could nevertheless derive from a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a reduction in the stability and predictability of regulatory earnings, which is not offset by other credit-strengthening measures and/or some form of protection from the Welsh Government's policy on competition in the sector.

## Other Considerations

Our rating assessment of Welsh Water is based on the rating methodology for Regulated Water Utilities, published in December 2015.

## Rating Factors

### Dwr Cymru Cyfyngedig

Regulated Water Utilities Industry Grid [1][2]	Current 31/03/2015		[3]Moody's 12-18 Month Forward ViewAs of February 2016	
	Measure	Score	Measure	Score
<b>Factor 1 : Business Profile(50%)</b>				
a) Stability and Predictability of Regulatory Environment		Aaa		Aaa
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)		A		A
d) Revenue Risk		A		A
e) Scale and Complexity of Capital Programme & Asset Condition Risk		A		A
<b>Factor 2 : Financial Policy (10%)</b>				
a) Financial Policy		Baa		Baa
<b>Factor 3 : Leverage and Coverage (40%)</b>				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.7x	Baa	1.5x - 1.7x	Baa
b) Net Debt / Regulated Asset Base (3 Year Avg)	60.8%	Baa	57% - 60%	Baa
c) FFO / Net Debt (3 Year Avg)	11.6%	Baa	8% - 10%	Ba
d) RCF / Net Debt (3 Year Avg)	11.6%	A	8% - 10%	Baa
<b>Rating:</b>				
Indicated Rating from Grid Factors 1-3		A3		Baa1
Rating Lift		0.5		0.5
a) Indicated Rating from Grid		A2		A3
b) Actual Rating Assigned				A3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 31/03/2015. Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on <http://www.moody's.com> for the most updated credit rating action information and rating history.



© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE. MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at [www.moody.com](http://www.moody.com) under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY'S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000. MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.