CREDIT ANALYSIS

# Dwr Cymru Cyfyngedig

Cardiff, United Kingdom

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Dwr Cymru Cyfyngedig and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

## Corporate Profile

*Monopoly provider of essential water and sewerage services in Wales*

Dwr Cymru Cyfyngedig ("Welsh Water") is the sixth-largest UK water utility by Regulatory Capital Value (RCV), providing water and sewerage services to approximately 1.2 million households and over 100,000 business customers 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 2009/10, Welsh Water had an RCV of £3,737 million (including the various adjustments by the Regulator at the 2009 price review) and reported revenues of £688 million and operating profit of £176 million.

Welsh Water currently has an A3 corporate family rating ("CFR"), with stable outlook. Moody's also rates the bonds issued by Dwr Cymru (Financing) Limited under a £3.0 billion Multicurrency Programme for the issuance of Asset-Backed Bonds, in order to fund the capital requirements and general business purpose of Welsh Water. The programme itself is not rated by Moody's, but we currently rate all issuance under the programme as follows:

Class A Notes: A3

Class B Notes: A3

Class R Notes: A3

Class C Notes: Baa2

The Class A Notes also benefit from an unconditional and irrevocable guarantee of scheduled principal and interest provided by MBIA UK Insurance Limited ("MBIA") pursuant to a financial guarantee insurance policy. However, given recent downgrades of MBIA's credit rating, the A3 rating of the Class A Notes issued by Dwr Cymru (Financing) Limited represents the assessment of Welsh Water's standalone credit quality absent the MBIA guarantee.

As is typical for UK water and sewerage companies, Welsh Water has relatively stable and predictable cash flows resulting from the company's regulated monopoly business, but exhibits negative free cash flows due to the high level of capital expenditure required to maintain and enhance the network in line with European and environmental legislation.

Figure 1 shows the financial highlights of Welsh Water for the financial year ended 31 March 2010.

*FIGURE 1*

**Financial Highlights for Dwr Cymru Cyfyngedig (as reported at 31 March 2010 - £m)**

| | REVENUES | GROWTH | OPERATING PROFIT | GROWTH | MARGIN |
|---|---|---|---|---|---|
| Water & Sewerage | 688.2 | +4.7% | 175.8 | +13.5% | 25.5% |

Source: Preliminary Results of Glas Cymru Cyfyngedig for the year ending 31 March 2010

The increase in Welsh Water's revenues is primarily a function of the inflation and the K-factor allowed by Ofwat (which was set at 2.2% for 2009/10), albeit reduced by the voluntary customer dividend that Welsh Water distributes to its customers by reducing their charges below the level allowed by the Regulator (the amount of customer dividend was £28 million in aggregate for 2009/10). Operating profit in the financial year 2009/10 was affected by a decrease in power costs, albeit partly offset by an increase of the provision for bad debts, and an exceptional restructuring cost of £29.5 million related to the termination of the outsourcing contracts discussed below.

Historically, around two-thirds of Welsh Water's operating expenditure related to outsourced service contracts with United Utilities Operating Services (for the operation of the water network and the wastewater network in north Wales) and with Kelda Water Services (for the operation of the wastewater network in south Wales and Herefordshire). These contracts were in place until the end of the regulatory period to March 2010. For the new regulatory period that commenced in April 2010, Welsh Water decided to undertake a corporate restructuring that resulted in the company transferring close to 1,600 staff back to Welsh Water. The decision was taken in light of challenging efficiency targets set by the Regulator for the current regulatory period and the fact that in negotiations with both service providers Welsh Water was unable to reach an agreement that would have satisfied the company that these efficiency targets could be reached under the existing outsourcing contracts.

In Moody's view, this move does not affect Welsh Water's ratings. As outlined in Moody's initial analysis on Welsh Water published in April 2001, we took a neutral view on Welsh Water's outsourcing strategy when the company entered into a refinancing transaction that resulted in a highly-leveraged funding structure. This reflects Moody's opinion that the outsourcing contracts had not achieved a significant risk transfer in respect of certain operational risks and the risks associated with the comparative competition and efficiency analysis that the Regulator applies, as Welsh Water retained the ultimate responsibility for fulfilling the regulatory and statutory obligations under its licence.

Whilst taking the operations back in-house will be a major task for Welsh Water, Moody's expects disruptions to the company's day-to-day business to be limited given that the existing outsourcing contracts already incorporated provisions for Welsh Water to accommodate this move.

## Ownership & Funding Structure

In May 2001, Welsh Water executed its highly-leveraged financing structure. The current group structure was also put in place.

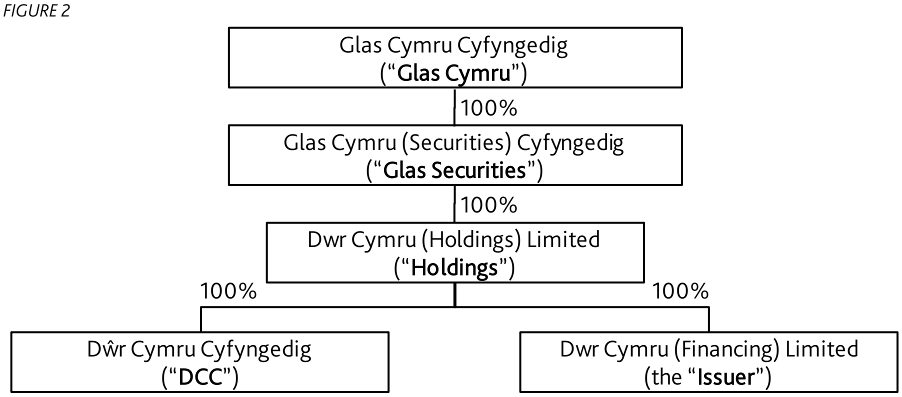
Welsh Water is the operating water company and owner of the necessary water and wastewater assets. Its funding is arranged through secured loans from a bankruptcy-remote special purpose company, Dwr Cymru (Financing) Limited ("DCF"). DCF itself funds these loans to Welsh Water with the proceeds of ongoing capital market issuance under its £3.0 billion Multicurrency Programme for the issuance of Asset-Backed Bonds. DCF has on-loaned or will on-lend an amount equal to the sterling-equivalent of the gross proceeds of each issue of Class of Notes to Welsh Water by way of intercompany loans. Each loan matches the term of the related Class of Notes. As such, the payment obligations of Welsh Water under the intercompany loans are intended to service any payments due and payable under the corresponding Notes.

Both Welsh Water and DCF are 100% owned by Dwr Cymru (Holdings) Limited ("Holdings"), which itself is 100% owned by Glas Cymru (Securities) Cyfyngedig ("Glas Securities"), which in turn is 100% owned by Glas Cymru.

Glas Securities and Holdings were incorporated in England & Wales and have no employees or physical assets, and no activities except the holding of shares. Glas Cymru is a private company, limited by guarantee, which operates on a not-for-profit basis. Its constitution only permits it to act as a holding company and to ensure that Welsh Water performs its functions and responsibilities required by the licence. As a not-for-profit organisation, Glas Cymru does not have any shareholders and operates solely for the benefit of its customers. Instead of shareholders, it has members chosen from a variety of backgrounds across the region in which Welsh Water operates. In January 2008, and following a round of public advertisement, Glas Cymru appointed 21 new members, bringing the current number of independent members to 72. The members are not entitled to receive any payments for services or dividend distribution from Glas Cymru and their liabilities are limited to £1 in the event of Glas Cymru being wound up. Members are nominated by an independent panel which operates in accordance with the 1995 recommendations of the Nolan Committee for standards in public life. Glas Cymru is subject to the provisions of the UK Companies Acts and hence its members have the right to remove and appoint directors, and Glas Cymru's board of directors is accountable to its members.

The following graph shows the existing group structure underneath the ultimate parent Glas Cymru.

*FIGURE 2*



Due to the not-for-profit status of its ultimate parent Glas Cymru and the absence of shareholders, the financial covenants embedded in Welsh Water's transaction are different from the other highly-leveraged structures.

## Management Strategy

*Management's focus on core business supports credit rating*

As discussed below, the covenant structure of Welsh Water's bond programme 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. Although this covenant structure and the restrictions in Welsh Water's licence mitigate event risk and leave little leeway for management outside of the core activities, 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 WaSC.

Since the close of the refinancing transaction in 2001, Welsh Water's performance has improved significantly, and the company has generally been able to achieve average efficiency and performance levels. This performance improvement has enabled the group to reduce its customer bills over the past years through the distribution of a so-called customer dividend.[1] However, given the challenging price review in 2009, Moody's understands that Welsh Water will not pay a customer dividend in 2010/11, the first financial year of the new regulatory period, and management will consider the payment of further customer dividends in the light of the company's performance during the period.

*Event risk substantially reduced by ring-fencing structure & ownership characteristics*

Overall, event risk remains high across the infrastructure sector. Specifically in the water sector, three of the largest WaSCs, Thames Water, Anglian Water and Southern Water, have been acquired by infrastructure funds in 2006 and 2007, followed more recently by Kelda Group in February 2008. Others, like United Utilities, have rearranged their capital structure, resulting in an increase in leverage at the regulated company level.

Moody's believes that the related event risk is less material for Welsh Water, as it benefits from a unique ownership structure. Furthermore, similar to other highly-leveraged water companies, Welsh Water exhibits a financial structure that provides some element of additional creditor protection. The bond covenant package enhances the company's regulatory ring-fencing as imposed by its license conditions, particularly through operational and financial restrictions, including cash-trapping triggers, which – if breached – prohibit any payment on any debt subordinated to the rated bonds,[2] payments to preference shares or other equity-like distribution (including the so-called customer dividends).

Key operational restrictions include:

» Restrictions on acquisitions, investments, disposals, mergers or other form of restructuring, usually requiring creditor consent

» Restriction of business to the appointed, i.e. regulated, activities

[1] Welsh Water effectively reduced the amount for which the customers are billed by the customer dividend, i.e. the revenues and cash flows that the company is reporting in its statutory account are lower than the level that would have been allowed by the Regulator.

[2] At the outset of the transaction, the only exception were payments under the unrated Class D Notes, issued at the initial issue date, which ranked junior to Class A, B, R and C Notes, but whose debt service would have continued if the company would have been in breach of the trigger event covenants. There are currently no Class D Notes outstanding.

Key financial covenants are, inter alia:

» Limitation on raising additional debt, other than debt that is subordinated to Class C Debt, if leverage (Net Debt to RCV) exceeds 75% for Senior Debt (Class A, B and R Notes, if issued) or 86% for Total Debt (Class A, B, R and C Notes)

» Distribution lock-up, if leverage (Net Debt to RCV) exceeds 90% for Total Debt (Class A, B, R and C Notes), and the Interest Coverage Ratio[3] falls below 2.0x (prior to adjusting for capital maintenance) or below 1.0x for the Interest Coverage adjusted to deduct actual or planned capital maintenance expenditure from the numerator

» Limitation of the concentration of maturities to 20% of the aggregate outstanding external indebtedness of borrowed money within any 24 months period

The terms apply to Welsh Water's existing bond programme, but any future creditors of Welsh Water will also have to accede to the same terms and conditions, so that as long as the current financing structure remains in place, management's ability to change the company's business or financial profile is relatively limited, and event risk for creditors is therefore reduced. However, Moody's notes that the degree of creditor protection provided at Welsh Water's current A3 CFR is lower than for comparable transactions (such as Anglian or Southern Water) as significant headroom remains compared to the thresholds that would restrict additional indebtedness or the payment of permitted distributions (including customer dividends).

Furthermore, we note that the distribution lock-up covenants, particularly in relation to the Interest Cover Ratio, are weaker than in other comparable transactions, for example the Interest Coverage Ratio excludes interest payments on Class C Notes (i.e. it is a senior interest cover only) and the minimum level for the Interest Coverage Ratio that takes into account the funding requirements to maintain the RCV at a stable level, i.e. similar to Moody's Adjusted Interest Coverage (see Factor 4, below, for further details) is comparably low. However, the weakness in the covenant structure is mitigated by Welsh Water's ownership structure with no external shareholders and therefore no particular pressure on dividend distribution. Moody's therefore believes that the transaction provides adequate creditor protection, given the specifics of the corporate structure. In any case, as noted above, any uplift for structural enhancements remains limited at Welsh Water's current A3 CFR level.

## Key Rating Considerations

Welsh Water's A3 CFR consolidates the legal and financial obligations of the company, its funding vehicle Dwr Cymru (Financing) Limited and the three holding companies that are part of the ring-fenced group. In line with our approach towards similar structured transactions, 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.

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.

[3] The Interest Coverage Ratio is defined as pre-tax operating cash flow of the consolidated Glas Cymru group divided by net senior interest (i.e. interest on Class A, B and R Notes and other senior ranking debt, excluding interest on Class C Notes, less interest receivable).

Moody's rating assessment is based on the application of the global Rating Methodology for Regulated Water Utilities, published in December 2009. The methodology grid results in an indicative factor outcome of Baa1 compared to the assigned A3 CFR, based on average three-year historical financial metrics. Moody's expects that Welsh Water will exhibit leverage of around 70% of Net Debt to RCV, in line with its publicly communicated target. When this is factored into the methodology grid, the indicated outcome is A3.

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

*FIGURE 3*

**Rating Methodology Grid for Regulated Water Utilities**

| 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%)*** | | | | | | | |
| a) Adjusted Interest Cover OR FFO Interest Cover | | | | x | | | |
| b) Net Debt / Regulated Asset Base (or Fixed Assets) OR Debt / Capitalisation | | | | | x | | |
| c) FFO / Net Debt | | | | x | | | |
| d) RCF / Capex | | | | | x | | |
| **Rating** | | | | | | | |
| a) Indicated Factor-Rating from Methodology | | | [Baa1] | | | | |
| + Rating Uplift for Additional Creditor Protection | | | - | | | | |
| = Final Indicated Grid Rating from Methodology | | | Baa1 | | | | |
| b) Actual Rating Assigned (CFR) | | | A3 | | | | |

* Key Credit Metrics scores based on three-year average historical financial of Glas Cymru Cyfyngedig.

In the following paragraphs, we discuss in more detail how Welsh Water scores for the main rating factors of the methodology and how it compares with its closest UK peers in the rated regulated water companies universe.

## FACTOR 1: REGULATORY ENVIRONMENT & ASSET OWNERSHIP MODEL

*Transparent and predictable regulatory regime continues to underpin low business risk profile*

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.

In relation to the asset ownership model, we score the UK water companies at Aa, reflecting direct ownership of the water and sewerage assets under a licence. However, this licence can be terminated for failure to comply with the terms and conditions set out in the relevant instrument of appointment. As a consequence, UK water companies can also be subject to a special administration regime, which can be invoked by the regulator or the UK government in case of severe underperformance or financial distress of a water company. The special administration order is meant to ensure the orderly transfer of the water and sewerage operations and assets to a new provider.

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 grow the 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 fact that there is strict regulatory oversight of tariff increases and that operators can be subject to challenging efficiency targets.

*Final determination provides challenges, but Welsh Water remains well positioned to face these*

Price limits for the next regulatory period (April 2010 - March 2015, or "AMP5") have recently been reviewed by Ofwat, the UK water industry's economic regulator. The Regulator published its final price determination for the AMP5 period in November 2009. In the final determination (FD), Welsh Water was 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 FD 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%.

The following table summarises the main assumptions of Ofwat's FD compared with Welsh Water's final business plan (FBP):

*FIGURE 4*

**Main Assumptions of Ofwat's Final Determination versus Welsh Water's Final Business Plan Parameter**

| FINAL BUSINESS PLAN ASSUMPTIONS 2010-15 | FD | FBP |
|---|---|---|
| Cost of Capital (real, post-tax) | 4.5% | 4.9% |
| RCV in 2015 (in 2007/08 prices) | £3,708m | £3,757m |
| Total Capex Programme (gross of grants and contributions; in 2007/08 prices) | £1,104m | £1,356m |
| Average annual increase in K 2010-15 | -0.8% | 0.7% |

The main challenge for Welsh Water will be in relation to the Regulator's efficiency targets embedded in the operating cost allowance for the new regulatory period. Over the five-year period from 1 April 2010 to 31 March 2015, Welsh Water will need to reduce its operating expenditure by around 20% of controllable costs. Moody's understands that the company intends to achieve this target primarily by implementing new technologies, reducing the amount and cost of energy to be procured, and a phased reduction in staff numbers by 300 over the next five years.

Moody's believes that Welsh Water's unique ownership structure with no shareholder dividend pressures will allow the company to retain any excess cash flows, as evidenced by the rapid deleveraging over the past decade. Therefore, the company is expected to exhibit sufficient financial flexibility within its current ratings to react to the challenges posed by the recent regulatory settlement.

*Recession impact on Welsh Water's revenues will be mitigated in future by revenue correction mechanism*

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, which 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 such costs breaches certain thresholds.

## FACTOR 2: OPERATIONAL CHARACTERISTICS & ASSET RISK

*Overall operational performance in line with industry average, but the company faces challenging efficiency targets*

Welsh Water's performance is generally in line with the targets set by the regulator. For 2008-09, Ofwat awarded the company a score of 406 out of a maximum of 438 in the regulators' overall performance assessment for water supply, sewerage services and customer service. This score positioned Welsh Water in the mid-field of the 10 water and sewerage companies. 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. In relation to its operating efficiency, the company has been ranked below average in Ofwat's assessment for 2008-09 (lower band C for water services and upper band C for sewerage, on a scale from A to E, with A being the most efficient). We understand that this assessment is primarily a reflection of relatively high power costs. A recent decrease in power wholesale prices has allowed Welsh Water to lock-in a significant portion of its AMP5 power requirements at prices below the allowance provided by the Regulator. The company believes that this will contribute to the required cost savings over AMP5.

As discussed above, as a consequence of the challenging efficiency targets set for the AMP5 period, Welsh Water decided to bring certain operational activities that had been outsourced to United Utilities and Kelda Water Services back in-house. The personnel working on these contracts has been transferred back into Welsh Water during April and May 2010. We expect Welsh Water to be able to adequately manage the transition process as well as the ongoing operations of its assets. Consequently, we score the company at Baa for its operational performance, i.e. in line with the sector average.

*Large capex programme with focus on asset maintenance*

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 £1.1 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 equals around 6% of the average RCV, 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 rating methodology 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 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 2.0x post-customer rebates and 2.3x pre-customer rebates, and a ratio of Net Debt to RCV around 70% for the financial year ended March 2010. Whilst the company’s gearing was affected negatively in the financial year 2008/09, primarily due to the volatility in inflation combined with timing differences affecting the indexation used to rebase index-linked debt versus that used to write forward the RCV, Welsh Water’s gearing for the year 2009/10 benefitted from a significant increase in inflation to 4.4% at March 2010.

Moody's notes that the not-for-profit nature of its parent company, with no shareholders and therefore no dividend pressures, allows Welsh Water to retain excess cash flows and thus retain some financial flexibility to counteract negative economic pressures and manage its operations, notwithstanding the challenging efficiency targets set by Ofwat. Moody's understands that the company decided not to pay a customer dividend for the first year of AMP5 to retain some headroom given the challenges in the final price determination. The payment of future customer dividends will be assessed annually.

Figure 5 below shows Welsh Water's coverage and leverage measures over the past three years.

*FIGURE 5*

**Group Coverage and Leverage as adjusted by Moody's**

| £ MILLIONS | 2007 | 2008 | 2009 | 2010 [5] |
|---|---|---|---|---|
| **Cash Flow Inputs** | | | | |
| FFO (Pre-Net Interest Expense) [1] | 349.9 | 388.8 | 392.1 | 420.4 |
| Net Interest Expense [2] | (129.0) | (128.9) | (125.0) | (113.5) |
| Funds from Operations (FFO) | 220.9 | 259.9 | 267.1 | 306.9 |
| Dividends (excluding customer dividends) | 0.0 | 0.0 | 0.0 | 0.0 |
| Retained Cash Flow (RCF) | 220.9 | 259.9 | 267.1 | 306.9 |
| Capex [3] | (250.3) | (270.7) | (344.5) | (346.4) |
| Working Capital Movements | 44.7 | (90.7) | 24.1 | (9.9) |
| Free Cash Flow | 15.3 | (101.5) | (53.3) | (49.4) |
| **Debt Inputs** | | | | |
| Short Term + Long Term Debt | 2,585.8 | 2,648.5 | 2,759.7 | 2,912.0 |
| Operating Leases (5x lease rental) | 0.0 | 0.0 | 0.0 | 0.0 |
| Underfunded and Unfunded Pension Obligations | 5.5 | 0.0 | 7.8 | 8.0 |
| Accrued Interest Removed | (81.0) | (42.1) | (41.9) | (43.9) |
| Cash & Cash Equivalents (excluding restricted cash) | (158.0) | (124.1) | (139.3) | (148.7) |
| Total Net Debt (as adjusted) | 2,352.3 | 2,482.3 | 2,586.3 | 2,627.4 |
| **Regulatory Inputs** | | | | |
| RCV (as published by Ofwat) | 3,310 | 3,529 | 3,574 | 3,737 |
| Operating Leases (5x rental) | 0.0 | 0.0 | 0.0 | 0.0 |
| 2005 Pension Deficit (Regulatory Allowance) | 3.5 | 3.3 | 2.9 | 2.5 |
| RCV (as adjusted) | 3,313.5 | 3,532.3 | 3,576.9 | 3,739.5 |
| Current Cost Depreciation (CCD as published by Ofwat and inflated) | 106.2 | 115.8 | 119.8 | 127.4 |
| Capital Element of Operating Leases (2/3 of lease rental) | 0.0 | 0.0 | 0.0 | 0.0 |
| Infrastructure Renewals Charge (IRC as published by Ofwat and inflated) | 56.9 | 59.0 | 58.8 | 61.6 |
| Total Regulatory Capital Charges (as adjusted) | 163.1 | 174.8 | 178.6 | 189.1 |
| **Key Credit Metrics [4]** | | | | |
| Net Debt / RCV | 71.0% | 70.3% | 72.3% | 70.3% |
| Adjusted Interest Cover | 1.4x | 1.7x | 1.7x | 2.0x |
| FFO Net Interest Cover | 2.7x | 3.0x | 3.1x | 3.7x |
| FFO / Net Debt | 9.4% | 10.5% | 10.3% | 11.7% |
| RCF / Net Debt | 9.4% | 10.5% | 10.3% | 11.7% |
| RCF / Capex | 0.88x | 0.96x | 0.78x | 0.89x |

[1] FFO (Pre-Net Interest Expense) includes the capital element of operating leases (2/3 of lease rental), which is added back as part of the depreciation.

[2] Net Interest Expense includes the interest element of operating leases (1/3 of lease rental) and the interest attributable to the pension debt adjustment. For the calculation of the key credit metrics, Moody's also removes the indexation element of the interest expense related to index-linked debt, i.e. the net interest expense shown in the above table resembles the normalised net cash interest payment.

[3] Capex as adjusted by Moody's includes the capital element of operating leases as well as the element of infrastructure renewal expenditure that has been expensed within opex.

[4] All ratios are post-customer dividends as reported in the financial statements of Glas Cymru Cyfyngedig. The customer dividend paid was £25m, £26m, £27m and £28m in the years 2007, 2008, 2009 and 2010, respectively.

[5] Pro-forma financials based on Preliminary Results for the financial year ended 31 March 2010

Source: 2007, 2008 and 2009 Annual Reports as well as 2010 Preliminary Results Presentation of Glas Cymru, Moody's.

*Solid liquidity position benefiting from pre-funding of capex requirements*

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 £249 million of cash and cash equivalents (including the proceeds of the £140 million of index-linked bond issued on 31 March 2010); and (iv) £420 million of undrawn committed bank facilities, (including £75 million from the EIB) available as at 31 March 2010. Moody's notes that in May 2010, the level of undrawn committed credit facilities (excluding the EIB funding) was reduced from £345 million to £100 million, given the high level of liquidity available to the company. Moody's regards Welsh Water's revised sources of funds as sufficient to cover the group's needs over the next 12 months, including limited short-term debt repayments and capital investments. In this context, Moody's notes that Welsh Water repaid approximately £113 million of its £125 million Class C Notes in June 2010 following a successful tender offer. The remaining £12 million Class C Notes are likely to be repaid in March 2011, when a coupon-step will be triggered.

We add that an additional credit positive is the existence of a £150 million special liquidity facility, which would be available to the company to service its debt if a standstill was declared following a breach of financial covenants.

*Historically negligible off-balance sheet exposure, but increase expected with transfer of staff on operating contracts back in-house*

Historically, Welsh Water has had no material off-balance sheet liabilities. As the company does not have any operating leases, the main adjustment has been in relation to an existing, very small pension deficit. In line with Moody's methodology regarding under- or unfunded pension liabilities and our approach to other regulated industries, we adjust the debt position of UK water utilities for the full amount of the under- and unfunded pension liabilities.

Glas Cymru operates a funded defined benefit pension scheme for current employees (based on final pensionable salary and pensionable service), the DCWW Pension Scheme. The assets of the scheme are held in a separate trustee administered fund. The DCWW Pension Scheme was closed to new members from 31 December 2005 and a new defined contribution scheme, the Dwr Cymru Defined Contribution Scheme, was introduced from 1 January 2006. As at 31 March 2010, Welsh Water reported a deficit of around £8 million under the defined benefit pension scheme.

Following the transfer of nearly 1,600 staff that were previously working under the outsourcing arrangements with the relevant subsidiaries of United Utilities and Kelda, around 1,000 employees are entitled to transfer their defined benefit pension obligations to Welsh Water. This transfer is likely to be on a fully-funded basis and would increase pension liabilities and assets at 31 March 2010 by around £177 million. Even though the transferred pension liabilities is likely to be fully funded initially, the increase in the overall liability may increase the potential for volatility in its value on an accounting basis.

Moody's also recognises that the Regulator provided additional funding over a period of 10 to 15 years to erase a portion of the pension deficit,[4] although this did not reflect the additional liabilities

4 At the regulatory price review in December 2004, Ofwat included funding for around 50% of the existing deficit of the regulated business. Given that Ofwat did not publish the deficit amount on which this calculation was based, Moody's uses the FRS17 deficit for the financial year ended 31 March 2005 as an approximation. 50% of such deficit is added to the RCV and this amount is depreciated over a period of 12 years, which is the time the regulator allowed to erase the deficit, and inflated annually by RPI. At the 2009 price review, Ofwat updated its funding approach and Moody's is currently considering whether our approach to including a regulatory pension asset into the RCV calculation requires an amendment.

taken over as part of the in-sourcing of operations, which initially are likely to be fully funded. We currently recognise the regulatory promise as an addition to the company's RCV, which acts as a counterbalance to the full deficit being added to the debt amount.

Moody's cautions that the development of the pension deficit as well as the regulatory treatment of the pension funding costs remain important factors to be considered in assessing a company's financial risk profile. With a deterioration in value across most asset classes as part of the current financial market turmoil, the value of pension plan assets has reduced, and pension deficit across industries increased.[5] At the current stage, we do not expect the development in pension deficits to be significant enough to result in rating changes.

## Structural Considerations

Welsh Water's A3 CFR factors in some degree of uplift (albeit not a full notch) stemming from its ownership structure and the structural enhancements of Welsh Water's financing structure, including (i) the presence of a liquidity facility of £150 million; (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 degree of uplift is lower than for comparable transactions (such as Anglian or Southern Water) given 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 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.

The rating methodology grid-indicated outcome of Baa1 achieves no further rating uplift from structural considerations or creditor protection, as Welsh Water would have significant headroom under the existing covenants to increase leverage before additional creditor oversight would be triggered. However, the assigned A3 CFR takes into account the company's stated policy of leverage around 70% as well as the unique not-for-profit status of the company's parent Glas Cymru.

As already noted, Moody's also rates the bonds issued by Welsh Water's funding vehicle, DCF. The A3 rating of the senior notes (Class A, B and R[6]) reflects the strength of the debt protection measures for the respective classes of bonds and other indebtedness of DCF that ranks pari passu with them.

5 Please also see Moody's Special Comment Pension Deficits: Back on the Agenda, published in January 2009.

6 The Class R Notes are designed as revolving tranches and similar in nature to committed bank facilities for the funding of working capital or capex requirements. The proceeds from the issuance of Class R Notes can be used by DCC to fund working capital and/or capital expenditure. At the close of the transaction in May 2001, the proceeds of the issue of the Class R Notes were immediately applied by the Issuer to repurchase these notes, which the Issuer was permitted to do under its Memorandum of Association and pursuant to the Conditions applicable thereto. The Class R Notes were not cancelled but remain within the clearing systems and are available to be resold from time to time subject to certain criteria. Any Class R Notes so resold may be repurchased by the Issuer on any day and will be repurchased by the Issuer no later than the interest payment date which immediately follows their resale, provided that no Issuer event of default under the Notes has occurred and is continuing. The Issuer will not be required to repurchase any Class R Notes on an interest payment date if any Class R Underwriter fails to finance such repurchase by subscribing for new Class R Notes. In this event, the Class R Notes that are not repurchased will remain in issue and interest will continue to accrue on them. Whilst held by, for or on behalf of DCF, DCC or Holdings or any of their respective affiliates, the Class R Notes will not accrue interest and will not confer any voting rights. There are currently no Class R Bonds outstanding.

The rating also reflects the priority of claim in the Issuer's payments waterfall, which should enhance recovery prospects.

We note that 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.

The Baa2 rating assigned to the Class C Notes reflects Moody's estimates of the default probability for these bonds and other debt ranking pari passu with them, which is the same as factored into Welsh Water's CFR, as well as the greatly heightened loss severity in case of default resulting from the presence of a large portion of debt with priority ranking. The rating also reflects the limited representation of Class C bondholders in certain matters, including revision of financial covenants and termination of standstill. On 25 May 2010, DCF announced an invitation to holders of Class C Notes to tender any or all of their Notes for purchase by DCF for cash. The tender offer was accepted by around 90% of existing Class C bondholders, and Welsh Water repaid around £113 million of Class C Notes in June 2010.

## Rating Positioning & Peer Comparison

Welsh Water's closest peers are the WaSCs, which have executed similar ring-fenced financing transactions, such as Anglian Water Services Limited in 2002, Southern Water Services Limited in 2003, Thames Water Utilities Limited in 2007, or Yorkshire Water Services Limited in 2009. All these transactions follow a very similar structure, involving two tranches of debt.

Figure 6 summarises the broad ratio bands we would expect a water company that has been financed under such a highly-leveraged financing structure to achieve.[7]

*FIGURE 6*

**Ratio Bands Expected for Highly-Leveraged WaSCs**

| DEBT TRANCHE | MAXIMUM LEVERAGE (NET DEBT / RCV) | MINIMUM ADJUSTED INTEREST COVER |
|---|---|---|
| Senior Class | 75% | 1.45-1.55x |
| Junior Class | 85% | 1.25-1.35x |

Following its significant deleveraging in the past, Welsh Water's financial performance is measured against management's publicly stated target of around 70% of Net Debt to RCV. Given the lower leverage, also the ratings and target metrics for the different Classes of debt issued by Welsh Water differ from the above outline.

Figure 6 compares the methodology grid scores of Welsh Water with those of its closest UK peers in the rated regulated water companies universe, namely Anglian Water Services Limited, Southern Water Services Limited, and Thames Water Utilities Limited.

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

*FIGURE 7*

**Peer Comparison Rating Grid for Regulated Water Utilities**

| GLOBAL REGULATED WATER UTILITIES | WELSH WATER | ANGLIAN WATER | SOUTHERN WATER | THAMES WATER |
|---|---|---|---|---|
| Factor 1: Regulatory Environment & Asset Ownership Model (40%) | | | | |
| 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 |
| Factor 2: Operational Characteristics & Asset Risk (10%) | | | | |
| a) Operational Efficiency | Baa | Baa | Baa | Baa |
| b) Scale and Complexity of Capital Programme & Asset Condition Risk | A | A | Baa | Ba |
| 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 |
| b) Ability and Willingness to Increase Leverage | A | A | A | A |
| c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities | Aa | Aa | Aa | Aa |
| Factor 4: Key Credit Metrics (40%)* | | | | |
| a) Adjusted Interest Cover OR FFO Interest Cover | Baa | Ba | Ba | Ba |
| b) Net Debt / Regulated Asset Base (or Fixed Assets) OR Debt / Capitalisation | Ba | Ba | Ba | Ba |
| c) FFO / Net Debt | Baa | Ba | Baa | A |
| d) RCF / Capex | Ba | Ba | Ba | B |
| Rating | | | | |
| a) Indicated Rating from Methodology | [Baa1] | [Baa2] | [Baa2] | [Baa2] |
| + Rating Uplift for Additional Creditor Protection | - | +1 | +1 | +1 |
| = Final Indicated Grid Rating from Methodology | Baa1 | Baa1 | Baa1 | Baa1 |
| b) Actual Corporate Family Rating Assigned (OpCo) | A3 | Baa1 | Baa1 | Baa1 |

* Key Credit Metrics scores the Adjusted Interest Coverage Ratio as well as Net Debt / Regulated Asset Base based on the financial covenant level for Anglian, Southern and Thames Water, otherwise ratios based on three-year average historical numbers.

Within its peer group, Welsh Water is the only WaSC rated at A3 on a corporate family basis, reflecting the ongoing strengthening of the company's financial metrics since it adopted a highly leveraged structure in May 2001. The A3 CFR and stable outlook assume that the absence of dividends due to the not-for-profit status of its ultimate parent company, Glas Cymru, will allow Welsh Water to continue to deleverage so as to demonstrate a Ratio of Net Debt to RCV around 70%. As discussed, the level of uplift for structural enhancements is lower than for the other transaction, given the limited effect the additional creditor protection can provide at Welsh Water's current A3 CFR.

Anglian Water and Southern Water exhibit very similar credit metrics, reflecting their similar financial structure. Anglian Water's Adjusted Interest Coverage has historically been slightly stronger reflecting a higher proportion of index-linked debt than Southern Water. On the derived ratios based on FFO and RCF before adjusting for regulatory capital charges, Southern Water remains slightly stronger due to a higher depreciation as a proportion of the RCV. For comparing the financial strength of water companies under the UK regulatory model, Moody's focused on the ratios of Net Debt to RCV and Adjusted Interest Coverage, as these are unaffected by potential differences of regulatory inputs in the companies' revenue building block.[8]

Thames Water's historical metrics reflects the fact that the company's funding structure allows Class B issuance only from April 2010, and leverage has therefore been restricted to 75% of Net Debt to RCV. The company furthermore benefits from a significant portion of index-linked debt in its funding structure. We note that in Figure 6 the Key Credit Metrics of Adjusted Interest Cover and Net Debt to RCV are scored to reflect the threshold levels of the distribution lock-up covenants. This reflects Moody's expectation that in the interest of its shareholders, Thames Water will adjust its financial profile to remain close to these covenant levels. This is also the case for Anglian and Southern Water.

During most of AMP4, all companies showed some level of headroom under their interest coverage ratios compared to Moody's general ratio guidelines for the sector, reflecting the availability of cheap index-linked debt primarily before the financial crisis in late 2007. This headroom will likely reduce in the new regulatory period from April 2010, following the reduction in the allowed cost of capital, and therefore bring the companies' performance closer to distribution lock-up covenants.

[8] For further details, please refer to Moody's Special Comment on the UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength, published in March 2006.

## Moody's Related Research

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### Industry Outlook

» UK Water Sector, September 2009 (119973)

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### Special Comment

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

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