Moody's Investors Service

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 18 Mar 2010

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	A3

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Key Indicators

Dwr Cymru Cyfyngedig

	Mar-09	Mar-08	Mar-07	Mar-06
Net Debt / RCV	**72.6%**	**70.3%**	**71.0%**	**76.9%**
Adjusted ICR	**1.7x**	**1.7x**	**1.4x**	**1.4x**
FFO Net Interest Cover	**3.1x**	**3.0x**	**2.7x**	**2.5x**
FFO / Net Debt	**10.3%**	**10.5%**	**9.4%**	**8.8%**
RCF / Net Debt	**10.3%**	**10.5%**	**9.4%**	**8.8%**
RCF / Capex	**77.6%**	**96.0%**	**88.3%**	**96.0%**

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

Opinion

Company Profile

Dwr Cymru Cyfyngedig ("Welsh Water") is the sixth-largest UK water utility by regulatory capital value ("RCV"), providing water and sewerage services to approximately 1.2 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 2008/09, Welsh Water had a Regulated Capital Value ("RCV") of GBP3,574 million and reported revenues of GBP657 million and operating profit of GBP155 million.

Recent Developments

On 9 February 2010, Welsh Water announced that it would undertake a corporate restructuring that will result in the company transferring staff, who are currently operating under an outsourcing agreement with United Utilities, back to Welsh Water within the next couple of months. On 12 March 2010, the company announced that it also agreed with Kelda Water Services, that the outsourcing contracts to operate Welsh Water's wastewater assets will terminate and the employees transfer back to Welsh Water as soon as possible.

Moody's believes that this move is unlikely to 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.

Rating Rationale

Welsh Water's A3 corporate family rating (CFR) consolidates the legal and financial obligations of the company, its funding vehicle Dwr Cymru (Financing) Limited and the three holding companies that are in the ring-fenced group. In line with our approach towards similar structured transactions (such as Anglian Water Services rated in 2002), 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.

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 expectation is 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:

FACTOR 1: REGULATORY ENVIRONMENT & ASSET OWNERSHIP MODEL

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

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, the 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.

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, Welsh Water has been required to reduce prices over AMP5 by an average of 0.8% p.a. in real terms. This compares to an average annual price increase of 0.5% p.a. for the industry as a whole and a 0.7% increase proposed in Welsh Water's final business plan. The final determination also proposes a weighted average cost of capital of 4.5% (real, post-tax), below the company's final business plan assumptions of around 4.9%.

In terms of revenue volatility, Welsh Water has some exposure to potential volume risk in relation to its industrial and commercial customer base. However, the overall proportion of non-household revenues is around the industry's average, i.e. around 25%, a relatively low exposure. Furthermore, revenue risk for the UK water companies is mitigated to some extent through the revenue-adjusted price cap mechanism introduced in the 2009 price review, 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

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 will result 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). Therefore, Welsh Water faces relatively challenging efficiency targets for AMP5. As a consequence, the company decided to bring certain operational activities that had been outsourced to United Utilities and Kelda Water Services back into Welsh Water. We score the company at Baa for its operational performance, i.e. in line with the sector average.

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

FACTOR 3: STABILITY OF BUSINESS MODEL AND FINANCIAL STRUCTURE

Welsh Water's scores reflect the additional event risk protection provided by the bond covenant and security package, which are designed to enhance the existing licence condition to ensure primary focus on the regulated activities. We score Aa for ability and willingness to pursue corporate activity and single-A for ability and willingness to increase leverage. For the targeted proportion of operating profit outside the core water activities, Welsh Water scores Aa.

These scores reflect the contractual restrictions placed on Welsh Water's management by the company's long-term financial structure, and are in line with other water and sewerage companies that follow a similar highly leveraged funding approach.

FACTOR 4: KEY CREDIT METRICS

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

Welsh Water's A3 rating reflects the ongoing strengthening of the company's financial metrics since it adopted a highly leveraged structure in May 2001, resulting in an Adjusted Interest Coverage Ratio of around 1.7x post-customer rebates and 1.9x pre-customer rebates, and a ratio of Net Debt to RCV around 70% over recent years. We note that the increase in gearing between March 2008 and March 2009 is primarily due to the volatility in inflation over the past year combined with timing differences affecting the indexation used to rebase index-linked debt versus that used to write forward the RCV. Furthermore, Moody's understands that Welsh Water has accelerated some of its capital investments, which will likely result in gearing levels slightly above of 70% in early AMP5.

Moody's notes that the not-for-profit nature of its parent company, with no shareholders and therefore no dividend pressures, would allow Welsh Water to retain excess cash flows. This should allow the company to 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 on an annual basis.

Structural Considerations

Welsh Water's A3 CFR factors in some degree of uplift (albeit not a full notch) stemming from the structural enhancements of Welsh Water's financing structure, including (i) the presence of a liquidity facility of GBP150 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 slightly different form the other transactions as the protection offered by certain financial covenants is less critical for a not-for-profit company without equity shareholders. Furthermore, the benefit of the security provided to bondholders remains limited by the regulated and essential nature of the services provided by Welsh Water as governed by its licence and the Water Industry Act 1991.

The 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.

Liquidity

Welsh Water's liquidity profile is very strong, supported by (i) the absence of dividend requirements due to its not-for-profit status, (ii) the stable and predictable cash flows generated by its regulated utility activity, (iii) the existence of GBP114 million of cash and cash equivalents as well as (iv) GBP455m of undrawn committed bank facilities available at 30 September 2009. GBP35 million of the facilities relate to a KfW-IPEX loan, which had been drawn in December 2009. Moody's regards Welsh Water's sources of funds as sufficient to cover the group's needs over the next 12 months, including limited short-tem debt repayments and capital investments. The next major debt maturity will occur in March 2011, when the company intends to repay its GBP125 million Class C Notes to avoid the embedded coupon step-up.

We add that additional comfort is taken from the existence of a GBP150m special liquidity facility which would be available to the company to service its debt in the event of a standstill being declared following a breach of financial covenants.

Rating Outlook

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

What Could Change the Rating - Down

Negative pressure on the ratings could derive from:

- Serious underperformance in operating or capital expenditure;

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

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

What Could Change the Rating - Up

Ongoing deleveraging, resulting in a further reduction of the ratio of Net Debt to RCV below 65% could result in positive rating pressure.

Rating Factors

Dwr Cymru Cyfyngedig

Global Regulated Water Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Regulatory Environment & Asset Ownership							

Model (40%)							
a) Stability and Predictability of Regulatory Environment	x						
b) Asset Ownership Model		x					
c) Cost and Investment Recovery (Ability & Timeliness)			x				
d) Revenue Risk			x				
Factor 2: Operational Characteristics & Asset Risk (10%)							
a) Operational Efficiency				x			
b) Scale and Complexity of Capital Programme & Asset Condition Risk			x				
Factor 3: Stability of Business Model & Financial Structure (10%)							
a) Ability and Willingness to pursue Opportunistic Corporate Activity (M&A, Disposals & Investments)		x					
b) Ability and Willingness to Increase Leverage			x				
c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities		x					
Factor 4: Key Credit Metrics (40%)*							
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 (OpCo)				A3			

* 3-year average historical financials

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