



Moody's Investors Service

Announcement: **Moody's affirms Welsh Water's A3 rating**

Global Credit Research - 17 Mar 2010

London, 17 March 2010 -- Moody's Investors Service has today affirmed the A3 corporate family rating ("CFR") of Dwr Cymru Cyfyngedig ("Welsh Water"), one of the ten UK regulated water and sewerage companies. The rating agency also affirmed the ratings of the various classes of debt issued by Dwr Cymru (Financing) Limited ("DCF"), the funding vehicle for Welsh Water. The outlook on all ratings is stable.

DCF's issuance is subject to the terms and conditions of its GBP3.0 billion Multicurrency Programme for the issuance of Asset-Backed Bonds. The programme itself is not rated by Moody's, but the rating agency currently rates 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 benefit from an unconditional and irrevocable guarantee of scheduled principal and interest provided by MBIA Assurance S.A. ("MBIA") pursuant to a financial guarantee insurance policy. However, given recent downgrades in MBIA's credit rating, the A3 rating of the Class A Notes issued by DCF represents the assessment of Welsh Water's stand-alone credit quality absent the MBIA guarantee.

Welsh Water's A3 CFR consolidates the legal and financial obligations of the company, its funding vehicle DCF and the three holding companies that are part of 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 Cyfyngedig, which has allowed Welsh Water to significantly reduce leverage since the initial financing structure was put in place in May 2001.

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%.

Welsh Water also faces very 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. Moody's said on 11 February 2010 that it regards this operational restructuring as ratings neutral.

Welsh Water will also have to execute a relatively large capital programme of around GBP1.1 billion (according to Ofwat's final determination and in 2007/08 prices), which corresponds to real growth in its Regulatory Capital Value ("RCV") of around 3% over AMP5. However, the main focus will be on maintenance expenditure, and the company is expected to become free cash flow positive during the course of AMP5. Moody's notes that this will ease the additional funding requirements associated with a large investment programme.

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 (defined by Moody's as Funds from Operations less Regulatory Capital Charges to Net Interest) 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. Moody's notes 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 requirement to pay dividends allows Welsh Water to retain excess cash flows. This should allow the company to retain some 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.

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.

The previous rating action on Welsh Water was implemented on 14 June 2007, when Moody's assigned the A3 corporate family rating to the group.

The principal methodology used in rating Welsh Water was Moody's rating methodology for Regulated Water Utilities, published in December 2009 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Welsh Water is the sixth-largest UK water utility by 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, a not-for-profit organisation. In the fiscal year 2008/09, Welsh Water had a RCV of GBP3,574 million and reported revenues of GBP657 million and operating profit of GBP155 million.

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