

Global Credit Research - 13 Sep 2011

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	A3

Contacts

Analyst	Phone
Stefanie Voelz/London	44.20.7772.5454
Neil Griffiths-Lambeth/London	
Andrew Blease/London	

Key Indicators

Dwr Cymru Cyfyngedig[1][2]

	Mar-11	Mar-10	Mar-09	Mar-08	Mar-07
Net Debt / RCV	66.1%	70.3%	72.3%	70.3%	71.0%
Adjusted ICR	1.6x	2.1x	1.7x	1.7x	1.4x
FFO Net Interest Cover	3.2x	3.8x	3.1x	3.0x	2.7x
FFO / Net Debt	10.8%	12.0%	10.3%	10.5%	9.4%
RCF / Net Debt	10.8%	12.0%	10.3%	10.5%	9.4%
RCF / Capex	111.8%	90.8%	77.5%	96.0%	88.3%

[1] Ratios are calculated post payment of customer dividend [2] All ratios are calculated using Moody's Standard Adjustments; Source: Moody's Financial Metrics TM

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

Opinion

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 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. At the end of the fiscal year 2010/11, Welsh Water had a Regulated Capital Value ("RCV") of GBP3,981 million and reported revenues of GBP677million and operating profit of GBP228 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. In line with our approach towards similar structured transactions (such as Anglian Water, Southern Water or Thames Water), 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, and the company's stated policy to maintain current leverage at around 70%.

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 A3, in line with the assigned A3 CFR, based on a three-year historical average.

DETAILED RATING CONSIDERATIONS

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.

Ofwat, the economic regulator for the water sector in England and Wales, is currently reviewing the regulation and structure of the industry to ensure that it is best able to address current and future challenges. The UK Government has recently received an independent review of Ofwat. This work may lead to significant changes in the way the industry is structured and regulated, most likely from the start of the next regulatory review period in 2015. However, Moody's believes that both government and the regulator are mindful of the need to preserve investor confidence in the regulatory framework and, more generally, the creditworthiness of the sector.

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 the regulator or the UK government can invoke in cases of severe underperformance or the financial distress of a water company. The special administration order aims 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 increase the company's 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 strict regulatory oversight of tariff increases and that operators can be subject to challenging efficiency targets.

Ofwat published its final price determination for the regulatory period from 1 April 2010 to 31 March 2015 ("AMP5") 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 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%.

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. This mechanism 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 these 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 2009-10, Ofwat awarded the company a score of 407 out of a maximum of 438 in the regulator's overall performance assessment for water supply, sewerage services and customer service. This score positioned Welsh Water in the lower mid-field of the 10 water and sewerage companies (2009-10 was the last year that Ofwat published the OPA assessment for companies; going forward this will be replaced by the service incentive mechanism that includes a qualitative score based on customer experience).

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). 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 in spring 2010. We score the company at Baa for its operational performance, i.e. in line with the sector average.

Arisk 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 credit metrics are calculated on the basis of the consolidated financial statements of its parent Glas Cymru.

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 1.6-1.7x post-customer rebates and 1.9-2.0x pre-customer rebates. Whilst Welsh Water 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. Gearing on the basis of Net Debt to RCV is maintained around 70%, in line with the company's target ratio. We note that the increase in gearing between March 2008 and March 2009 was primarily due to the volatility in inflation at that time combined with timing differences affecting the indexation used to rebase index-linked debt versus that used to write forward the RCV.

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 enable the company to retain some financial flexibility to counteract negative economic pressures and manage its operations, notwithstanding the challenging efficiency targets set by Ofwat. We note that the industry is facing additional operational pressures due to the adoption of private sewers in autumn 2011, although the final determination included some protection allowing companies to apply for an interim price determination provided they can justify cost pressures to the regulator. The UK water companies will also have to manage their financial profile carefully in light of the recent reductions in the Construction Price Index relative to RPI, which will influence the calculation of the RCV at the next price review.

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 standby liquidity facility of GBP135 million covering 12 months of debt service, (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 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 grid-indicated outcome of A3 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.

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 around GBP138 million of cash and cash equivalents, as well as (iv) GBP140 million of undrawn committed bank facilities (maturing in May 2016) available at 30 June 2011. To provide funding for its investment programme, Welsh Water also arranged a GBP100 million European Investment Bank facility, which was still undrawn as at 30 June 2011. Furthermore, on 6 July 2011, Welsh Water's financing subsidiary also issued GBP120 million index-linked bonds. As a result, Moody's regards Welsh Water's 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 add that additional comfort is taken from the existence of the GBP135m 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%) [1][2]							
a) Adjusted Interest Coverage (3-year average)				x			
b) Net Debt / Regulated Asset Value (3-year average)				x			
c) FFO / Net Debt (3-year average)				x			
d) RCF / Capex (3-year average)					x		
Rating							
a) Indicated Factor-Rating from Grid				(A3)			
+ Rating Uplift for Additional Creditor Protection				-			
= Final Indicated Rating from Grid				A3			
b) Actual Rating Assigned (OpCo)				A3			

[1] All ratios are calculated using Moody's Standard Adjustments [2] 3-year average historical financial information as of 31 March 2011; Source: Moody's Financial Metrics



© 2011 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S ("MIS") CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS 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 ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

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. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. 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.

MIS, 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 MIS have, prior to assignment of any rating, agreed to pay to MIS 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 under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Any publication into Australia of this document is by MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657, which holds Australian Financial Services License no. 336969. 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.

Notwithstanding the foregoing, credit ratings assigned on and after October 1, 2010 by Moody's Japan K.K. ("MJKK") are MJKK's current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. In such a case, "MIS" in the foregoing statements shall be deemed to be replaced with "MJKK". 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.

This credit rating is an opinion as to the creditworthiness or 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 dangerous for retail investors to make any investment decision based on this credit rating. If in doubt you should contact your financial or other professional adviser.