MOODY'S
INVESTORS SERVICE

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 02 Dec 2014

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	A3

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Key Indicators

[1]**Dwr Cymru Cyfyngedig**

	3/31/2014	3/31/2013	3/31/2012	3/31/2011	3/31/2010
Adjusted Interest Coverage	1.8x	1.7x	1.6x	1.6x	2.1x
Net Debt / Regulated Assets Value	61.9%	61.7%	63.0%	66.1%	70.3%
FFO / Net Debt	11.7%	11.6%	11.2%	10.9%	12.0%
RCF / Capex	0.9x	1.0x	1.1x	1.1x	0.9x

[1] 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

Rating Drivers

Stable cash flows from monopoly water business supported by a well-established, transparent and predictable regulatory regime

Lower AMP6 allowed return will reduce currently ample rating headroom

Average AMP5 operational performance

Creditors benefit from structural protections

Protected against increasing sector business risk by Welsh Government opposition to competition

Corporate Profile

Dwr Cymru Cyfyngedig (Welsh Water) is the sixth-largest UK water utility by regulatory capital value (RCV), providing water and sewerage services to approximately 3.2 million people in a region that covers most of Wales and certain adjoining areas of England.

Welsh Water's ultimate parent company is Glas Cymru Cyfyngedig (Glas Cymru), a not-for-profit organisation. In the fiscal year 2013/14, Welsh Water had a RCV of GBP4,468 million and reported revenues of GBP737 million and operating profit of GBP204 million.

Rating Rationale

Welsh Water's A3 corporate family rating (CFR) consolidates the legal and financial obligations of the company, its funding vehicle Dwr Cymru (Financing) Limited and the three holding companies that are in the ring-fenced group.

The A3 rating reflects (1) the group's low business risk profile as monopoly provider of water services operating under a well-established, transparent and predictable regulatory framework; (2) the group's targeted level of leverage, which at 70% (measured as net debt to Regulatory Capital Value or "RCV"), is lower than peers with similar financial structures; (3) the structural enhancements of the bond covenant and security package. In terms of the covenant and security package; and (4) the protection provided against increasing business risk by the Welsh Government's opposition to increasing competition in the sector.

Welsh Water's A3 rating currently does not incorporate any significant uplift for credit-enhancing features. Given its moderate leverage, Welsh Water exhibits significant headroom in its financial metrics compared to the additional indebtedness trigger levels embedded in its financing structure.

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 of leverage at or below 70%, both of which contribute to the fact that Welsh Water's A3 CFR is one notch higher than the corporate family ratings of peers, such as Anglian Water, Thames Water and Yorkshire Water.

DETAILED RATING CONSIDERATIONS

STABLE CASH FLOW GENERATION SUPPORTED BY WELL-ESTABLISHED AND TRANSPARENT REGULATORY REGIME

Welsh Water operates a monopoly water and sewerage business in the UK which benefits from a very transparent, stable and predictable regulatory regime overseen by the Water Services Regulation Authority (Ofwat). The UK regulatory framework has clearly defined risk allocation principles and has applied them consistently in the past.

The regulator is currently engaged in the PR14 price setting process for the next regulatory period, which will run from April 2015 to March 2020 (AMP6). Though it has recently introduced a number of changes, the regulator has generally acted in a transparent fashion, including the provision of enhanced disclosure around its working assumptions (including publication of its financial models) compared with previous price-setting processes.

LOWER AMP6 ALLOWED RETURN WILL REDUCE CURRENTLY AMPLE RATING HEADROOM

On 30 May 2014, Welsh Water received its draft determination for the AMP6 regulatory period (with further information on the non-household retail price control published on 29 August 2014). It is due to receive its final determination in December 2014.

If there are only minor changes between the draft determination and the final determination, we consider that the settlement would be likely to present some challenges for Welsh Water, in particular, given the reduction in allowed returns. The company's provisional allowed return in the wholesale business is 3.7% (allowed, real), a material reduction, compared to the 5.1% (vanilla, real) for the appointed business, that it currently receives. Ofwat has further suggested that the return could fall still further in the final determination, as a result of the persistence of the low yield environment. However, Welsh Water's relatively low leverage (potentially slightly lower than 60%) entering the new period will give them more flexibility to absorb the impact of the reduction.

In relation to the most material part of the plan, Welsh Water's proposed total wholesale menu expenditure (GBP2,525 million in 2012/13 prices) was GBP26.5 million or just over 1% lower than the cost baseline modelled by the regulator, which puts the company close to the level of "top-quartile" efficiency.

The group's choices around "speed of money" i.e. the "pay-as-you-go" ratio for total wholesale expenditure and the RCV "run-off rate" as well as its long-dated financial structure (with no bond maturities in AMP6) mean that, relative to its existing RCV, it should have a relatively modest new debt raising requirement in the period. We expect that the company should need to raise between GBP400-600 million during AMP6 to finance a programme, which would see the combined RCV of the water and wastewater businesses rising 7% in real terms over the period.

We would expect the group to set its financial policy for the period (including target gearing) following the final determination and anticipate that the group should have sufficient headroom to maintain a credit profile in line with our guidance for the A3 rating, provided that it does not seek to reverse the recent trend of falling leverage in a material sense.

AVERAGE AMP5 OPERATIONAL PERFORMANCE

Welsh Water's performance has generally been in line with improving Service Incentive Mechanism (SIM) scores and mid-level performance overall in AMP5 to-date.

After a "marginal" assessment of the serviceability of sewerage non-infrastructure assets in 2011/12, the group's serviceability scores have been "stable" across all its assets.

This notwithstanding, the company received a "shortfall" in its draft determination, penalising it for consistently weak performance in the area of water supply interruptions. If confirmed in the final determination, the impact of this would be a reduction in allowed AMP6 revenues of over GBP30 million (in 2012/13 prices).

CREDITORS BENEFIT FROM STRUCTURAL PROTECTIONS

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.

Welsh Water's debt structure includes (1) the presence of a standby liquidity facility of GBP135 million covering 12 months of debt service; (2) a first ranking fixed charge over the shares in the company; and (3) the agreement by financial creditors to give up their individual rights to petition for insolvency proceedings, which could modestly improve recovery in a default scenario.

Moody's notes 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.

Therefore, unlike for comparable transactions (such as Anglian or Thames Water), Welsh Water's rating achieves no further uplift from structural considerations or creditor protection, as the company would have significant headroom under the existing covenants to increase leverage before additional creditor oversight would be triggered.

PROTECTED AGAINST INCREASING SECTOR BUSINESS RISK BY WELSH GOVERNMENT OPPOSITION TO COMPETITION

On 14 May 2014, the Water Act 2014 received Royal Assent. The Act grants the UK Government a series of powers to make regulations to, inter alia, increase the scope of competition within the sector. The first step in this direction - market opening in the non-household retail segment - is due to take place by April 2017.

We do not expect the introduction of retail competition per se to have a material impact on the credit quality of the sector, given the relatively small scale of these activities. However the introduction of competition in other parts of the value chain, including in relation to water supply and treatment, may increase business risk in the sector in towards the end of the decade.

In this respect, the decision of the Welsh Government, which has devolved powers in this area, to continue to use regulatory incentives (rather than competition) to encourage innovation, will likely protect Welsh Water's credit quality if business risk in the sector continues to increase.

Liquidity

Welsh Water's liquidity profile is very strong, supported by (1) the absence of dividend requirements due to Glas Cymru's not-for-profit status; (2) the stable and predictable cash flows generated by its regulated utility activity; (3) the existence as at 31 March 2014 of GBP94 million of cash and cash equivalents; (4) GBP120 million of undrawn committed bank facilities which mature in 2019.

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 GBP135 million special liquidity facility which would be available to the company to service its debt in the event of a standstill being declared following a breach of financial covenants.

Rating Outlook

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

What Could Change the Rating - Up

Ongoing deleveraging, resulting in a further and sustainable reduction of the ratio of Net Debt to RCV well below 65% could result in positive rating pressure. We note however, that the reduction in allowed returns will likely slow the pace of deleveraging and put pressure on the adjusted interest coverage ratio.

What Could Change the Rating - Down

Downward pressure could materialise following (1) persistent failure to meet regulatory targets or other unexpected severe deterioration in performance that resulted in the company's net debt/RCV being materially weaker than our guidance; (2) the receipt by the company of a final determination which would have a material adverse effect on the group's credit metrics, compared with the draft determination; or (3) a material adverse change in the regulatory framework.

Other Considerations

Moody's assessment of Welsh Water's credit quality is based on the rating methodology for Regulated Water Utilities, published in December 2009. The grid-implied outcome is A2 based on a three-year average of historic financial metrics and is one notch higher than the assigned rating of A3.

Rating Factors

Dwr Cymru Cyfyngedig

Regulated Water Utilities [1][2]	**Current As at 31 March 2014**			[3]**Moody's 12-18 months forward viewAs at November 2014**	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)					
a) Stability and Predictability of Regulatory Regime		Aaa			Aaa
b) Asset Ownership Model		Aa			Aa
c) Cost and Investment Recovery (Ability & Timeliness)		A			A
d) Revenue Risk		A			A
Factor 2: Efficiency & Execution Risk (10%)					
a) Operational Efficiency		Baa			Baa
b) Scale & Complexity of Capital Programme & Asset Condition Risk		A			A
Factor 3: Stability of Business Model & Financial Structure (10%)					
a) Ability & Willingness to Pursue Opportunistic Corporate Activity		Aa			Aa

b) Ability & Willingness to Increase Leverage		A		A
c) Targeted Proportion of Operating Profit Outside Core Water and Wastewater Activities		Aa		Aa
Factor 4: Key Credit Metrics (40%)				
a) Adjusted Interest Coverage (3 year Avg)	1.7x	Baa	1.6-1.8x	Baa
b) Net Debt / Regulated Asset Value (3 Year Avg)	62%	Baa	58-63%	Baa
c) FFO / Net Debt (3 Year Avg)	11.5%	Baa	9-12%	Baa-Ba
d) RCF / CAPEX (3 Year Avg)	1.0x	Baa	0.7-0.9x	Ba
Rating:				
a) Indicated Rating - Rating from Grid		A2		A3
+ Rating Uplift for Additional Creditor Protection		-		-
= Final Indicated Rating from Grid		A2		A3
b) Actual Rating Assigned				A3

[1] All ratios are calculated using Moody's Standard Adjustments. [2] 3-year average historical financial information as of 3/31/2014. Source: Moody's Financial Metrics . [3] This represents Moody's forward view, and unless noted in the text, does not incorporate significant acquisitions and divestitures

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

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