FITCH AFFIRMS DWR CYMRU'S SENIOR SECURED DEBT AT 'A'

Fitch Ratings-London-17 July 2014: Fitch Ratings has affirmed Dwr Cymru (Financing) Ltd's (Dwr Financing) senior secured class A debt and class B debt rating (both wrapped and unwrapped) at 'A' and its class C debt at 'BBB+'. The company has redeemed all its existing class C debt and, therefore, the affirmation of the senior subordinated class C debt of the bond programme at 'BBB+' indicates the level at which Fitch would expect to rate any prospective issuance, if any. The Outlooks on the ratings are Stable.

Dwr Financing is the debt-raising vehicle of Dwr Cymru Cyfyngedig (Dwr Cymru or Welsh Water). Dwr Cymru is one of the ten appointed water and sewerage companies (WaSC) in England and Wales.

The affirmation reflects Dwr Cymru's sound regulatory and operational performance for the financial year ending March 2014 (FY14) and the material reduction of earnings expected for the upcoming regulatory period from April 2015 to March 2020 (asset management plan 6; AMP6). While interest cover is under pressure, Fitch notes that the group has substantial financial flexibility in terms of gearing and robust cash flow characteristics. Taking this into account and the not-for-profit business model, the Outlook remains Stable. Fitch has indicated there is limited headroom as part of the rating sensitivities.

KEY RATING DRIVERS

Material Reduction of Earnings in the Sector

The regulator has guided towards a cost of capital of 3.85% for the regulated companies, lower than Fitch had expected. Companies may be able to earn additional returns from incentives. Taking into account draft determinations published to date, it appears that efficiency targets for total expenditure in the wholesale price controls may leave some room for outperformance, whereas allowances for the retail price controls are challenging and may offset some or all of the savings from the wholesale business.

Assumptions for the Forecast

In terms of outcome delivery incentives, the financial rewards and penalties in the draft determination for Welsh Water are skewed towards the downside. Therefore, Fitch assumed for purposes of the rating forecast that the company will earn the cost of capital of 3.85% and no premium or penalty, before factoring in negative GBP52.1m of revenue adjustments relating to the previous price control period (ie service incentive mechanism (SIM), capital incentive scheme (CIS) and revenue correction mechanism).

Financial Flexibility Mitigates Interest Cover

Fitch forecasts pension-adjusted net debt/regulatory asset value (RAV) below 60% for the combined class A and class B debt for the period to March 2020, materially lower than the ratio guideline of the low 70s for the existing rating. Post-maintenance and post-tax interest cover (PMICR) is expected to range between 1.3x and 1.5x (1.4x being the five-year average), slightly lower than the ratio guideline of minimum 1.5x.

In addition, considering the cash flow dynamics of the group, ie that the company will be free cash flow neutral before potential customer rebates or additional capital projects for the benefit of customers, financial flexibility in terms of gearing compensates for the low interest cover. Therefore, the Outlook on the ratings remains Stable.

Additional Perspective on Credit Metrics

Fitch notes that Dwr Cymru's board of directors consciously decided to pursue capital schemes over and above the regulator's funded baseline in the period to March 2015, which support asset resilience and sustainability of operations. This investment is treated as overspend under the CIS, leading to a material log up of RAV in March 2015 and a cumulative revenue penalty of negative GBP91.2m for AMP6. Reducing the log up of RAV to avoid the revenue penalty (in a net present value neutral manner) would have provided for regulatory gearing around 60% and PMICR above 1.5x, in which case both metrics meet the guidelines comfortably.

Sound Regulatory Performance

In FY14 Dwr Cymru met leakage targets, improved pollution incident performance and maintained a SIM score of 84. The company reported stable asset serviceability for all asset categories. However, as part of the draft determination, Ofwat assessed water infrastructure to be marginal for the whole price control, given that the company revised its data for the DG3 measure (less than 12 hours supply interruption) as part of their business plan submission. Overall, Dwr Cymru delivered sound regulatory performance and Fitch perceives it as a middle ranking company in the industry.

Not-for-Profit Organisation

Dwr Cymru is a not-for-profit organisation, which makes it unique among its peers as there is no shareholder pressure to pay dividends, and consequently it can reinvest all its financial surpluses into the business for the benefit of customers.

LIQUIDITY

As of 31 March 2014, Dwr Cymru had GBP92m in cash and cash equivalents available as well as GBP140m of undrawn, committed bank facilities against debt falling due over the next two years of GBP56m. This funding position will provide for sufficient liquidity for capital expenditure and operating requirements into 2016. In accordance with transaction documentation, the group also maintains a GBP135m reserve liquidity facility that would be available in times of financial distress.

RATING SENSITIVITIES

Positive: Future developments that could lead to a positive rating action include:

- A sustainable reduction in target gearing to below 60% and improvement of PMICR above 1.6x together with maintenance of top half regulatory performance.

However, at this stage an upgrade seems rather unlikely.

Negative: Future developments that could lead to negative rating action include:

- Given the ample financial flexibility in terms of gearing and tight interest cover, the following combinations could lead to a downgrade: gearing in the mid-70s and PMICR below 1.5x; gearing above 67.5% and PMICR below 1.4x; gearing above 60% and PMICR below 1.3x.
- A marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework.

Contact:
Principal Analyst
Victoria Munarriz
Analyst
+44 20 3530 1419

Supervisory Analyst
Oliver Schuh
Director
+44 20 3530 1263
Fitch Ratings Limited

30 North Colonnade
London E14 5GN

Committee Chair
Arkadiusz Wicik
Senior Director
+48 22 338 62 86

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology', dated 28 May 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393