FitchRatings

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

Fitch Ratings-London-01 December 2015: 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+'. Dwr Financing has redeemed all its existing class C debt and, therefore, the affirmation of the senior subordinated class C debt of the bond programme indicates the level at which Fitch would expect to rate prospective issuance, if any. The Outlooks are Stable.

Dwr Financing is the debt-raising vehicle of Dwr Cymru Cyfyngedig (Dwr Cymru or Welsh Water). Dwr Cymru is one of the 10 appointed water and sewerage companies (WaSC) in England and Wales.

The affirmation reflects our expectation that Dwr Cymru will maintain adequate financial metrics for the ratings, despite the material reduction of earnings for the current 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.

KEY RATING DRIVERS

Increased Business Risk in the Sector

We believe that business risk in the water sector has increased for AMP6, and is now more closely aligned with regulated UK gas and electricity network businesses. In addition to a significant reduction in the cost of capital, total expenditure will be benchmarked to the top quartile by 2020, representing a more demanding target for capital expenditure. Ofwat is pursuing progressive targets for the retail price controls, eliminating protection from inflation and implementing catch-up efficiency targets using an average cost to serve, which does not fully reflect each company's operating cost base.

Good Regulatory Performance

Fitch perceives Dwr Cymru as a middle-ranking company in the industry in terms of regulatory and operational performance. We expect the efficiency targets for total expenditure in the wholesale price controls will leave Dwr Cymru 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. Dwr Cymru will need to improve its regulatory performance to ensure it will meet current top quartile levels by the end of the current regulatory period in March 2020.

Financial Flexibility Mitigates Interest Cover

We expect the company to be free cash flow neutral to positive before dividends, customer rebates and/or additional capital projects for the benefit of customers. Financial flexibility in terms of gearing compensates for the low interest cover. Fitch forecasts pension-adjusted net debt/ regulatory asset value (RAV) at or below 60% for Dwr Cymru's combined class A and class B debt for the period to March 2020, materially lower than the ratio guideline for the rating of the low 70s. Post-maintenance and post-tax interest cover (PMICR) is expected to range between 1.3x and 1.5x (1.4x is the five-year average), slightly lower than the ratio guideline of minimum 1.5x.

Additional Perspective on Credit Metrics

Fitch notes that Dwr Cymru's board of directors opted to pursue capital schemes over and above the regulator's funded baseline in the period to March 2015 in order to support asset resilience and sustainability of operations. This investment is treated as overspend under the Capital Incentive Scheme (CIS), leading to a material log up of RAV in March 2015 and around GBP50m revenue penalty for AMP6. Removing the penalty from revenue allowance for AMP6 would have resulted in regulatory gearing around 60% and PMICR above 1.5x, in which case both metrics meet the rating guidelines.

KEY ASSUMPTIONS
Fitch's key assumptions for the rating case for Dwr Cymru include:
- Regulated revenues in line with the final determination of tariffs for April 2015 to March 2020, i.e. assuming no material over- or under- recoveries.
- No totex out- or underperformance over the five year price control.
- Retail price inflation of 0.75% for FY15, 1% for FY16, 2% for FY17 and 2.5% thereafter.
- No impact on cash flow generation from outcome delivery incentives, given that financial rewards and penalties will all be taken into account as part of the next price review.

RATING SENSITIVITIES
Positive: Future developments that could lead to 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 Fitch views an upgrade as rather unlikely.

Negative: Future developments that could lead to negative rating action include:
- Given the ample financial flexibility in terms of gearing but 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.

LIQUIDITY
Dwr Cymru's minimum liquidity requirement is documented in the secured, covenanted transaction structure through which the company is funded. As of 31 October 2015, Dwr Cymru had GBP180m in cash and cash equivalents, GBP150m of undrawn, committed revolving credit facilities (maturing in 2019 and 2020) as well as GBP130m undrawn loans against debt falling due of GBP124m before March 2018. This funding position will provide for sufficient liquidity for capital expenditure and operating requirements for the next 24 months. In accordance with transaction documentation, the group also maintains a GBP135m reserve liquidity facility that would be available in times of financial distress.

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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 - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362