MOODY'S
INVESTORS SERVICE

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 05 Mar 2015

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Positive
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

Proposed investments will result in further RCV growth and additional funding needs

Efficiency challenge remains following stretching determination

Continued deleveraging could result from revised financial policy

Creditors benefit from structural protections

Protected against increasing sector business risk by Welsh Government's current policy on 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 organization. In the fiscal year 2013/14, Welsh Water had a RCV of GBP4,468 million, reported revenues of GBP 737 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 60% (measured at 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; 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 leverage target of 60%, 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 and Thames Water.

DETAILED RATING CONSIDERATIONS

STRONG REGULATORY ENVIRONMENT AND CERTAINTY AROUND CASH FLOWS FOLLOWING FINAL DETERMINATION

The UK water sector benefits from a very transparent, stable and predictable regulatory regime, which is based on clearly defined risk allocation principles and their consistent application in setting water tariffs by an independent regulatory body, the Water Services Regulation Authority (Ofwat).

Ofwat published the final price determination for the sector in December 2014 and Welsh Water accepted its final determination in February 2015. As part of the determination, Ofwat changed the way it sets tariffs for the water companies in England and Wales. For the five-year period commencing 1 April 2015 (AMP6), tariffs have been set to reflect (1) separate price controls for retail and wholesale activities; (2) increased customer involved in companies' business planning and focus on long-term outcomes rather than short-term outputs; (3) more tailored outcome delivery incentives; and (4) a total expenditure (totex) cost assessment.

We view the changes introduced for AMP6 as being largely credit neutral for the UK water sector as a whole. We expect that Ofwat will continue to develop its vision of competition and Moody's will assess the wider implications for the credit quality of the sector, as and when more details become available. Overall we view the introduction of competition into a previously fully regulated monopoly sector as credit negative.

Welsh Water's final determination includes (1) an allowed return on 3.6% per annum of the wholesale RCV; (2) a net retail margin of 1% for household and non-competitive non-household retail activities; and (3) a net retail margin of 2.5% for non-household retail activities. The overall allowed return, which for a notional company is around 3.74% per annum (vanilla, real), is significantly lower than the 5.1% return allowed in the current period. This will put pressure on Welsh Water's adjusted interest coverage ratio, especially given its relatively high cost of debt, relative to the sector. However, we place less emphasis on this ratio for Welsh Water given that it has no pressure to pay dividends.

PROPOSED INVESTMENTS WILL RESULT IN FURTHER RCV GROWTH AND ADDITIONAL FUNDING NEEDS

As is the case for peers, Welsh Water faces some risk in the execution of its significant capital programme and the associated financing and refinancing requirements. For AMP6, Welsh Water has been allowed total expenditure (totex), which includes opex and capex of around GBP2.6 billion (in 2012/13 prices) for the wholesale part of the business. This will result in the RCV growing by just over 7% in real terms over AMP6, while the average bill will fall by 5% in real terms by the end of the period, in line with the industry average bill decline.

Welsh Water will have to maintain good access to capital markets, with net funding requirements (including refinancing needs) expected to be around GBP650 million over the next five years. As the company's next bond maturity is in 2021, this principally relates to the financing of AMP6 investments, although the company will need to pay almost GBP200 million in scheduled amortisations and maturities of lease and bank facilities.

EFFICIENCY CHALLENGE REMAINS FOLLOWING STRETCHING DETERMINATION

Welsh Water received a final determination, which overall was slightly more favourable than the draft - in particular, there was only minimal change in the amount of allowed total expenditure. The allowance for the wholesale water control was around 1% or GBP4 million lower than the amount requested in the company's final business plan while Ofwat's cost threshold for the wastewater business was GBP41 million higher than in the company's plan. The implication is that if the company delivers in accordance with its plan, it will outperform and retain a share of the underspend following the PR19 control in addition to just under GBP5 million of additional revenues received in AMP6 by virtue of its implied totex menu choices.

However the company faces a meaningful challenge to deliver on its ambitious plan, especially given its capex overspend in AMP5 and in view of the fact that Ofwat has assessed the serviceability of its water infrastructure assets as "marginal" in four out of five years of AMP5. The latter has resulted in a serviceability "shortfall" penalty of nearly GBP13 million deducted from the March 2015 RCV at the start of the period. If it does not materially improve its performance in relation to certain Outcome Delivery Incentives (ODIs), in particular, interruptions to water supply and customer acceptability of drinking water, Welsh Water could face meaningful financial exposure. However, as with the majority of its peers, we do not expect that any such exposure would crystallised until the PR19 price control.

The task in the retail businesses is arguably tougher, with Welsh Water being recognised as having one of the highest average cost to serve (ACTS) in the industry. Ofwat has allowed the company nearly GBP45 million in extra bad debt and debt management costs incremental to the ACTS, however the three year "glide path" to what the regulator considers to be an efficient level of costs will be challenging to achieve in the context of a relatively small cost base.

However, these risks are partially mitigated by the company's relatively strong (top quartile among WaSCs, second quartile across the industry) performance in relation to the Service Incentive Mechanism (SIM) in AMP5 and the fact that it will not face an increased scope of competition in the non-household retail segment. Furthermore, given the company's ownership by the not-for-profit Glas Cymru, it has significantly more financial flexibility than many peers, including that to make discretionary investments which could reduce the risk of underperforming in relation to ODIs.

CONTINUED DELEVERAGING COULD RESULT FROM REVISED FINANCIAL POLICY

At the same time as it accepted the final determination, Welsh Water communicated to investors its intent to reduce its target gearing level from 70% net debt to RCV in AMP5 to 60% in AMP6. In fact, the company deleveraged over the period from close to 70% to around 60%, meaning that meaningful further deleveraging would not be required to achieve the AMP6 target.

In order to maintain stable leverage, Welsh Water would need to materially increase the extent to which it spends its "equity" returns, compared with historic practice. The company has not yet decided on its AMP6 distribution policy but in our base case, we estimate that it would need to distribute or invest around GBP80-90 million per annum in order to maintain gearing around 60%. This would be a step change compared to the long-term average of closer to GBP30 million per annum, hence we currently consider it likely that the company will continue to deleverage in AMP6.

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 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 it licence and the Water Industry Act 1991.

Therefore, unlike for comparable transactions (such as Anglian Water 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.

INSULATED AGAINST INCREASING SECTOR BUSINESS RISK BY WELSH GOVERNMENT'S CURRENT POLICY ON 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 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, could 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 December 2014 of GBP157 million of cash and cash equivalents; and (4) GBP120 million of undrawn committed bank facilities which mature in 2019/20.

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. This position has strengthened further since the recent signing of a new GBP230 million facility from the European Investment Bank.

Finally, we add that additional comfort is taken from the existing 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 positive rating outlook reflects Moody's expectation that Welsh Water's gearing will continue to reduce below 60% net debt to RCV unless it materially increases the scope of customer rebates and discretionary investments not funded by the regulator. This would be consistent with a higher rating.

What Could Change the Rating - Up

The ratings could be upgraded once there is greater clarity about Welsh Water's plans for the use of its equity returns and its actual performance compared with the level of expenditure allowed by the regulator and associated performance commitments. Positive rating pressure could arise if the company's gearing trended below 60%.

What Could Change the Rating - Down

As the outlook is positive, Moody's does not foresee downward rating pressure arising in the next two years. A materially unfavourable change in the regulatory framework for the UK Water sector, combined with a change in the Welsh Government's current policy on competition in the sector could, however, significantly increase business risk.

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 March 2015**	
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		1.4x-1.6x	Ba-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		9-11%	Baa-Ba
d) RCF / CAPEX (3 Year Avg)	1.0x	Baa		0.5x-0.7x	Ba-Baa
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