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CREDIT OPINION
28 November 2016

Update

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RATINGS

Dwr Cymru Cyfyngedig

Domicile	United Kingdom
Long Term Rating	A2
Type	LT Corporate Family Ratings - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Dwr Cymru Cyfyngedig

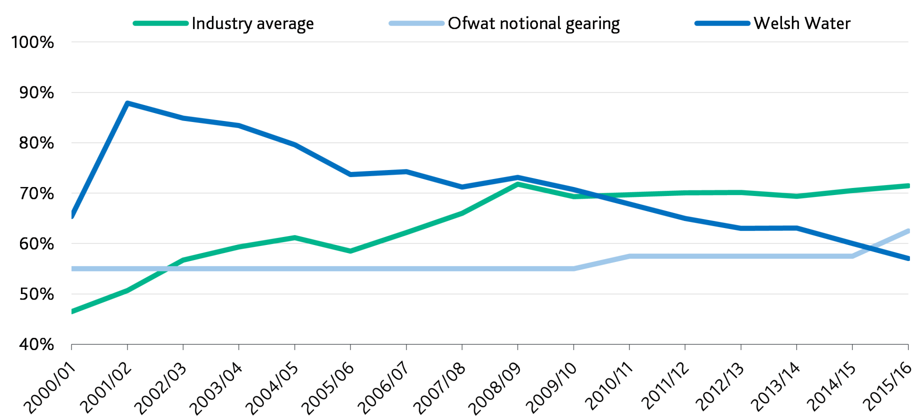
Update Following Rating Upgrade to A2 Stable

Summary Rating Rationale

The A2 rating for Dwr Cymru Cyfyngedig (Welsh Water) reflects the combination of (1) the group's very low business risk profile as the monopoly provider of essential water and sewerage services, with stable and predictable cash flows generated under a transparent and well-established regulatory regime; (2) a low level of gearing at or below 60%, calculated as the group's consolidated net debt to regulatory capital value (RCV); (3) the not-for-profit status of Welsh Water's ultimate parent company, Glas Cymru, which allows Welsh Water to manage the distribution of its profits in order to maintain the company's publically stated gearing target of 60% net debt to RCV; and (4) the decision by the Welsh Government not to implement retail competition for incumbent water companies operating wholly or mainly in Wales in April 2017, which evidenced a cautious approach to market reform.

Exhibit 1

Welsh Water's gearing has fallen below both the sector average and the regulator's assumption for a notionally geared company



Gearing ratios are as reported by companies to Ofwat and do not reflect Moody's standard adjustments
Source: Companies' performance reports, Ofwat, Moody's Investors Service

Credit Strengths

- » Stable cash flows generated from the provision of monopoly water and wastewater services under well established, transparent and predictable regulatory regime
- » Low financial leverage: at or below 60% net debt to RCV
- » Flexibility on distributions due to not-for-profit status of parent company Glas Cymru
- » Welsh government's cautious approach to market reform

Credit Challenges

- » Changes to regulation may reduce cash flow stability and create financial pressure for the sector
- » Cost of debt above sector average reduces adjusted interest coverage ratio

Rating Outlook

The stable outlook reflects Moody’s expectation that Welsh Water’s leverage will remain at or below 60% net debt to RCV over the rest of AMP6.

Factors that Could Lead to an Upgrade

A further and sustained improvement in leverage beyond the ratios expectations underpinning the current A2 ratings could put positive pressure on Welsh Water’s ratings.

Factors that Could Lead to a Downgrade

- » A deterioration of the group’s financial profile stemming from, for example, weaker than expected operational performance and resulting in net debt to RCV consistently above 60%, would result in a rating downgrade.
- » Downwards rating pressure could also arise as a result of (1) a material adverse change to the water regulatory framework; and/or (2) unforeseen funding difficulties.

Key Indicators

Exhibit 2

Key adjusted indicators for Welsh Water Plc

Dwr Cymru Cyfyngedig

	3/31/2016	3/31/2015	3/31/2014	3/31/2013	3/31/2012
Adjusted Interest Coverage Ratio	1.5x	1.8x	1.6x	1.6x	1.5x
Net Debt / Regulated Asset Base	56.5%	59.0%	61.9%	61.7%	63.0%
FFO / Net Debt	12.1%	11.7%	11.4%	11.6%	11.2%
RCF / Net Debt	12.1%	11.7%	11.4%	11.6%	11.2%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics ™

For definitions of Moody's most common ratio terms please see the accompanying User's Guide. The calculation of the adjusted interest coverage ratio treats customer rebates as a reduction in revenue. Treating these rebates as dividends instead (given their discretionary nature) would increase the ratio to 1.55x (from 1.49x) in FY16.
Source: Moody's Investors Service

Detailed Rating Considerations

Transparent regulatory regime with certainty around cash flows through March 2020 but additional challenges thereafter

The UK water sector benefits from a 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 price determination for the current five-year period in December 2014. Welsh Water's final determination includes (1) an allowed return of 3.6% per annum on the wholesale RCV; (2) a net retail margin of 1% for household retail activities; and (3) a net retail margin of 1.2% 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% p.a. return for the previous period, reflecting a low interest-rate environment.

Exhibit 3

Evolution of the allowed regulatory return

	Ofwat PR04	Ofwat PR09	Ofwat PR14
Notional gearing	**55.0%**	**57.5%**	**62.5%**
Existing debt			2.65%
New debt			2.00%
Existing: new debt ratio			3
Explicit debt issuance cost			0.1%
Cost of debt (pre-tax)	**4.3%**	**3.6%**	**2.59%**
Risk-free rate	2.5-3.0%	2.0%	1.25%
Equity risk premium	4.0-5.0%	5.4%	5.50%
Total market return	6.5-8.0%	7.4%	6.75%
Asset beta			0.3
Debt beta			
Equity beta	1.00	0.90	0.80
Cost of equity (post-tax)	**7.7%**	**7.1%**	**5.65%**
Vanilla WACC*	**5.8%**	**5.1%**	**3.74%**
Retail Margin	n/a	n/a	0.14%
Wholesale WACC	**n/a**	**n/a**	**3.60%**

* Figures presented for the 'appointee' WACC, equivalent to the PR09 WACC. The wholesale WACC is the appointee WACC minus the retail margin. All figures expressed in real terms.
Source: Ofwat, Moody's Investors Service

As part of the last price review, Ofwat changed the way it sets tariffs for the water companies in England and Wales. For the five-year period that commenced on 1 April 2015 (AMP6), tariffs were set to reflect (1) separate price controls for retail and wholesale activities; (2) increased customer involvement in companies' business planning and focus on long-term outcomes rather than short-term outputs; (3) more tailored Outcome Delivery Incentives (ODI); and (4) a total expenditure (totex) cost assessment.

The introduction of separate price controls for retail and wholesale services is in part to facilitate retail competition for non-household (NHH) customers (with consumption below 50 Ml/yr; those above this threshold can already change supplier). Competition, which the regulator expects to start in 2017, was enabled by legislation - the Water Act 2014 - which amongst other measures, also provides for increased upstream competition with changes to the water supply licensing regime to allow new entrants to supply water and wastewater services to NHH customers.

However, competition will not be extended in Wales in 2017, where the Welsh government is taking a more circumspect approach, stating in its most recent policy document: *"We will monitor the costs and benefits of market reform, which will apply to water companies* *operating wholly or mainly in England from April 2017. This will inform our future policy about services for non-household customers served by water companies located wholly or mainly in Wales."* This cautious approach is likely to protect Welsh Water from the potential (and relatively limited) credit risks we see from non-household competition, at least in the next year or two.

We view the changes introduced for AMP6 as being largely neutral for the UK water sector as a whole. However, Ofwat continues to develop its regulatory approach for the water sector, and as part of the so-called 'Water 2020' programme, further changes will be introduced at the next price review in 2019. These include (1) separate price controls for bio-resources (comprising the treatment and disposal of sewage sludge) and water resource management; and (2) a change in indexing revenues and regulated assets, moving to consumer prices index (CPI) from retail prices index (RPI) inflation.

In addition, Ofwat is reviewing its methodology for determining the cost of debt as part of setting the overall regulatory return allowance and concluded in a cost and benefit analysis, requested by the government, that extending retail competition to household services may be beneficial for customers.

While not affecting companies' tariffs over the current regulatory period, we continue to view the overall developments as credit negative for the sector, with increased risk of cash flow volatility likely.

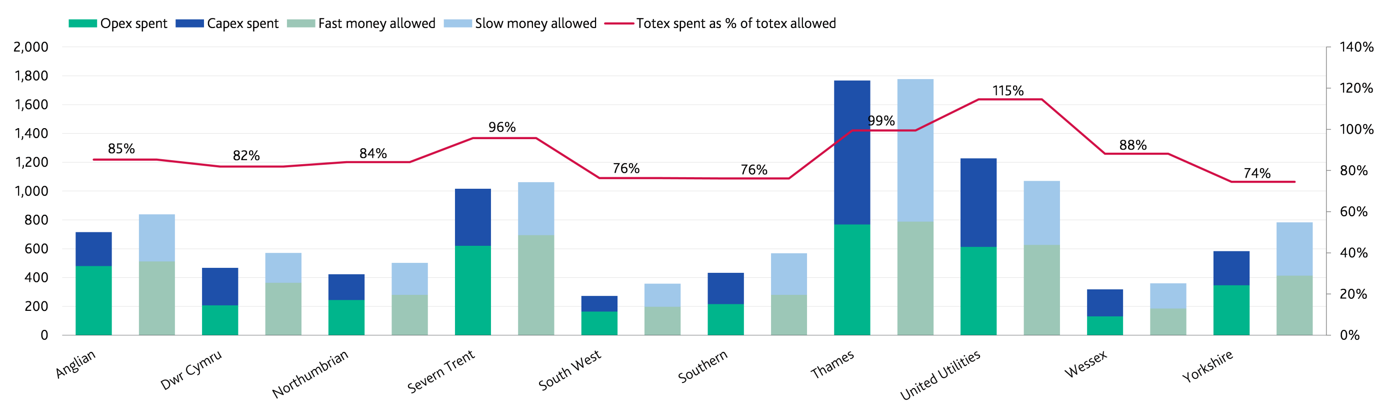
Operational performance solid in first year of regulatory period

Welsh Water had a good performance in the first year of AMP6, and is well on-track to achieve its objectives.

Welsh Water had a strong year on the wholesale side. On the opex side, total outperformance of £36 million was to a large extend due to rates refunds including the 2005 water network assessment (total £24.5 million), but also to operational efficiency.

Welsh Water also underspent by £61.9 million against Ofwat's implicit capex target. However it was mostly due to scope/reprofiling of capex, with various enhancement projects delayed as the company is still finalising out its investment rollout plan. We anticipate that the envisaged capex plan will be fully delivered by the end of the period.

Exhibit 4
Welsh Water has underspent in the first year of the AMP



Source: Companies' performance reports (March 2016), Ofwat, Moody's Investors Service

With capex only delayed and efficiencies already realised on the opex side, Welsh Water is in good position to meet its totex targets for the period. While it had submitted totex £4 million higher that Ofwat's determination on the water side, its submission was £41 million lower on the wastewater side: it will outperform if it delivers against its own submitted plan.

Retail was the more challenging part of Welsh Water's final determination, and the fact that the company was behind targets (by £10 million) in 2015-16 reflects that while Welsh Water tends to score around the sector average (8-10 out of 18) under SIM, it has a higher than average cost to serve (ACTS) in the industry, due notably to the sparsely populated rural areas it covers, and because of relatively high levels of social deprivation impacting the cost of bad debt.

However given (1) the relatively small size of the retail business (around 8% of revenue) and (2) the fact that the Welsh Government's policy stance will protect Welsh Water from competition (at least in the short term), we would not expect potential retail underperformance to be material in the context of the company's overall credit profile.

Investment programme necessitates net funding requirements of £235 million over AMP6

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 £2.6 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 £235 million over the five-year period that started on 1 April 2015. 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 approximately £160 million in scheduled amortisations and maturities of lease and bank facilities.

Not-for-profit ownership structure provides support, although limited benefits from structural protections at current rating level

Welsh Water intends to return all of its forecast surpluses to customers, by way of additional investments and/or direct customer rebates. These distributions are discretionary payments which could easily be adjusted in order to maintain the company's publicly-stated gearing target of around 60% net debt to RCV. Similarly, planned investments outside the regulated business of up to £100 million in unregulated commercial activities could be reduced or postponed to maintain financial flexibility.

Welsh Water's debt structure includes (1) the presence of a standby liquidity facility of £135 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.

We believe that the protection provided by the financial covenants, particularly the limitations for additional indebtedness and permitted distributions (including customer dividends and distributions to the new holding company), is limited at Welsh Water's A2 rating level as the company would have significant headroom under the existing covenants to increase leverage before additional creditor oversight would be triggered. We also note 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.

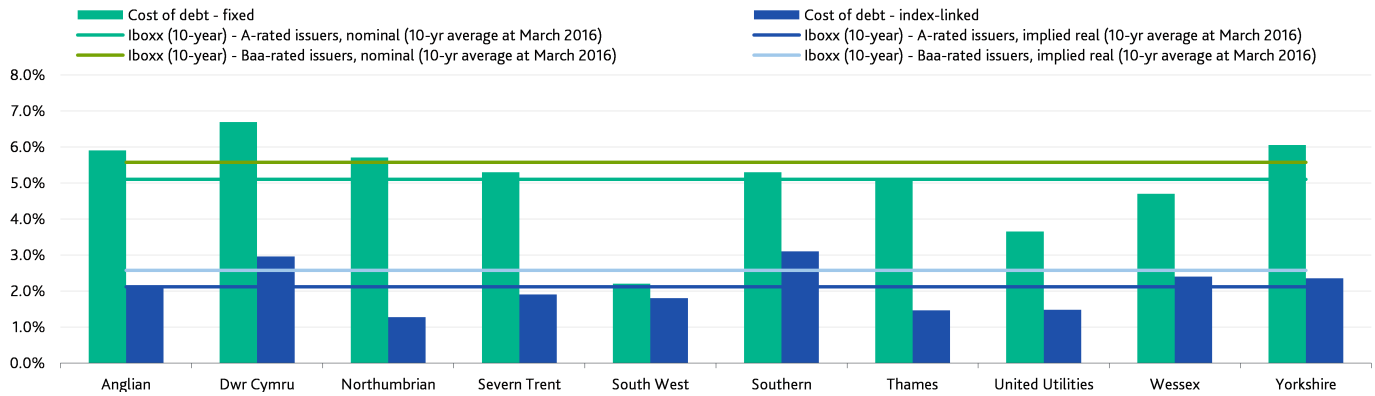
Welsh Water less exposed to low-for-longer interest rate environment

A 'low for longer' interest rate scenario could result in a significant reduction in allowed returns for the UK water sector from 2020 and poses particular risks for companies with more expensive and longer-term debt relative to likely regulatory assumptions.

UK economic regulators base their allowed return calculations on a notional company, that is to say a hypothetical entity with a set gearing (trending towards the average sector gearing, but currently lower) and a certain capital structure. For example, in the water sector the notional gearing is 62.5%, and the notional company would have around 33% of index-linked debt within its capital structure. Ofwat also assumes a split between embedded and new debt, when setting the cost of debt allowance. Historically, Ofwat has been guided by historical average rates over a ten-year horizon when setting the cost of embedded debt. Continuing with this approach during an extended period of low interest rates, future cost of debt as well as cost of equity (driven by reducing risk-free rates) allowances will invariably decline. Current gilt curves could, for example, support, an overall reduction in the allowed wholesale return from 3.6% in the current period by at least 100 basis points from April 2020.

Companies will benefit from the low interest rate environment over time as they raise new debt. However, companies with debt tenors beyond that assumed by the regulator, may be exposed as allowed returns will converge to market rates, unless historical funding costs have been below average. Welsh Water's average debt maturity is broadly in line with the sector average, with its next bond maturity in 2021.

Exhibit 5
Welsh Water's cost of debt is above the sector average



Source: Companies' performance reports (March 2016), Ofwat, Moody's

Although Welsh Water's average cost of debt is above the sector average, its below average gearing levels leaves it in a solid position compared with most of its industry peers to accommodate this potential challenge.

Liquidity Analysis

Welsh Water's liquidity is strong. Its cash position of £80 million (as at 31 March 2016) and liquidity facilities of £415 million (of which £135 million only being available for debt service in case of default), in addition to expected cash flow from operations of £240 million more than cover expected capex of around £260 million and debt service of c. £30 million over the next 12 months. Welsh Water has also agreed a £250 million AMP6 facility with the European Investment Bank which it expects to execute early in 2017.

Corporate Profile

Dwr Cymru Cyfyngedig (Welsh Water, A2 stable) is the sixth-largest UK water utility by Regulatory Capital Value (RCV), providing water and sewerage services to approximately 3 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 2015/16, Welsh Water had a Regulatory Capital Value (RCV) of £5.0 billion (after adjustments at the end of the regulatory period), reported revenues of £743 million and operating profit of £161 million.

Rating Methodology and Scorecard Factors

Welsh Water is rated in accordance with our rating methodology for Regulated Water Utilities published in December 2015. Under the rating methodology we score the qualitative factors for Welsh Water, the core operating subsidiary of Glas Cymru, which accounts for the vast majority of the group's operating profit. However, leverage and coverage ratios under Factor 3 take into account the consolidated financial profile of the entire Glas Cymru group.

Exhibit 6

Key rating factors for Dwr Cymru Cyfyngedig

Regulated Water Utilities Industry Grid [1][2]	Current FY 3/31/2016		Moody's 12-18 Month Forward View As of November 2016 [3]	
Factor 1 : Business Profile(50%)	Measure	Score	Measure	Score
a) Stability and Predictability of Regulatory Environment	Aaa	Aaa	Aaa	Aaa
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)	A	A	A	A
d) Revenue Risk	A	A	A	A
e) Scale and Complexity of Capital Programme & Asset Condition Risk	A	A	A	A
Factor 2 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 3 : Leverage and Coverage (40%)				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.7x	Baa	1.5x-1.7x	Baa
b) Net Debt / Regulated Asset Base (3 Year Avg)	59%	Baa	57%-59%	Baa
c) FFO / Net Debt (3 Year Avg)	11.7%	Baa	10%-11%	Baa
d) RCF / Net Debt (3 Year Avg)	11.7%	A	8%-9%	Baa
Rating:				
Indicated Rating from Grid Factors 1-3		A3		A3
Rating Lift		+0.5		+0.5
a) Indicated Rating from Grid		A2		A2
b) Actual Rating Assigned (OpCo/HoldCo)		A2		A2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 3/31/2016 Source: Moody's Financial Metrics ™
[3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
DWR CYMRU CYFYNGEDIG	
Outlook	Stable
Corporate Family Rating	A2

Source: Moody's Investors Service

Moody's Related Research

Press Release

» Moody's upgrades Welsh Water's ratings to A2; outlook stable, November 2016

Sector In-Depth

» Retailers likely to have weak credit quality, October 2016

» Low interest rate scenario is credit negative for water and energy networks, October 2016

» Transition to CPI creates risks for water and energy networks, January 2016

» Redefining real: adoption of CPI will transform index-linked debt market, raise risks for regulated sectors, January 2016

» Final determination remains challenging but in line with expectations, December 2014

Sector Comment

» Ofwat consults on wholesale-retail credit terms, June 2016

» Ofwat confirms approach for PR19, May 2016

» 'Water 2020' Proposals Are Credit Negative, January 2016

» Government proposes competition for household customers; a credit negative, December 2015

» Upstream Reform Could Muddy UK Waters, October 2015

» Environmental damage likely to attract more material fines, July 2015

Industry Outlook

» UK Water Sector: Stable outlook but macroeconomic and regulatory pressures rising, October 2016

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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