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

Fitch Ratings-London-15 September 2016: Fitch Ratings has affirmed Dwr Financing's senior secured class A debt and class B debt rating (both wrapped and unwrapped) at 'A'. The agency has also affirmed the subordinated class C debt of Dwr Financing's bond programme at 'BBB+'. As there is no class C debt currently in issue the 'BBB+' rating indicates the level at which Fitch would expect to rate prospective class C issuance. 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 10 appointed water and sewerage companies (WaSC) in England and Wales.

The affirmation factors in Dwr Cymru's lowered target gearing to 60% to reflect reduced earnings for the regulatory period to March 2020 (AMP6). Although interest cover is low, gearing on net debt-to-regulatory capital value (RCV) provides more than adequate headroom for the ratings. The capital structure benefits from enhancements including trigger mechanisms, such as profit distribution lock-up provisions tied to financial, positive and negative covenants and debt service reserve liquidity.

KEY RATING DRIVERS
Increased Business Risk
We believe that business risk in the water sector has increased for AMP6 and is now more closely aligned with the regulated UK electricity & gas network businesses. In addition to a significant reduction in the cost of capital, total expenditure (totex) is benchmarked to the top quartile by 2020, setting a more demanding target for capex. Ofwat is pursuing progressive targets for retail price controls, reducing inflation indexation and implementing catch-up efficiency targets based on average cost to serve, rather than fully reflecting each company's operating cost base.

Solid Regulatory Performance
Dwr Cymru met regulatory targets for most categories, including leakage and reported stable performance for all asset categories in the financial year to March 2016. However, deferral of capex accounted for GBP62m of total outperformance of nearly GBP100m. Fitch views Dwr Cymru as a second quartile performer in the sector.

We expect the company, which has hedged 90% of its energy purchases in sterling until FY20, to continue to improve regulatory performance over AMP6 based on its track record. Generally, we perceive the wholesale price controls to offer opportunity for outperformance, while the retail price controls are very tight and likely to offset some of the savings achieved in wholesale.

Longer-term Regulatory Challenge
There will be a log-down (regulatory downward adjustment) to RCV of GBP63.7m (2013 prices) as a midnight adjustment on 31 March 2020, leading to less than a 1% increase in our estimated net debt-to-RCV for FY20. If we took account of additional capex in RCV for AMP7 (April 2020 to March 2025), these additions would offset the impact from the RCV log-down. With 32% of debt at fixed rates, an increase in RPI above 2.5% would lower net debt-to-RCV.

There will be several major challenges facing the WaSCs in March 2020, including reduced indexation of RCV to CPI, proposals for indexation of cost of new debt and possibly household competition. However, the latter would need legislation from the Welsh government, which was not involved in the relevant consultation.

Gearing Headroom
With no access to equity funding, Dwr Cymru has steadily reduced gearing over time to ensure continued access to debt finance. This is underpinned by strict board governance on customer distributions, which may only be made after returns have been earned.

Regulatory gearing at FYE16 was 57%. Fitch forecasts pension-adjusted net debt/RCV at or below 60% for the company's combined class A and B debt for AMP6, materially lower than our ratio guideline of 67.5%. This gearing headroom compensates for our expectations of post maintenance post tax interest cover (PMICR) at between 1.4x and 1.5x over the remainder of AMP6, close to our ratio guideline of a minimum 1.4x.

KEY ASSUMPTIONS
Fitch's key assumptions within the rating case for Dwr Cymru include:
-Totex in line with Ofwat's regulatory allowance over AMP6.
-Customer distributions in line with company guidance to maintain net debt/ RCV at below 60%
-RPI of 2% for FY17 and 2.5% thereafter, consistent with peers
-No allowance made for the GBP73m Loughor project for reducing local sewage flooding

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 along with maintenance of second quartile regulatory performance.

Negative: Future developments that could lead to negative rating action include:
- A marked deterioration in operating and regulatory performance or adverse changes to the regulatory framework.
- A sustainable increase in gearing to 67.5% and decline in PMICR to below 1.4x

LIQUIDITY
As of 30 June 2016 Dwr Cymru had unrestricted cash and cash equivalents of GBP154m and GBP210m undrawn revolving credit facilities and committed loans. The European Investment Bank has also approved a further GBP250m loan facility to fund AMP6 capex. Fitch expects around negative GBP195m cumulative free cash flow up to and including FY18. However, we believe liquidity is adequate for the next 24 months with no significant refinancing requirements before FY21. In accordance with transaction documentation, the group also maintains a GBP135m reserve liquidity facility 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)
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