MOODY'S
INVESTORS SERVICE

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 24 Feb 2016

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Positive
Corporate Family Rating	A3

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Key Indicators

[1]**Dwr Cymru Cyfyngedig**	31/03/2015	31/03/2014	31/03/2013	31/03/2012
Adjusted Interest Coverage Ratio	1.8x	1.6x	1.6x	1.5x
Net Debt / Regulated Asset Base	59.0%	61.9%	61.7%	63.0%
FFO / Net Debt	11.7%	11.4%	11.6%	11.2%
RCF / Net Debt	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

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 and wastewater business supported by a well-established, transparent and predictable regulatory regime, although recently proposed changes could be credit negative

- Partially protected against increasing sector business risk by Welsh Government's current policy on competition

- Efficiency challenge remains following stretching determination

- Conservative financial policy

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 organisation. In the fiscal year 2014/15, Welsh Water had a Regulatory Capital Value (RCV) of GBP4.8 billion (after adjustments at the end of the regulatory period), reported revenues of GBP753 million and operating profit of GBP202 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 and wastewater services operating under a well-established, transparent and predictable regulatory framework; (2) the protection provided against increasing business risk by the Welsh Government's opposition to increasing competition in the sector; and (3) 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%.

Given its moderate leverage, Welsh Water's A3 rating currently does not incorporate any significant uplift for credit-enhancing features.

DETAILED RATING CONSIDERATIONS

TRANSPARENT AND WELL-ESTABLISHED REGULATORY REGIME SUPPORTS CURRENT CREDIT QUALITY, BUT PRESSURE FOR AMP6 AND BEYOND

Welsh Water's A3 rating reflects it very low business risk as monopoly provider of water and wastewater services operating under a well-established, transparent and predictable regulatory regime.

Over the past five years, the economic regulator for the water and sewerage companies in England and Wales (Ofwat) has been reviewing the regulation and structure of the industry to ensure that it is best able to address current and future challenges. Building on this, Ofwat has introduced changes to its framework and methodology of setting price limits for the five-year period that started on 1 April 2015 (AMP6). Main changes include notably the introduction of retail competition for non-household customers in 2017.

Whilst we view the changes to the regulatory framework for PR14 as being largely neutral for the UK water sector as a whole, we believe that Ofwat's planned new approach to its 2019 price review, known as "Water 2020", and the government's proposed extension of retail competition to the household market in England, would increase credit risk for water companies if implemented altogether. Proposed changes include reforms relating to sludge treatment and disposal, a move towards CPI indexation of revenues and RCV, third party provision of new water resources, and a new approach to setting the cost of debt allowance.

We consider that both the government and regulator are mindful of the need to preserve investor confidence in the industry; nevertheless we see the business risk of the sector increasing over the medium to long term as more parts of the currently monopolistic value chain become subject to competitive pressures. 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 partly protect Welsh Water's credit quality if business risk in the sector continues to increase.

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 GBP600 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 almost GBP200 million in scheduled amortisations and maturities of lease and bank facilities.

EFFICIENCY CHALLENGE REMAINS FOLLOWING STRETCHING DETERMINATION

Welsh Water faces a meaningful challenge to deliver on its ambitious plan, especially 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, although it is now assessed as "stable". 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 some 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 even more challenging, with Welsh Water being recognised as having one of the highest average cost to serve (ACTS) in the industry.

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.

CONSERVATIVE FINANCIAL POLICY

Welsh Water targets a gearing level of 60% in AMP6 - broadly in line with the current position. In order to maintain stable leverage, we estimate that Welsh Water would need to distribute or invest around GBP80-90 million per annum, which would be a step change compared to the long-term average of closer to GBP30 million per annum. We believe that the proposed creation of a new holding company as the parent of Glas Cymru, which would be able to make investments in new businesses funded by financial surpluses from Welsh Water, is unlikely to affect significantly Welsh Water's financial profile given the proposed aggregate cap on investments at GBP100 million (indexed).

LIMITTED BENEFIT FROM STRUCTURAL PROTECTIONS AT CURRENT RATING LEVEL

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.

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 A3 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.

Liquidity

Welsh Water's liquidity profile is 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) a cash position of GBP55 million at 31 December 2015; and (4) around GBP250 million of undrawn credit facilities with the EIB, KfW and other banks at 31 December 2015. We view these 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.

We take additional comfort 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 our 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, distributions to the new holding company once it is created, and discretionary investments not funded by the regulator.

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 remains sustainably at or below 60%.

What Could Change the Rating - Down

As the outlook is positive, we do not expect downward rating pressure. Negative pressure on the ratings could nevertheless derive from a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a reduction in the stability and predictability of regulatory earnings, which is not offset by other credit-strengthening measures and/or some form of protection from the Welsh Government's policy on competition in the sector.

Other Considerations

Our rating assessment of Welsh Water is based on the rating methodology for Regulated Water Utilities, published in December 2015.

Rating Factors

Dwr Cymru Cyfyngedig

Regulated Water Utilities Industry Grid [1][2]	**Current 31/03/2015**		[3]**Moody's 12-18 Month Forward ViewAs of February 2016**	
Factor 1 : Business Profile(50%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Environment		Aaa		Aaa
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)		A		A
d) Revenue Risk		A		A
e) Scale and Complexity of Capital Programme & Asset Condition Risk		A		A
Factor 2 : Financial Policy (10%)				
a) Financial Policy		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)	60.8%	Baa	57% - 60%	Baa
c) FFO / Net Debt (3 Year Avg)	11.6%	Baa	8% - 10%	Ba
d) RCF / Net Debt (3 Year Avg)	11.6%	A	8% - 10%	Baa
Rating:				
Indicated Rating from Grid Factors 1-3		A3		Baa1
Rating Lift		0.5		0.5
a) Indicated Rating from Grid		A2		A3
b) Actual Rating Assigned				A3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 31/03/2015. 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