MOODY'S
INVESTORS SERVICE

CREDIT OPINION
12 September 2017

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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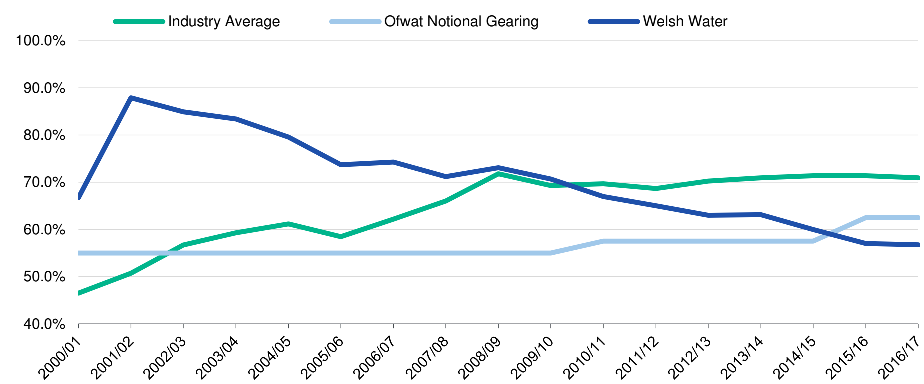
Dwr Cymru Cyfyngedig

Annual update following FY 2016/17 results

Summary

The credit quality of Dwr Cymru Cyfyngedig (Welsh Water, A2 stable) reflects the combination of (1) its 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.

» Well established, transparent and predictable regulatory regime.

» Moderate financial leverage and not-for-profit status of parent company provide significant financial flexibility.

» Welsh government's cautious approach to market reform reduces risk compared with English peers.

Credit Challenges

» Changes to regulation, aimed at increasing competition in certain parts of the value chain, may reduce cash flow stability and create financial pressure for the sector.

» Persistently low interest rate environment will likely see allowed returns cut in the next regulatory period 2020-25.

» Cost of debt above sector average result in comparably weak 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 at least until 2020.

Factors that Could Lead to an Upgrade

A further and sustained improvement in leverage beyond the ratio 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

	3/31/2017	3/31/2016	3/31/2015	3/31/2014	3/31/2013
Adjusted Interest Coverage Ratio	1.5x	1.5x	1.8x	1.6x	1.6x
Net Debt / Regulated Asset Base	56.0%	56.5%	59.0%	61.9%	61.7%
FFO / Net Debt	10.6%	12.1%	11.7%	11.4%	11.6%
RCF / Net Debt	10.6%	12.1%	11.7%	11.4%	11.6%

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

Corporate Profile

Dwr Cymru Cyfyngedig (Welsh Water) is the sixth-largest UK water utility by 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 Holdings Cyfyngedig (Glas Cymru), a not-for-profit organisation. In the fiscal year 2016/17, Welsh Water had a RCV of £5.2 billion and reported revenues of £744 million and operating profit of £105 million.

Detailed Credit 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; 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 market opening in April 2017.

However, competition will not be extended in Wales, with the Welsh government 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, and may prove supportive as Ofwat is looking into further market opening across parts of the water and wastewater value chain.

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 'Water2020' 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 a measure of consumer prices index (CPI) from retail prices index (RPI) inflation.

In its draft methodology consultation for the 2019 price review, published in July 2017, Ofwat also indicated a significant cut in allowed returns under an assumption that the current low interest-rate environment continues to persist, albeit partially offset by the switch in indexation measures. Furthermore, efficiency challenges will increase, particularly for average performers, which could put a further strain on cash flows. Welsh Water's comparably low RCV gearing against most peers and no dividend pressure from shareholders provides unique flexibility. However, the company may not be immune from challenging performance requirements.

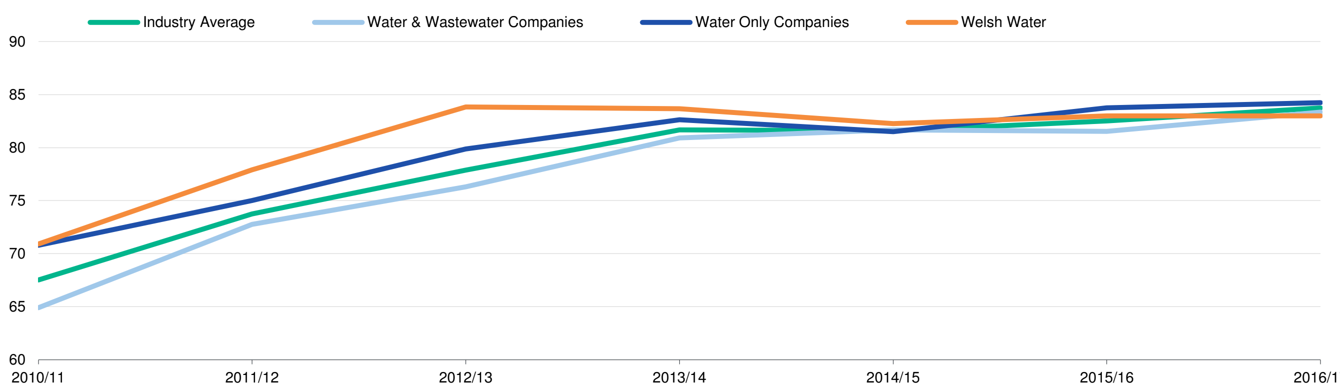
We continue to view the overall developments as credit negative for the sector, with increased risk of cash flow volatility likely from 2020 (please see 'UK Water Sector: Ofwat signals challenging price review', July 2017).

Solid operational performance record in the current regulatory period

Welsh Water exhibited solid performance in the first two years of AMP6, and is well on-track to achieve its objectives.

While operating expenditure increased during 2016/17, ongoing efficiency measures have helped offset the negative impact. The company continues to perform well against the performance commitments agreed with its customers, and maintains a good score under the Service Incentive Mechanism, which measures direct customer service.

Exhibit 4
Customer service in line with the sector



Source: Companies' Annual Performance Reports, Moody's

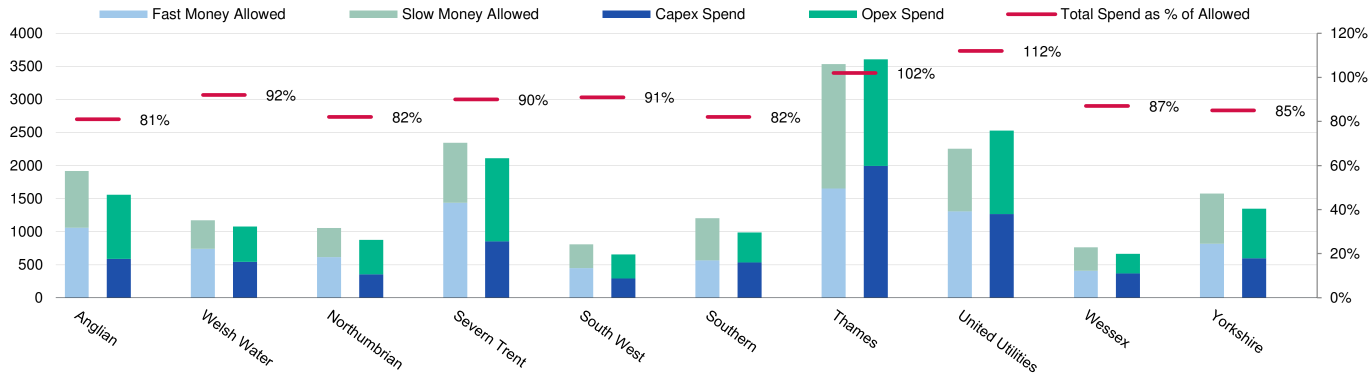
The main challenge remains around water discolouration, which management expects will incur an overall penalty over the period, and a comparably low allowance for retail costs. Welsh Water has a higher than average cost to serve (ACTS) in the industry, due notably to the sparsely populated rural areas it covers, and because of relatively high levels of social deprivation impacting the cost of bad debt.

Capex programme to reflect additional investments into areas of customer focus

As is typical for the sector, 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.

While the company spent less than its allowance in the first two years of the current regulatory period, this was mostly due to re-profiling of capex in the first year of the AMP and we anticipate that the envisaged capex plan will be fully delivered by the end of the period.

Exhibit 5
Welsh Water has underspent in the first year of the AMP, but will catch up over the remaining period



Source: Companies' performance reports (March 2016 and 2017), Ofwat, Moody's Investors Service

We expect net funding requirements (including refinancing needs) around £300-350 million over the five-year period that started on 1 April 2015, including board approved customer distributions in form of additional investments and/or revenue reductions. This amount also takes into account approximately £108 million in scheduled amortisations and maturities of lease and bank facilities, with the next major bond maturity only in 2021.

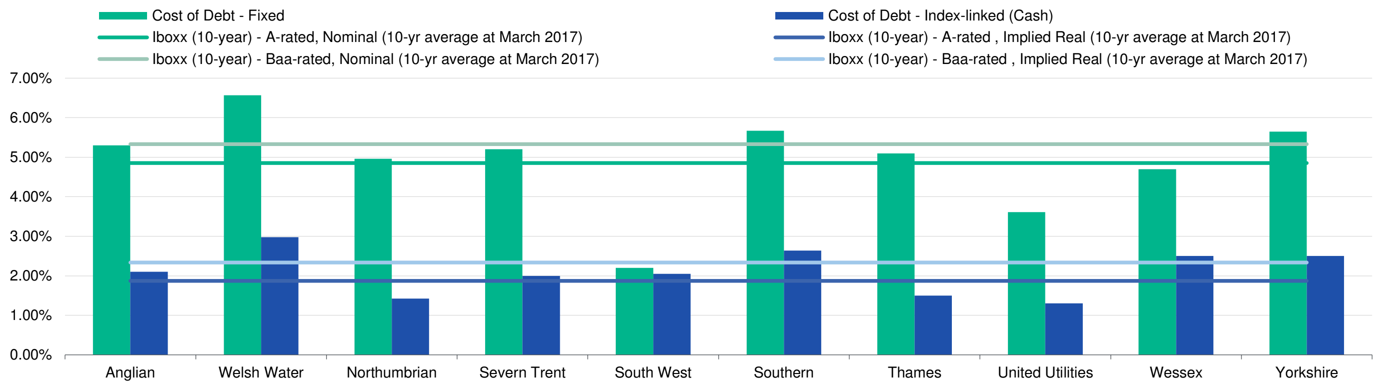
Welsh Water less exposed to cut in allowed returns from 2020

A significant reduction in allowed returns for the UK water sector from 2020 poses particular risks for companies with more expensive and longer-term debt relative to 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. This assumes returns are being set with respect to RPI inflation, which has been the case in the past. For the 2019 price review, Ofwat is proposing to inflate companies' revenues with the consumer prices index including owner occupiers' housing costs (CPIH, the national statistical office's headline measure for inflation since March 2017). Similarly, the regulatory capital value (RCV), on which the allowed return is calculated, will be indexed (1) 50% of the RCV at 31 March 2020 by RPI; and (2) 50% of the RCV at 31 March 2020 and all new additions to the RCV from 1 April 2020 by CPIH. Assuming a differential between RPI and CPIH of around 100bps and an initial 50:50 split of the return on RCV, could suggest a blended RPI-CPIH return of around 2.8-3.1%, taking into account the cost of equity assumptions, mentioned in Ofwat's July draft methodology consultation.

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.

Exhibit 6
Welsh Water exhibits among the highest cost of funding across peers



Source: Companies' performance reports (March 2017), Ofwat, Moody's

Although Welsh Water's embedded debt cost is above the sector average, its modest gearing provides financial flexibility. In addition, the not-for-profit nature of its parent, with no requirement for dividend distributions, leaves potential for further deleveraging, should this be required.

Liquidity Analysis

Welsh Water's liquidity is strong, underpinned by the stable and predictable cash flows generated by its regulated utility activity. As at 31 March 2017, the Glas group had a cash position of £95 million, and credit facilities of £460 million, including from the European Investment Bank and Kreditanstalt für Wiederaufbau (KfW), with £60 million drawn in May 2017. Including the undrawn credit facilities, Welsh Water is substantially pre-funded for the remainder of the AMP6 period. Furthermore, as required by Welsh Water's financing agreements the company benefits from £135 million of additional facilities to cover up to 12 months of debt service payments.

Structural Considerations

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

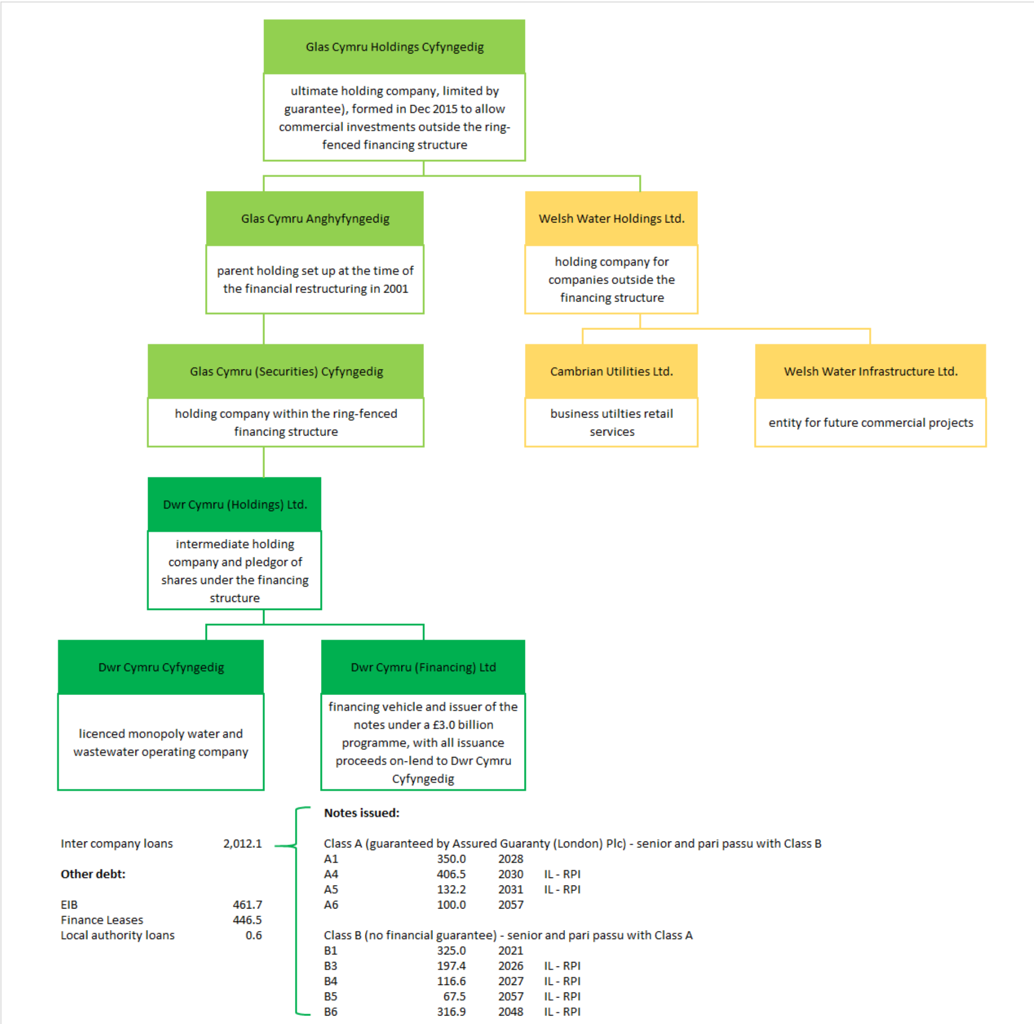
Welsh Water's ultimate parent is a not-for-profit organisation, requiring no dividend distributions. Instead, any profits made by the company have been used to reduce gearing over time and accumulate reserves.

In line with a stable gearing target of around 60% net debt to RCV, management intends to return forecast surpluses to customers, either by way of additional investments or customer rebates, which reduce the amount billed to consumers. However, these are discretionary items and the company enjoys unusual financial flexibility.

In December 2015, the group set up a new holding company to allow investments outside of the existing financing structure, and management is - at this stage - considering to invest up to £100 million in unregulated commercial activities. These small investments are also discretionary and are not intended to jeopardise the financial strengths of the core water and wastewater business.

Exhibit 7 highlights that currently all of the consolidated group's debt sits within the financing structure around the core operating company.

Exhibit 7
Simplified group & debt structure as at March 2017



Source: Company, Moody's

Welsh Water's debt structure includes a set of financial covenants, particularly the limitations for additional indebtedness and permitted distributions (including customer dividends and distributions to the new holding company), but the company currently maintains significant headroom against these. Hence, we see limited value of credit structural features, which also include (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), at the current A2 rating level.

We also note that Welsh Water's covenant structure is slightly different from other highly-covenanted transactions in the UK water sector 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 its licence and the Water Industry Act 1991.

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.

The grid indicates a rating of A2, in line with the assigned rating for Welsh Water.

Exhibit 8

Rating Factor Grid for Dwr Cymru Cyfyngedig

Financial metrics based on Glas Cymru consolidated accounts

Regulated Water Utilities Industry Grid [1][2]	Current FY 3/31/2017		Moody's 12-18 Month Forward View As of September 2017 [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)	1.6x	Baa	1.5x - 1.7x	Baa
b) Net Debt / Regulated Asset Base (3 Year Avg)	57.1%	Baa	55% - 60%	Baa
c) FFO / Net Debt (3 Year Avg)	11.5%	Baa	10% - 12%	Baa
d) RCF / Net Debt (3 Year Avg)	11.5%	A	10% - 12%	A
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				A2

Note: (1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) At at 03/31/2017. (3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate any significant acquisitions or divestitures.

Source: Moody's Financial Metrics TM

We note that Welsh Water benefits from 0.5 notches of uplift from regulatory ring-fencing provisions, embedded in its licence.

Ratings

Exhibit 9

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

Source: Moody's Investors Service

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