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CREDIT OPINION
23 December 2019

Update

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RATINGS

Dwr Cymru Cyfyngedig

Domicile	United Kingdom
Long Term Rating	A2 , Possible Downgrade
Type	LT Corporate Family Ratings - Fgn Curr
Outlook	Rating(s) Under Review

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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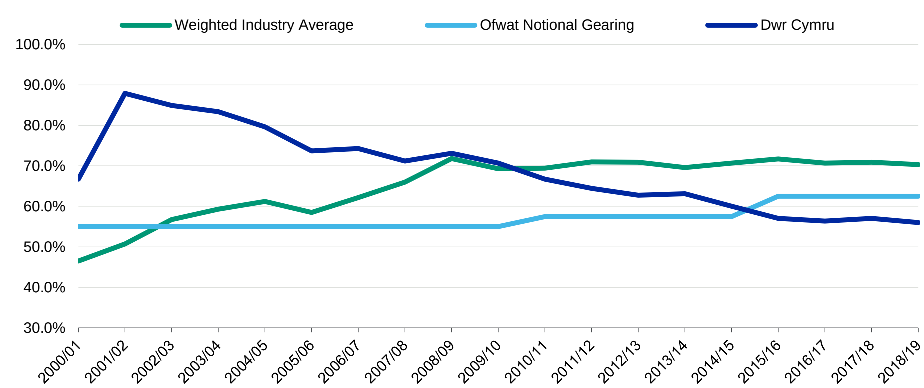
Dwr Cymru Cyfyngedig

Update following review for downgrade and final determination publications

Summary

The credit quality of Dwr Cymru Cyfyngedig (Welsh Water, A2, under review for downgrade) is supported by (1) its low business risk profile as the monopoly provider of essential water and sewerage services in Wales, 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 regulated gearing has fallen below both the sector average and the regulator's assumption for a notionally geared company
Regulatory gearing ratios as reported by companies to Ofwat



Regulated gearing ratios as reported by companies to Ofwat and not reflective of Moody's standard adjustments.
Source: Companies' annual performance reports, Ofwat, Moody's Investors Service

Despite strong credit fundamentals, Welsh Water faces negative pressure from (1) a significant cut in allowed returns from 2020 and more challenging performance targets, as outlined in the regulator's final determination in December 2019; (2) our revised and slightly more demanding financial ratio guidance for the sector, which has been recalibrated to reflect our perception of increased regulatory risk; and (3) the company's financial policy as indicated in its business plan submission of 3 September 2018.

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

» Significant cut in allowed returns from April 2020 will weaken interest coverage ratios, with additional pressure due to the company's comparably high cost of embedded debt.

» 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, although Welsh companies are less exposed.

» More demanding efficiency and performance targets will likely increase cash flow volatility in the next price control period.

Rating Outlook

The A2 ratings are under review for possible downgrade, reflecting Welsh Water's exposure to the significant cut in allowed returns from 2020 and more challenging targets and our expectation that these will weigh on the company's financial metrics and, absent credit-strengthening measures and/or significant outperformance, key ratios will fall below our guidance for the current rating category.

The rating review will consider (1) the company-specific total expenditure allowances and operational performance incentives; (2) potential management and shareholder actions to improve financial flexibility, for example through de-gearing the business, and the ability to achieve this in a timely manner; and (3) the company's decision to accept or reject the final determination. We will endeavor to conclude the review within the next three months.

Factors that Could Lead to an Upgrade

Given the ratings review we currently do not envisage any upward rating pressure. The rating could be confirmed if we conclude that the impact of the final determination is likely to be adequately mitigated by a combination of strong outperformance ability and/or credit-strengthening measures or a more favourable outcome from the CMA, as the case may be.

Factors that Could Lead to a Downgrade

The rating could be downgraded if, taking into account such measures as management may implement, it appears that Welsh Water will likely have insufficient financial flexibility to accommodate the regulatory determination. In particular, the rating could be downgraded if we concluded that the regulatory settlement was likely to result in Welsh Water having gearing, measured by net debt to RCV, materially above 55%, and AICR persistently below 1.5x.

In addition, downward rating pressure could result from (1) diversification away from Welsh Water's core regulated water and wastewater business that would result in an increase of the overall business risk, or credit risk implications for Welsh Water from future developments of the wider Glas Cymru group; and/or (2) 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 in each case are not offset by other credit-strengthening measures; or (3) or the company facing unforeseen funding difficulties.

Key Indicators

Welsh Water exhibits a solid financial profile

	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	12-18 months forward view
Adjusted Interest Coverage Ratio	1.8x	1.5x	1.5x	1.4x	1.5x	1.2x-1.4x
Net Debt / Regulated Asset Base	58.9%	56.5%	56.0%	56.7%	58.3%	55%-60%
FFO / Net Debt	11.7%	12.1%	10.6%	9.9%	9.4%	7%-10%
RCF / Net Debt	11.7%	12.1%	10.6%	9.9%	9.4%	7%-10%

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

Recent developments

Following publication of Ofwat's final determination for 2020-25 control period, we have placed on review for downgrade the A2 corporate family rating of Dwr Cymru Cyfyngedig (Welsh Water) and the A2 senior secured debt ratings of Dwr Cymru (Financing) UK Plc. The A2 rating of those bonds that are subject to a financial guarantee by Assured Guaranty (Europe) plc (A2 stable) of timely payments of scheduled interest and principal will continue to reflect the insurance financial strength rating of the guarantor and is unaffected by this action.

The rating actions take into account (1) Welsh Water's exposure to a significant cut in allowed wholesale returns to ca. 2.42% real in cash terms from 2020 on a 50:50 blended inflation basis, compared with 3.6% in the current period; (2) a reduction in total expenditure allowances compared with the company's requests; and (3) challenging performance targets, which we expect could lead to financial penalties for most companies, including Welsh Water. Specifically, the rating review reflects the anticipated pressure on the company's financial metrics, particularly interest coverage, absent a more favourable determination following a referral to the Competition and Markets Authority (CMA), material balance sheet strengthening or significant outperformance.

On 16 December 2019, Ofwat published its final determination for the five-year regulatory period commencing 1 April 2020 (AMP7) for the water and wastewater companies operating in England and Wales. As previously flagged by the regulator, the determination includes a significant cut in allowed cash returns to ca. 2.42% for the wholesale activities at the start of the new period, which incorporates the regulator's decision to link half of the regulatory assets to the Consumer Prices Index adjusted for housing costs (CPIH), with the rest remaining linked to the Retail Prices Index (RPI). As the share of regulatory assets linked to CPIH grows over time, we estimate that Welsh Water will have an average allowed cash return of around 2.5% over AMP7. On an RPI-stripped basis, for comparison with the current period, allowed returns will fall to 1.92% (1.96% including retail margin) from 3.6% (3.74% including the retail margin) , a nearly 50% cut. The low returns put particular pressure on companies, including Welsh Water, which have expensive existing debt. Welsh Water's modest gearing of around 60% of net debt to regulatory capital value (RCV) may help offset some of the pressure, if it can be maintained at these levels, despite the pressure on cost efficiencies.

Ofwat's allowances for "base" operating and maintenance expenditure, excluding enhancement projects but including retail costs, were £2.5 billion, roughly £15 million below what the company requested, a remaining efficiency gap of only 0.6%. The main cost pressure remains on the retail activities, where the company has also been suffering in the current period. The final determination also included significant disallowances on enhancement expenditure of around £171 million. Although Welsh Water may decide not to invest into enhancement projects that it did not receive funding for, this may impact its performance under the outcome delivery incentives and increase the risk of performance penalties. If, on the other hand, the company chose to overspend on totex, under the totex sharing mechanism, up to 40-45% of this overspend would be added to the RCV in 2025 or recovered over the 2025-30 period but would result in higher debt and weaker cash flow over AMP7.

In addition to base cost overspend, we estimated that, under the draft determination, Welsh Water faced performance penalties of around £50 million in aggregate over the period, of which roughly £31 million are linked to the common target across all companies for water supply interruptions and internal sewer flooding. While penalties will be paid with a two-year lag and may thus only bite in the later part of the period, the majority of penalties would still affect cash flows during the AMP7 period. In addition, the calibration of targets and incentive rates means that severe weather events could carry disproportionate downside risk. As part of the rating review, we will assess the changes in the final determination to the calibration of incentives and the associated risk of penalties as well as the company's plans to mitigate any underperformance.

Like its peers, Welsh Water must decide before 16 February 2020 whether to accept the final determination. If it does not then Ofwat will refer it to the CMA for review, which will take between six to twelve months to decide upon the matter. This means that even if an appeal is successful, the final determination will still apply until March 2021, creating immediate pressure on cash flow and key credit metrics.

The remainder of this document reflects the company's position as at the draft determination and will be updated when the review is concluded.

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 financial year ending 31 March 2019, Welsh Water had a RCV of just under £5.7 billion, and the Glas Cymru group reported revenues of £782 million and operating profit of £69 million, primarily attributable to Welsh Water.

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 has, to date, reset price limits every five years and published its final methodology for the 2019 price review (PR19), covering the period from April 2020 (AMP7), in December 2017. The methodology indicated a significant cut in allowed returns under an assumption that the current low interest-rate environment will persist, albeit this will be partially offset by a switch in inflation indexation measures.

According to Ofwat's December 2017 guidance, and on a like-for-like Retail Price Index (RPI) basis, the proposed wholesale allowed return would decrease from the 3.6% set at the 2014 price review (PR14) to 2.3% from April 2020.

However, in its draft determination for the sector, published on 18 July 2019, the regulator updated its view and proposed an allowed cash wholesale return of 2.58%, 22 bps below its "early view" guidance. This figure was based on market data from February 2019, and Ofwat noted that market movements between February and June would support a further reduction of 37 bps. In total, this would translate into a roughly 140 bps cut in cash returns from the 3.6% allowed in the current 2015-20 period (see "Regulated Water Utilities - UK: Ofwat tightens the screws further").

Exhibit 3
Allowed cash returns to fall materially from April 2020

	Ofwat PR14	Ofwat PR19 Final Methodology Dec 2017			Ofwat PR19 Draft Determination Jul 2019 (Feb cut-off)			Ofwat PR19 Draft Determination Jul 2019 (Jun data)		
	RPI-based	RPI-based	CPI-based	50:50	RPI-based	CPI-based	50:50	RPI-based	CPI-based	50:50
Notional gearing	**62.5%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**	**60.0%**
Existing debt	2.65%	1.59%	2.58%	2.09%	1.46%	2.46%	1.96%	1.46%	2.46%	1.96%
New debt	2.00%	0.38%	1.37%	0.88%	0.35%	1.33%	0.84%	-0.38%	0.60%	0.11%
Existing: new debt ratio	75%	70%	70%	70%	80%	80%	80%	80%	80%	80%
Explicit debt issuance cost	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%
Cost of debt (pre-tax)	**2.59%**	**1.33%**	**2.32%**	**1.83%**	**1.34%**	**2.33%**	**1.84%**	**1.19%**	**2.19%**	**1.69%**
Risk-free rate	1.25%	-0.88%	0.10%	-0.39%	-1.42%	-0.45%	-0.94%	-1.95%	-0.99%	-1.47%
Equity risk premium	5.50%	6.31%	6.37%	6.34%	6.88%	6.95%	6.92%	7.42%	7.49%	7.46%
Total market return	6.75%	5.44%	6.47%	5.96%	5.47%	6.50%	5.99%	5.47%	6.50%	5.99%
Equity beta	0.80	0.77	0.77	0.77	0.71	0.71	0.71	0.63	0.63	0.63
Cost of equity (post-tax)	**5.65%**	**4.01%**	**5.03%**	**4.52%**	**3.46%**	**4.48%**	**3.97%**	**2.75%**	**3.75%**	**3.25%**
Vanilla WACC*	**3.74%**	**2.40%**	**3.40%**	**2.90%**	**2.19%**	**3.19%**	**2.69%**	**1.82%**	**2.81%**	**2.31%**
Retail Margin	0.14%	0.10%	0.10%	0.10%	0.11%	0.11%	0.11%	0.11%	0.11%	0.11%
Wholesale WACC	**3.60%**	**2.30%**	**3.30%**	**2.80%**	**2.08%**	**3.08%**	**2.58%**	**1.71%**	**2.70%**	**2.20%**
Wholesale WACC (cash)	3.60%			2.80%			2.58%			2.20%

* Vanilla WACC represents the pre-tax cost of debt and post-tax cost of equity at the appointee level. The wholesale WACC is the appointee WACC minus the retail margin. PR19 nominal returns are deflated into a real return, using 2% and 3% deflators for the Consumer Price Index, adjusted for housing costs (CPIH) and Retail Price Index (RPI), respectively. The latter is also compared with the current period's RPI-linked real return.
Source: Ofwat, Moody's Investors Service

The draft determination also envisages increasing efficiency challenges for companies, including: (1) a totex efficiency and a frontier shift set at the upper quartile level as opposed to the sector average level; and (2) an outcome delivery incentives mechanism calibrated so that only the top quartile performers can achieve a reward. Even average performers could be negatively affected, putting a further strain on companies' cash flows.

The draft determination also confirms companies' commitment to accept the regulator's proposals under the 'Putting the Sector Back in Balance' consultation, which included (1) a sharing mechanism of financing outperformance from high gearing; and (2) increased transparency of dividend and executive pay policies. The 'Putting the sector back in balance' measures marked a change in direction for the regulator, in our view, in response to political and public pressure and evidenced a modest deterioration in the stability and predictability of the regime. The regulator has long maintained that capital structure is a matter for shareholders but, with the new measures, will exert greater influence. Accordingly, in May 2018, we revised the scoring for the stability and predictability of the regulatory regime under our rating methodology for Regulated Water Utilities to Aa from Aaa. At the same time we modestly tightened our ratio guidance (please see 'Regulated Water Utilities - UK: Regulator's proposals undermine the stability and predictability of the regime', May 2018).

Given that Welsh Water exhibits one of the lowest gearing level within the sector, the above sharing mechanism will have no impact on the company, but Ofwat still required management to accept the mechanism in principle.

In relation to Ofwat's market reform agenda, companies purely operating in Wales will be subject to more protection that their English counterparts. In the context of the introduction of competition for non-household retail activities, the Welsh government stated: *"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 may also prove supportive as Ofwat is looking into opening the market to further competition across other parts of the water and wastewater value chain.

Solid operational performance record in the current regulatory period, but performance pressures from 2020

Welsh Water has exhibited solid performance in the first four years of the current regulatory period, largely performing in line with its targeted objectives. The company achieved a small cumulative net reward of £0.1 million (in 2012/13 prices), which is also the position management expects by the end of the period. The company's main challenge in this period remains around water discolouration, which management expects to incur an overall penalty over AMP6.

For AMP7, outcome delivery incentives (ODIs), which include the performance targets agreed with customers, have been revised and we estimate that Ofwat's changes at the draft determination stage could result in Welsh Water incurring performance penalties of up to £31 million under the 14 ODIs that are common across all water and sewerage companies, plus additional £19 million of penalties under bespoke performance commitments, if it performed in line with its original business plan assumptions.

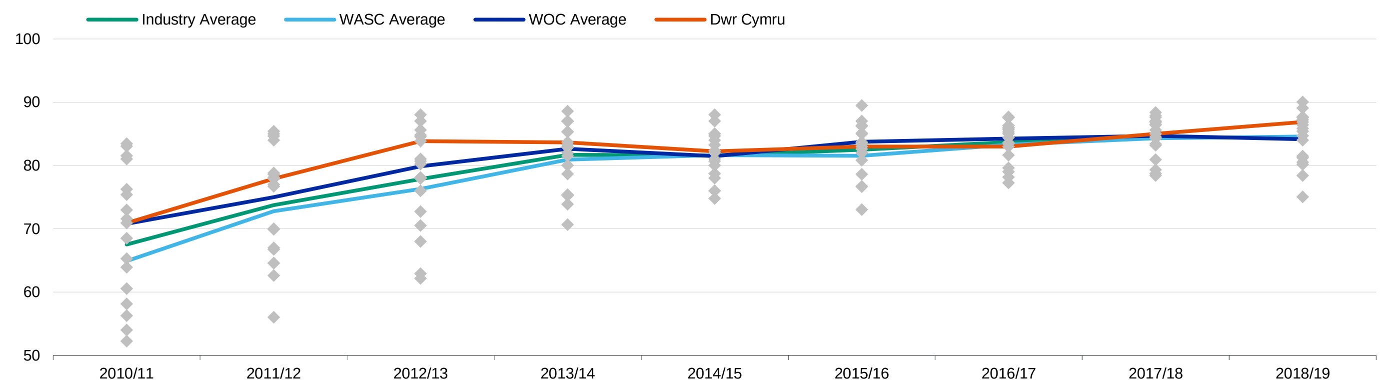
The majority of the £31 million common ODIs penalty is linked to water supply interruptions and internal sewer flooding, where Ofwat has both increased the penalty/reward rates and introduced more stretching targets, while the £19 million penalty on bespoke ODIs is primarily related to external sewer flooding where the annual targets have also been tightened.

On customer service, Welsh Water generally maintained a score under the Service Incentive Mechanism – which measures direct customer service – in line with the industry average. However, it will still face a small penalty of £2.1 million based on Ofwat's reconciliation of current period's performance, which will reduce the company's revenue for AMP7, albeit marginally.

Exhibit 4

Welsh Water's customer service over the last five years has been largely in line with the sector average

Total SIM scores over AMP5 and AMP6 to date for water and wastewater companies



Source: Companies' annual performance reports, Ofwat

Capex programme to reflect additional investments into areas of customer focus

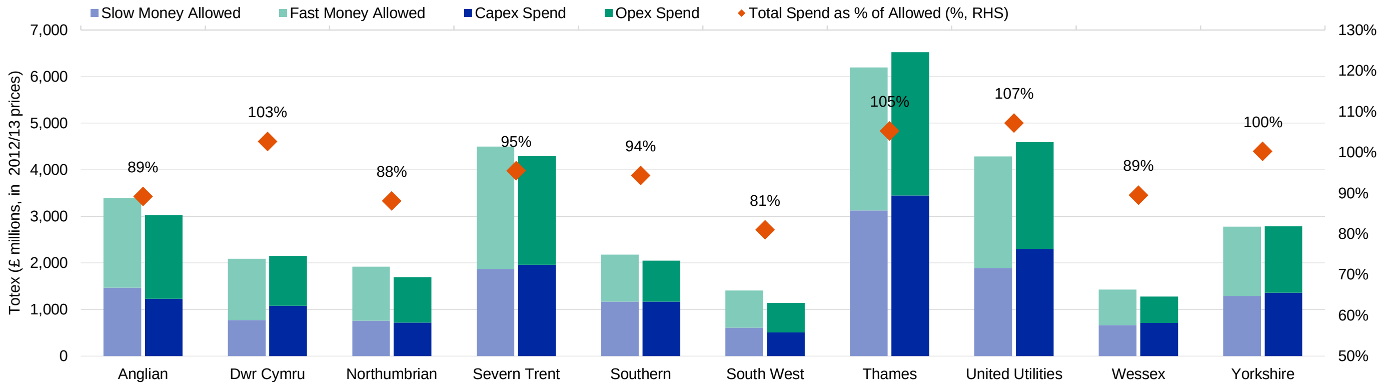
As is typical for the sector, Welsh Water faces some risk in the execution of its significant capital programme and the associated financing and refinancing requirements. For AMP6, Welsh Water has been allowed total expenditure (totex), which includes opex and capex, of around £2.6 billion (in 2012/13 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.

The company spent less than its allowance in the first two years of the current regulatory period, mostly due to re-profiling of capex in the first year of the AMP. Investments have been ramped up during the next two years, and the company also expect to invest additional monies on behalf of its customers, which will ultimately mean overall totex exceeding the allowance at the end of AMP6.

Exhibit 5

Welsh Water's overall investments will exceed totex allowance for the period as the company continues to invest into areas of customer priority

Cumulative spend (in £ millions) over 2015/16 - 2018/19 versus allowed totex



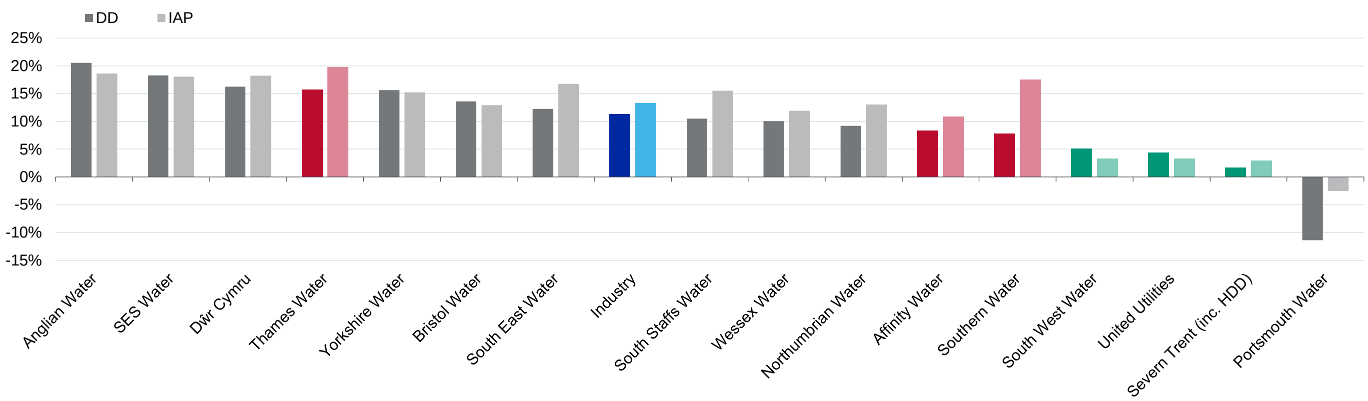
Source: Companies' performance reports, Ofwat, Moody's Investors Service

For AMP7, we expect Welsh Water to face a significant efficiency challenge as it has one of the highest cost gaps in the industry, based on Ofwat's draft determination (see Exhibit 6 below).

Exhibit 6

Ofwat's draft determination implies that Welsh Water may have to cut its proposed total expenditure by around 16% to meet the regulator's efficient view of costs

Cost efficiency challenge at draft determination (DD) compared with initial assessment of companies' business plans (IAP)



The red, green and blue colours highlight significant scrutiny companies, fast-tracked companies and the industry overall, respectively. The above costs exclude pension deficit repair costs (for which Ofwat will make an allowance in accordance with its policy set out in Information Notice 13/17) and third-party costs. Costs are gross of grants and contributions. Percentages are calculated by dividing the difference between companies proposals and Ofwat's estimate with the companies' proposals, thus showing by how much companies would need to reduce their proposed costs to meet Ofwat's view.

Source: Ofwat

The efficiency gap is primarily linked to enhancement expenditure, where nearly half of the amount requested by the company was disallowed by the regulator, particularly in relation to investments around long-term resilience and supply-demand management. While the company may decide not to invest into enhancement projects that it hasn't received funding for, individual performance commitments linked to such expenditure could result in negative implications for ODI performance if the investment is not made.

On base operating and maintenance costs, Welsh Water would have to reduce its proposed expenditure by only ca. 3.8% to achieve Ofwat's level of efficient costs, which is below the industry average of 4.2%.

However, another cost challenge is linked to the retail cost allowance, where the company's proposed costs remain more than 20% higher than Ofwat's efficient view. Retail costs have also been a pressure point in the current period, with Welsh Water's average cost to serve above the industry average, 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.

Welsh Water's high cost of embedded debt exposes the company 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.

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 RCV, on which the allowed return is calculated, will be indexed:

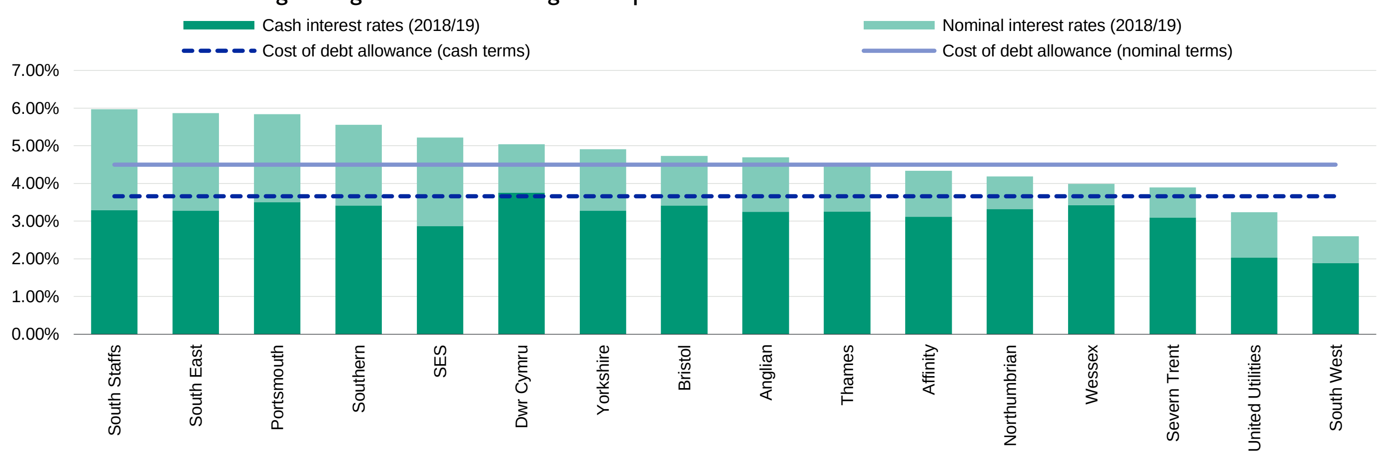
1. 50% of the RCV at 31 March 2020 by RPI; and
2. 50% of the RCV at 31 March 2020 and all new additions to the RCV from 1 April 2020 by CPIH.

Assuming a differential between RPI and CPIH of around 100bps and an initial 50:50 split of the return on RCV, the blended RPI-CPIH wholesale return would be around 2.6%, based on Ofwat's draft determination, potentially falling to 2.2% on the look-ahead of latest market date (see also Exhibit 3 above).

While companies will benefit from the low interest rate environment over time as they raise new debt, those with debt tenors beyond that assumed by the regulator will be exposed as allowed returns will converge to market rates, unless historical funding costs have been below average.

Exhibit 7

Welsh Water exhibits among the highest cost of funding across peers



Source: Companies' performance reports, Ofwat, Moody's Investors Service

Welsh Water's embedded debt cost is among the highest in the sector, which increases pressure on interest coverage ratios in a low return environment. However, the company's modest gearing provides additional financial flexibility and the not-for-profit nature of its parent, with no requirement for dividend distributions, leaves potential for further deleveraging, should this be required.

Nevertheless, the company's September business plan submission for AMP7 suggests a financial policy that would maintain gearing roughly at current levels very close to the 60% mark. Based on the draft determination we estimate an average AICR of 1.3x over the 2020-25 period. However, this could fall toward 1.1x if the lower 2.2% wholesale return or an element of ODI penalty is taken into account.

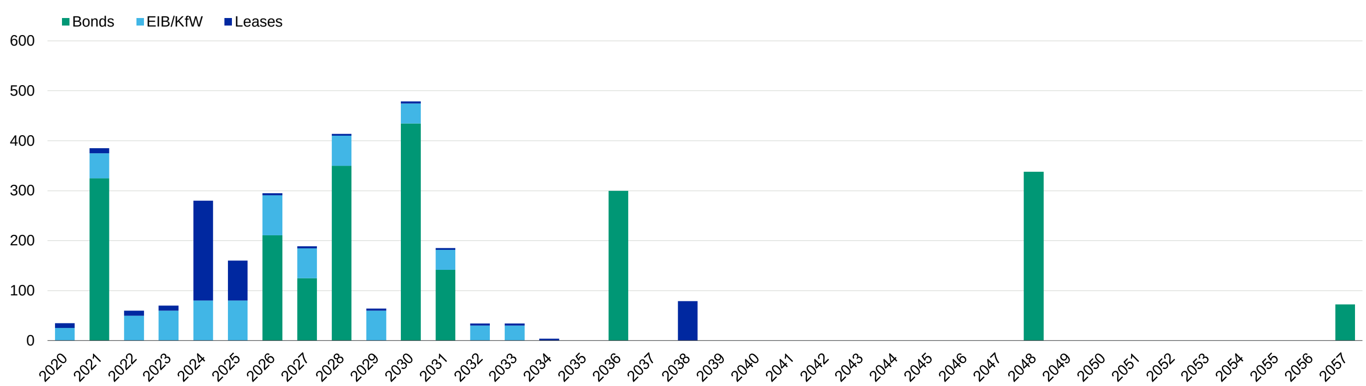
We believe that absent significant outperformance and/or a favourable regulatory settlement, it is unlikely that Welsh Water's financial metrics will be able to maintain a 1.5x AICR and RCV gearing at or below 55%, required for the current A2 rating. We note that Welsh Water's AICR guidance of 1.5x already considers the benefit of the company's ownership and governance structure, which provide unique flexibility, as well as less competitive pressures on its operations, given the Welsh Assembly's more cautious stance toward retail competition.

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 2019, the Glas group had a cash position of just over £501 million (including short-term deposits, or £362 million when offset against the bank overdraft), mostly attributable to Welsh Water, and undrawn credit facilities of £170 million, available until November 2020. 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.

The next major debt maturity is the £325 million 6.907% bond due in March 2021.

Exhibit 8
Welsh Water's debt maturity profile is well spread out



Source: Company's investor report

Structural Considerations

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

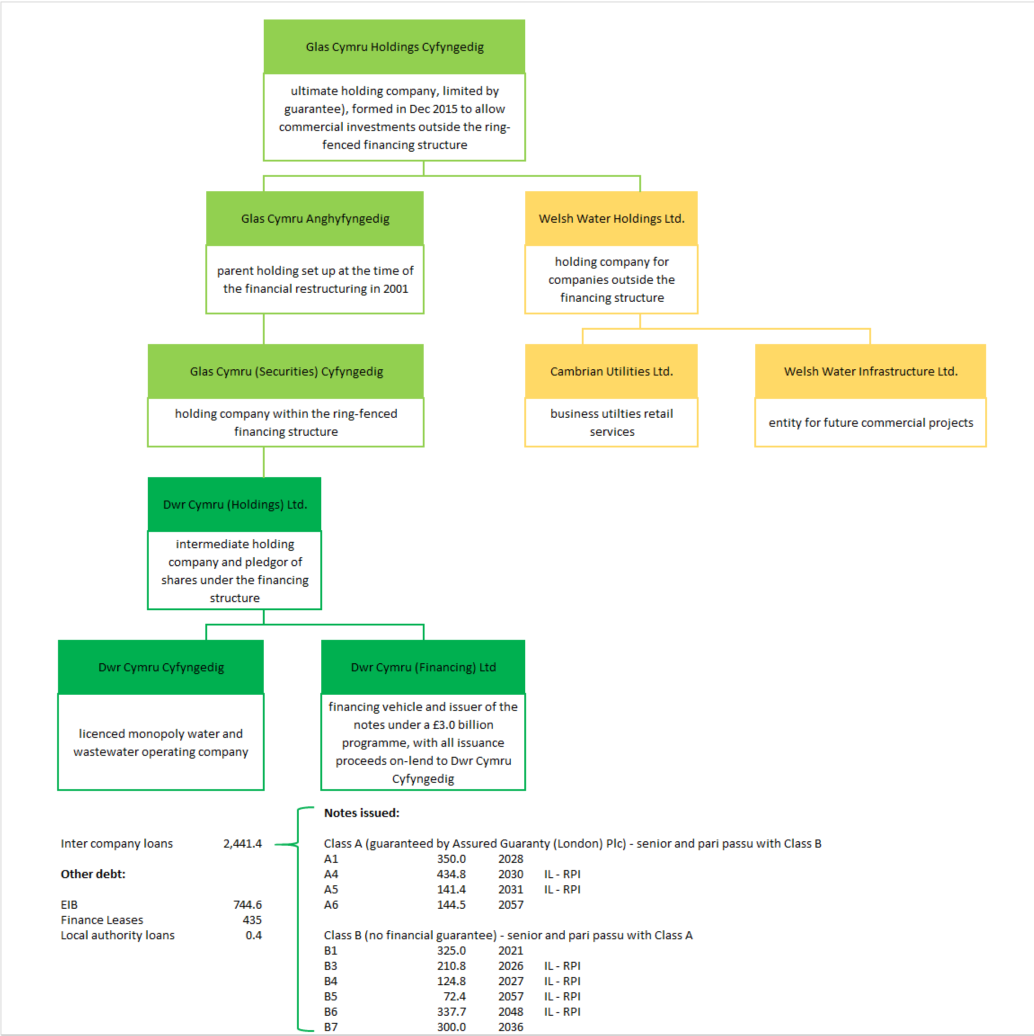
Welsh Water's ultimate parent is a not-for-profit organisation, requiring no dividend distributions. Instead, any profits made by the company have been used to reduce gearing over time and accumulate reserves.

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 permitted 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 9 highlights that currently all of the consolidated group's debt sits within the financing structure around the core operating company.

Exhibit 9
Simplified group and debt structure as at 31 March 2019



Source: Company's investor report

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.

Issuer substitution credit neutral

With effect of 1 August 2019, all outstanding obligations in relation to ca. £1.7 billion of bonds, originally issued by Dwr Cymru (Financing) Limited under a £3.0 billion medium-term notes issuance programme, have been transferred to Dwr Cymru (Financing) UK Plc, a new UK-based issuer that has substituted the previous Cayman Island-based issuer.

The issuer substitution was approved by majority creditors on 7 June 2019, and the parties to the existing covenanted financing transaction have agreed to replace the Cayman Islands incorporated Dwr Cymru (Financing) Limited with Dwr Cymru (Financing) UK Plc including (among other things) as principal debtor under the existing bonds per the companies' announcement from 1 August 2019. In our view, the substitution does not adversely impact the rights of the lenders under the covenanted financing structure, or the financial risk profile of the operating company, save for certain transaction and possible tax costs, which we consider immaterial in the context of the size of the overall business. Instead, it aims to improve transparency, trust and customer confidence following challenges to the sector from the regulator and Government around complex financing structures and the use of offshore funding vehicles.

For more details, please refer to Moody's Issuer Comment 'Dwr Cymru Cyfyngedig: Proposed restructuring transaction is credit neutral', published May 2019.

Rating Methodology and Scorecard Factors

Welsh Water is rated in accordance with our rating methodology for Regulated Water Utilities, last published in June 2018. 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 scorecard-indicated outcome is Baa1, reflecting – particularly in the 12-18 months forward view – the pressure from lower allowed returns from 1 April 2020.

Rating Methodology Grid - Dwr Cymru Cyfyngedig
Financial metrics based on Glas Cymru consolidated accounts

Regulated Water Utilities Industry Grid [1][2]	Current FY 3/31/2019		Moody's 12-18 Month Forward View As of October 2019 [3]	
Factor 1 : Business Profile(50%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Environment	Aa	Aa	Aa	Aa
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)	1.5x	Ba	1.2x - 1.4x	Ba
b) Net Debt / Regulated Asset Base (3 Year Avg)	57.0%	Baa	55% - 60%	Baa
c) FFO / Net Debt (3 Year Avg)	9.9%	Ba	7% - 10%	Ba
d) RCF / Net Debt (3 Year Avg)	9.9%	Baa	7% - 10%	Baa
Rating:				
Indicated Rating from Grid Factors 1-3		Baa2		Baa2
Rating Lift	**0.5**	**0.5**	**0.5**	**0.5**
a) Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned				A2

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) At at 03/31/2019. (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 11

Category	Moody's Rating
DWR CYMRU CYFYNGEDIG	
Outlook	Rating(s) Under Review
Corporate Family Rating	A2[1]

[1] Placed under review for possible downgrade on December 20 2019

Source: Moody's Investors Service

Appendix

Exhibit 12

Dwr Cymru Cyfyngedig

Selected peer comparison

(in GBP million)	Dwr Cymru Cyfyngedig A2 Rating(s) Under Review FYE Mar-17	FYE Mar-18	FYE Mar-19	Wessex Water Services Limited A3 Rating(s) Under Review FYE Mar-17	FYE Mar-18	FYE Mar-19	United Utilities Water Limited A3 Stable FYE Mar-17	FYE Mar-18	FYE Mar-19	Severn Trent Water Limited A3 Rating(s) Under Review FYE Mar-17	FYE Mar-18	FYE Mar-19
Revenue	744	757	782	525	541	548	1,680	1,717	1,798	1,556	1,607	1,673
EBITDA	377	527	427	334	340	339	1,136	1,190	1,175	907	919	1,005
Regulated Asset Base (RAB)	5,222	5,471	5,673	2,978	3,142	3,264	10,665	11,089	11,465	8,423	8,920	9,349
Total Debt	3,024	3,388	3,811	2,208	2,183	2,243	6,886	7,695	7,803	5,723	5,968	6,378
Net Debt	2,924	3,100	3,310	2,105	2,147	2,243	6,690	7,195	7,477	5,723	5,956	6,365
Adjusted Interest Coverage Ratio	1.5x	1.4x	1.5x	2.0x	2.0x	1.8x	2.6x	2.9x	2.9x	1.8x	1.7x	2.0x
FFO / Net Debt	10.6%	9.9%	9.4%	11.7%	11.8%	11.2%	13.4%	13.4%	13.1%	13.0%	13.0%	12.9%
RCF / Net Debt	10.6%	9.9%	9.4%	7.4%	7.5%	7.2%	9.9%	9.0%	8.1%	9.6%	9.5%	9.4%
Net Debt / Regulated Asset Base	56.0%	56.7%	58.3%	70.7%	68.3%	68.7%	62.7%	64.9%	65.2%	67.9%	66.8%	68.1%

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months. RUR* = Ratings under Review, where UPG = for upgrade and DNG = for downgrade. Rating for Wessex Water Serviced Limited is assigned at the level of its finance subsidiary Wessex Water Services Finance Plc.
Source: Moody's Financial Metrics™

Exhibit 13

Dwr Cymru Cyfyngedig

Moody's adjusted debt breakdown

(in GBP million)	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19
As Reported Total Debt	3,150	2,943	2,978	3,359	3,766
Pensions	33	57	95	80	96
Non-Standard Public Adjustments	(59)	(48)	(49)	(51)	(51)
Moody's Adjusted Total Debt	3,124	2,952	3,024	3,388	3,811
Cash & Cash Equivalents	(271)	(135)	(101)	(289)	(501)
Moody's Adjusted Net Debt	2,853	2,817	2,924	3,100	3,310

All figures are calculated using Moody's estimates and standard adjustments. Non-standard public adjustment relates to the removal of accrued interest from the debt amount.
Source: Moody's Financial Metrics™

Exhibit 14

Dwr Cymru Cyfyngedig

Moody's adjusted FFO breakdown

(in GBP million)	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19
As Reported Funds from Operations (FFO)	273	265	228	212	221
Pensions	4	2	8	7	7
Capitalized Interest	(6)	(4)	(10)	(16)	(16)
Alignment FFO	(25)	1	(18)	(40)	(35)
Unusual Items - Cash Flow	29	15	31	55	46
Non-Standard Public Adjustments	59	62	72	89	87
Moody's Adjusted Funds from Operations (FFO)	333	340	311	307	310

All figures are calculated using Moody's estimates and standard adjustments. Unusual items add back indexation to FFO, while the non-standard adjustment adds back expensed infrastructure renewal expenditure, which is treated as capex.
Source: Moody's Financial Metrics™

Exhibit 15

Dwr Cymru Cyfyngedig

Selected historical financial data, Moody's-adjusted

(in GBP million)	FYE Mar-15	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19
INCOME STATEMENT					
Revenue	753	743	744	757	782
EBITDA	306	495	377	527	427
EBITDA margin %	40.7%	66.6%	50.6%	69.6%	54.7%
Interest Expense	154	133	154	193	186
Net income	(81)	57	(87)	(36)	(125)
BALANCE SHEET					
Cash & Cash Equivalents	271	135	101	289	501
Net Property Plant and Equipment	3,572	4,837	5,056	5,296	5,521
Total Assets	4,483	5,628	5,848	6,321	6,784
Total Liabilities	4,494	4,550	4,740	5,090	5,563
Total Debt	3,124	2,952	3,024	3,388	3,811
Net Debt	2,853	2,817	2,924	3,100	3,310
Total Equity	(11)	1,079	1,108	1,231	1,221
CASH FLOW					
Funds from Operations (FFO)	333	340	311	307	310
Cash Flow From Operations (CFO)	316	301	284	294	307
Dividends					
Retained Cash Flow (RCF)	333	340	311	307	310
Capital Expenditures	(327)	(257)	(315)	(409)	(452)
Free Cash Flow (FCF)	(11)	43	(32)	(116)	(145)
INTEREST COVERAGE					
(FFO + Interest Expense) / Interest Expense	3.2x	3.6x	3.0x	2.6x	2.7x
Adjusted Interest Coverage Ratio	1.8x	1.5x	1.5x	1.4x	1.5x
LEVERAGE					
Regulated Asset Base (RAB)	4,839	4,989	5,222	5,471	5,673
Net Debt / Regulated Asset Base	58.9%	56.5%	56.0%	56.7%	58.3%
FFO / Net Debt	11.7%	12.1%	10.6%	9.9%	9.4%
RCF / Net Debt	11.7%	12.1%	10.6%	9.9%	9.4%

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

REPORT NUMBER 1208310

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