MOODY'S INVESTORS SERVICE

CREDIT OPINION
21 September 2020

Update

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RATINGS

Dwr Cymru Cyfyngedig

Domicile	Cardiff, United Kingdom
Long Term Rating	A3
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

Regular update following publication of March 2020 results

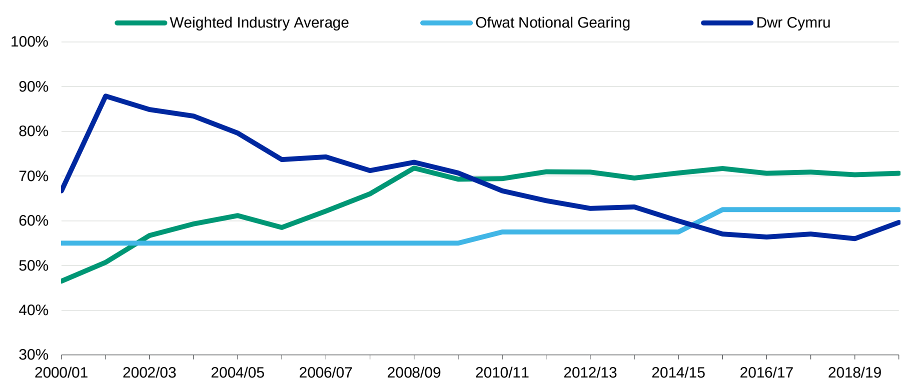
Summary

The credit quality of Dwr Cymru Cyfyngedig (Welsh Water, A3, stable) is supported by (1) its low business risk profile as the monopoly provider of essential water and sewerage services across most of Wales, with stable and predictable cash flows generated under a transparent and well-established regulatory regime; (2) a low level of gearing around 60%, calculated as the group's consolidated net debt to regulatory capital value (RCV); (3) the not-for-dividend status of Welsh Water's ultimate parent company, Glas Cymru Holdings Cyfyngedig, which allows Welsh Water to manage the distribution of its profits in order to maintain the company's 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



Regulatory 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 fundamentals, credit quality is constrained by a challenging regulatory determination for the 2020-25 period, which included (1) a significant cut in allowed wholesale returns to ca. 2.42% real in cash terms, compared with 3.6% previously; (2) a reduction in total expenditure allowances compared with the company's requests; and (3) stringent performance targets, which will likely lead to financial penalties for Welsh Water.

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-dividend status of parent company provide significant financial flexibility

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

Credit Challenges

» Material cut in allowed returns for the five-year regulatory period that commenced on 1 April 2020

» More demanding efficiency and performance targets that could increase cash volatility

» Further changes to regulation, aimed at increasing competition in certain parts of the value chain, which may create additional financial pressure for the sector, although Welsh companies are less exposed

Rating Outlook

The stable outlook reflects our expectation that the company will be able to maintain financial metrics in line with guidance for its A3 corporate family rating (as outlined below).

Factors that Could Lead to an Upgrade

The ratings could be considered for an upgrade, if Welsh Water appeared likely to exhibit a ratio of net debt to RCV consistently at or below 55% and an Adjusted Interest Coverage Ratio (AICR) comfortably above 1.5x. Any upgrade would also have to take into account the evolution of the regulatory and business risks at that time.

Factors that Could Lead to a Downgrade

The ratings could be downgraded if Welsh Water's financial metrics appeared likely to deteriorate, such that gearing, measured by net debt to RCV, would increase above 65%, and AICR remained persistently below 1.35x.

In addition, downward rating pressure could result from (1) diversification away from Welsh Water's core regulated water and wastewater business leading to an increase of the overall business risk, or credit risk implications for Welsh Water from future developments of the wider Glas Cymru group; or (2) higher business risk for the sector as a result of legal 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 Finally, unforeseen funding difficulties could also lead to a rating downgrade.

Key Indicators

Exhibit 2

Welsh Water's financial profile expected to be in line with the A3 rating guidance despite lower returns from 1 April 2020

	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	AMP7 forward view (analytical approach)	AMP7 forward view (stat. accounting)
Adjusted Interest Coverage Ratio	1.5x	1.5x	1.4x	1.5x	1.5x	1.4x-1.6x	1.3x-1.5x
Net Debt / Regulated Asset Base	56.5%	56.0%	56.7%	58.3%	59.1%	58%-60%	58%-60%
FFO / Net Debt	12.1%	10.6%	9.9%	9.4%	9.3%	10%-11%	10%-11%
RCF / Net Debt	12.1%	10.6%	9.9%	9.4%	9.3%	10%-11%	10%-11%

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. We note that the calculation of the historical AICR 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, the last shown historical year, in which the company paid an explicit customer dividend (although it has provided separate support through social tariffs since). Over AMP7, we expect the company to pay £11m p.a. as customer rebates. For ease of comparison, we have shown forward-looking figures using both our analytical approach (treating them as dividends) and statutory accounting approach (treating them as revenue reduction).

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 parts of Herefordshire and Cheshire.

Welsh Water's ultimate parent company is Glas Cymru Holdings Cyfyngedig (Glas Cymru), a not-for-dividend organisation. In the financial year ending 31 March 2020, Welsh Water had an RCV of around £5.9 billion, and the Glas Cymru group reported revenues of £779 million and operating profit of £30 million, primarily attributable to Welsh Water.

Detailed Credit Considerations

Transparent regulatory regime, but falling returns pressure companies' financial flexibility

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).

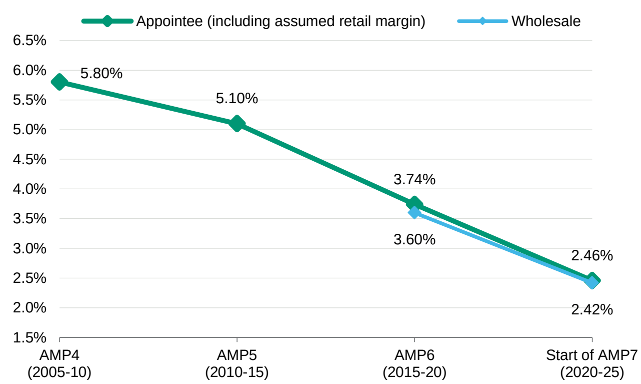
Ofwat has, to date, reset price limits every five years and published its final determination for the 2020-25 period, known as AMP7, in December 2019.

As previously flagged by the regulator, the determination included 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 only link half of the regulatory assets as at March 2020 to the Retail Prices Index (RPI), with the remainder and any new additions linked to the Consumer Prices Index adjusted for housing costs (CPIH). As the share of regulatory assets linked to CPIH grows over time, we estimate that most companies will have an average allowed cash return of around 2.5% over AMP7. For comparison and on a like-for-like RPI-stripped basis, allowed returns will fall by close to 50% to 1.92% (1.96% including retail margin) in AMP7 from 3.6% (3.74% including the retail margin) in AMP6 (April 2015 - March 2020).

Exhibit 3

Significant cut in allowed returns, despite lower inflation index

Real (cash) allowed returns

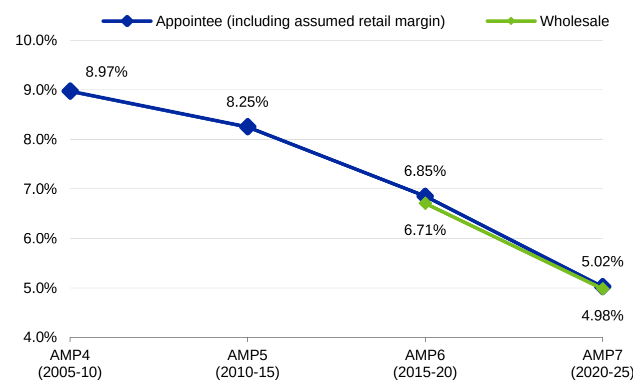


Since PR14, Ofwat has separated retail activities from the wholesale services.
Source: Ofwat

Exhibit 4

Unprecedented cut in nominal allowed returns

Nominal (total) returns including forecast inflation of RCV



Assuming ex ante expectation of 3% RPI inflation and 2% CPIH inflation
Source: Ofwat, Moody's Investors Service estimates

The final determination also envisaged increasing efficiency challenges for companies, including: (1) totex efficiency, with a frontier shift of 1.1%, 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. Consequently, average as well as below average performers could be negatively affected, putting a further strain on companies' cash flows.

The final determination also confirmed 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 had 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).

Welsh Water's regulatory gearing is (and is expected to remain throughout AMP7) well below the 70% gearing threshold set by Ofwat for high gearing outperformance payments to customers. The company will not, therefore, be affected by this mechanism over the period.

Welsh Water's high cost of embedded debt increases pressure from lower returns

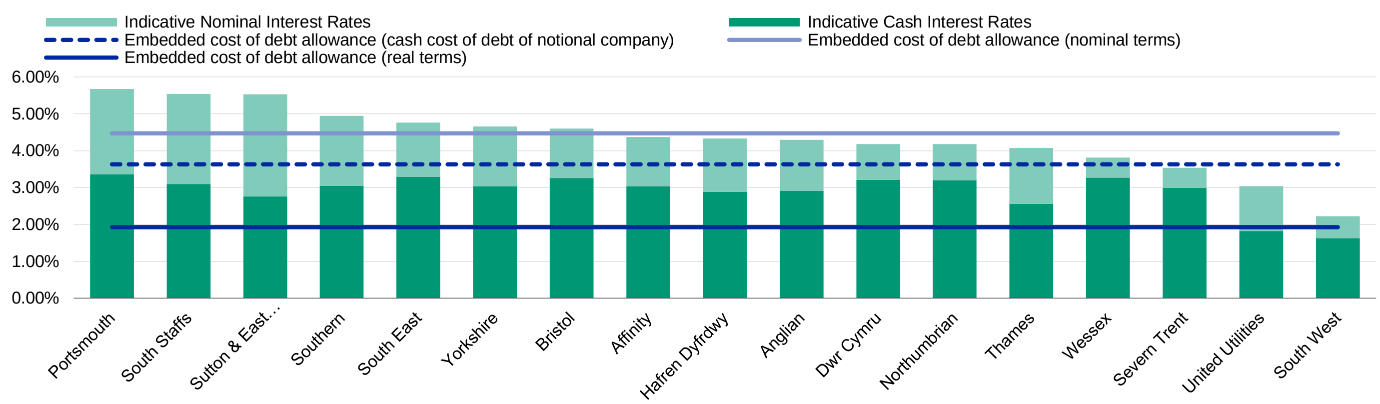
The cut in allowed returns poses particular risks for companies, like Welsh Water, with more expensive and longer-term debt relative to regulatory assumptions.

For the financial year ending 31 March 2020, the cost of Welsh Water's embedded debt remained above the sector average of 4% nominal and one of the highest in cash terms at 3.2% compared with a sector average of 2.7%. This is exacerbated by the fact that the company pays the inflation-element of the coupon under a large part of its inflation-linked derivatives on an annual basis.

Exhibit 5

Welsh Water exhibits among the highest cash cost of funding across peers

Embedded cost of debt reported as at 31 March 2020, compared with Ofwat embedded cost of debt allowance for PR19



In setting the notional cost of capital, Ofwat assumes a debt mix of two-thirds nominal fixed rate debt and one third inflation-linked. Taking this into account, an implicit notional embedded cash cost of debt for AMP7 is roughly 3.6% (the dashed dark-blue line). However, the inflation element of the allowed return will flow through only over time through the indexation of the RCV, and the real RPI-CPIH-blended embedded cost of debt allowance is ca. 1.9% (the solid dark blue line).
Source: Companies' performance reports, Ofwat, Moody's Investors Service

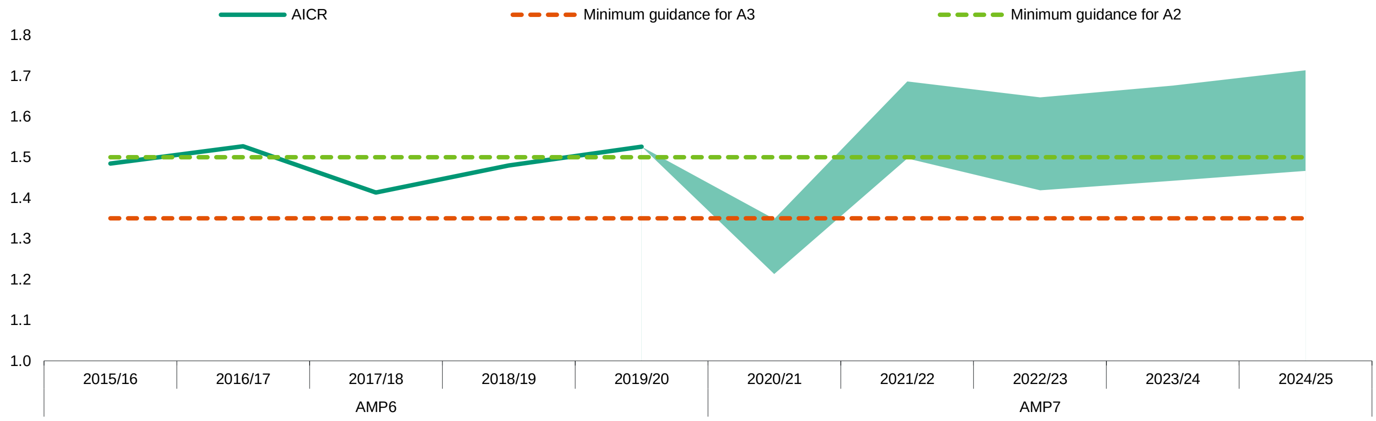
To reduce its overall funding costs, Welsh Water raised £300 million senior bonds and £200 million subordinated (junior) bonds in February 2020 at fixed rates of 1.375% and 1.625%, respectively, subsequently swapped into an index-linked coupon with negative annual interest rates averaging around -1.6%. The new debt will refinance a £325 million 6.907% bond due in March 2021 and fund ongoing investment requirements. In addition to the new bonds, the company also entered into an inflation-linked derivative contract to swap the existing £350 million bonds due in 2028 from a 6% fixed rate to a RPI-linked exposure.

These arrangements will materially reduce the company's embedded debt cost, particularly from April 2021 but Welsh Water will continue to face pressure relative to the regulatory cost of debt allowance as most of the remaining particularly expensive debt will not mature before AMP8.

Under our base case scenario, we expect Welsh Water's AICR to be around 1.5x over AMP7, albeit below this level prior to the maturity of the £325 million bond in March 2021 and exposed to the risk of operational or financial underperformance.

Exhibit 6

Moody's forecast evolution of Welsh Water's AICR



Source: Consolidated statutory accounts for historical ratios, Ofwat for regulatory building blocks and Moody's Investors Service's forecast

On gearing, measured as net debt to RCV, we expect Welsh Water to remain just below 60% for a majority of AMP7. Gearing could, however, fall closer to the 55% mark in the later years of the period if performance was better than our base case assumptions and excess cash was kept within the business rather than returned to customers, through a reduction in revenues or additional investments over and above the current plan.

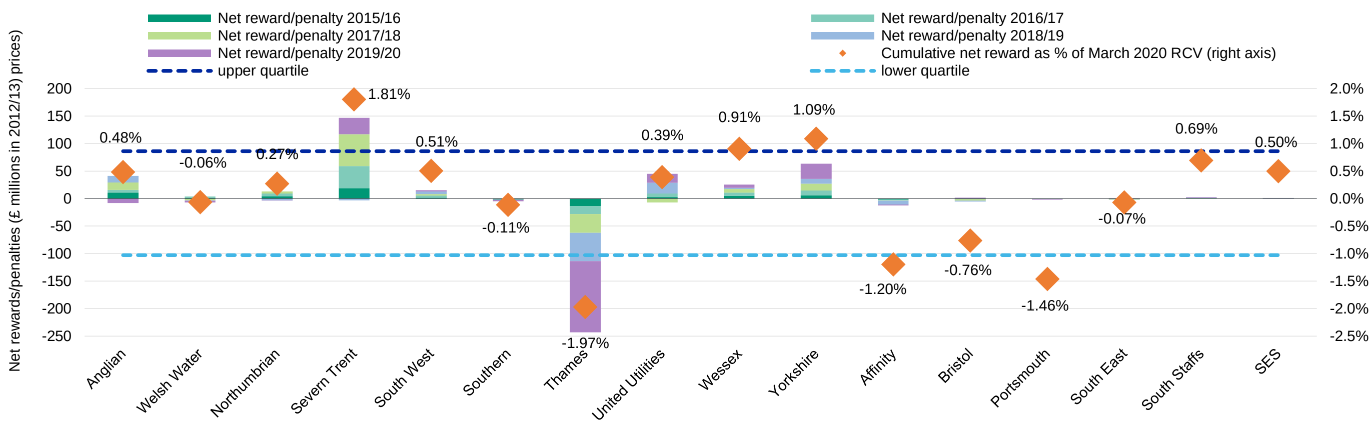
Solid operational performance record in last regulatory period, but pressures in AMP7

Welsh Water exhibited solid performance over AMP6, broadly in line with its targeted objectives. The company suffered a small cumulative net penalty of £3.1 million (in 2012/13 prices) on outcome delivery incentives (ODIs) in aggregate for the five years, which is carried over into AMP7 revenues.

Exhibit 7

Welsh Water's ODI rewards and penalties have generally offset each other during AMP6

Cumulative ODI reward/penalties (in 2012/13 prices) in absolute terms (LHS) and relative to March 2019 RCV (RHS)



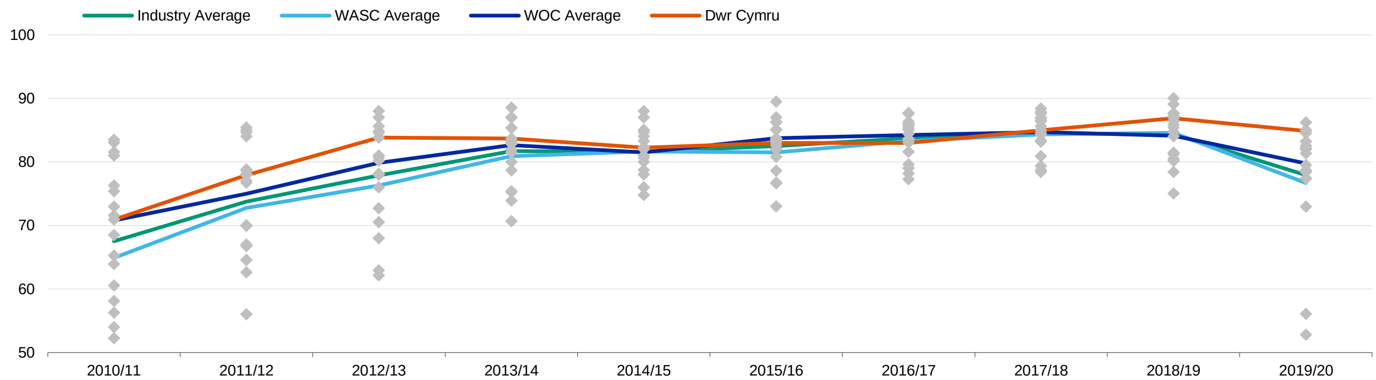
Source: Companies' annual performance reports, Ofwat, Moody's Investors Service

On customer service, Welsh Water generally maintained a score under the Service Incentive Mechanism (SIM) – which measures direct customer service – in line with the industry average, but improving over the last two years of AMP6. Nevertheless, it will still face a small penalty of £1.0 million based on Ofwat's reconciliation of current period's performance, which will marginally reduce the company's revenue for AMP7.

Exhibit 8

Welsh Water's customer service has been at or above the sector average

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



Source: Companies' annual performance reports, Ofwat

Looking ahead, we estimate that Ofwat's final determination could result in Welsh Water incurring performance penalties in the range of £30-40 million over the 2020-25 period. We expect the majority of these penalties to be linked to stretching common targets on water supply interruptions and internal sewer flooding, as well as tightened bespoke targets on external sewer flooding. While management anticipates rewards on some performance measures, in particularly around customer service, we consider an overall net penalty likely.

Capex programme continues to reflect customer interests, with a significant cost challenge from 2020

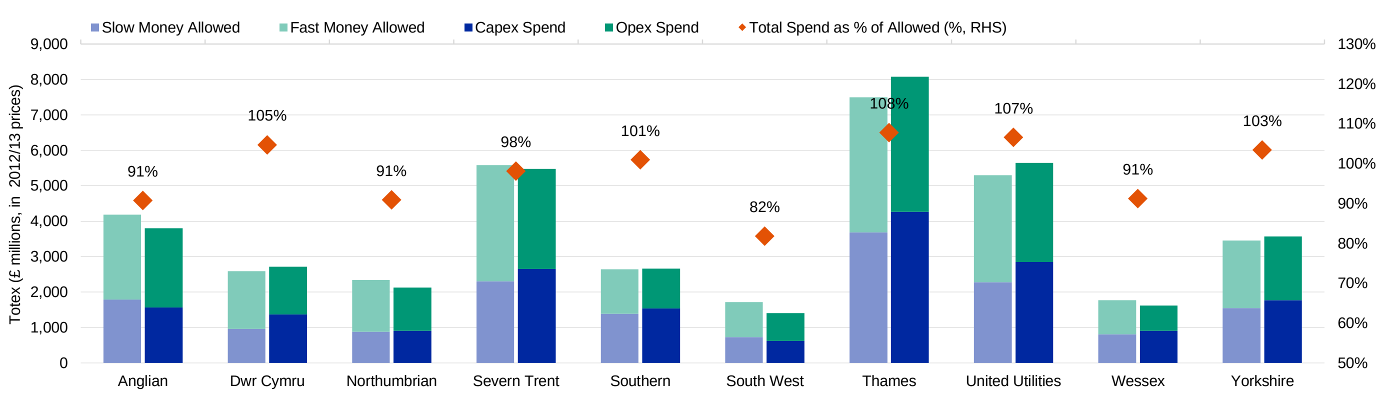
As is typical for the sector, Welsh Water faces some risk in the execution of its significant capital programme and the associated financing and refinancing requirements. For AMP6, Welsh Water had been allowed total expenditure (totex, which includes opex and capex) of around £2.6 billion (in 2012/13 prices) for the wholesale part of the business, implying real RCV growth of just over 7% if capex is spent in line with assumptions.

The company spent 105% of its allowance over the AMP6 period, mostly due to re-investing additional monies on behalf of its customers (just under £200 million over the five-year period). While this investment is in excess of monies agreed for the period, it will still be recognised as overspend against the regulatory allowance. In this context, Ofwat increased Welsh Water's RCV and revenue for AMP7 by £47.0 million and £23.9 million (in 2017/18 prices), respectively, reflecting AMP6 totex performance.[1]

Exhibit 9

Welsh Water's overall investments exceeded totex allowance for the period as the company re-invested outperformance for the benefit of customers

Cumulative spend (in £ millions) over AMP6 versus allowed totex



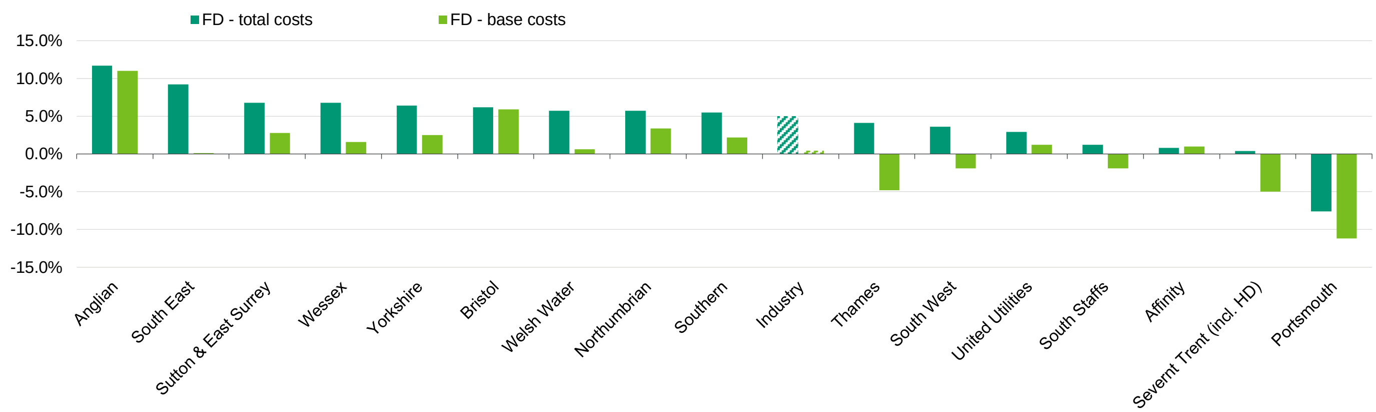
Source: Companies' performance reports, Ofwat, Moody's Investors Service

For AMP7, Welsh Water faces a significant efficiency challenge of £171 million (or 22.5%) on enhancement and £25 million (or 10.9%) on household retail expenditure. However, on base operating and maintenance expenditure, the company received roughly £10 million in excess of its business plan request and management expects to be able to offset the remaining efficiency challenge on enhancement and retail expenditure through additional savings on base costs.

Exhibit 10

Ofwat's final determination shows an overall totex challenge of 5.6% for Welsh Water over AMP7

Cost efficiency challenge at final determination (FD)



FD efficiency challenge compares FD allowance against companies' response to draft determinations (DD) from August 2019. Comparison of base cost efficiencies may be affected by re-classification from base to enhancement expenditure (and vice versa) between DD and FD.
Source: Ofwat

The efficiency gap on enhancement expenditure, with nearly half of the amount requested by the company disallowed by the regulator, mainly relates to investments around long-term resilience and network water quality. 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.

Exhibit 11

Movement in key enhancement disallowances between draft determination (DD) and final determination (FD) relative to the company's request

Amounts in £ millions

Enhancement area	WSH	DD	FD	Explanation provided by Ofwat at DD
Supply & Demand side	94.5	32.8	90.5	Water: Ofwat increased allowance for project Cartref, Tywyn Aberdyfi scheme and the request for installing new meters
Network water quality	117.9	59.2	96.9	Ofwat increased allowance due to additional data from the company and support from the Drinking Water Inspectorate
Security	19.5	9.7	12.2	SEMD and non-SEMD costs: 10% challenge for non-SEMD and reduced allowance for SEMD as the company is already spending above the benchmark
Wastewater resilience	72.2	3.9	3.9	No change in Ofwat's view that sewer flooding risks should be covered by the econometric approach to base costs
Water resilience	113.7	3.6	18.7	Allowed investment for "Extending our South Wales grid" but no allowance for "Hereford supply resilience" as Ofwat thinks that this is either covered in other areas or not sufficiently evidenced
Transitional expenditure	74.4	20.9	33	Loughor Estuary: related to reduction of discharges due to the European Court of Justice ruling; only 2019-20 costs are allowed, but not prior years' expenditure
Supply strategy	73	13.6	13.6	The Cwm Taf project has been moved to DPC and only procurement process costs are allowed
Total	565.2	143.7	268.8	

Source: Company's business plan, Ofwat's draft and final determination

In addition, retail costs continue to be a pressure point, 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 increasing the cost of bad debt management. The company has made operational losses on the retail activities over AMP6, and is running the risk to do so also for AMP7.

Structural Considerations

Limited benefits from structural protections at current rating level

Welsh Water's debt structure includes a set of financial covenants, particularly limitations on additional indebtedness and permitted distributions (including customer dividends and distributions to the holding company), but the company currently maintains significant headroom against these. We therefore 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 A3 rating level.

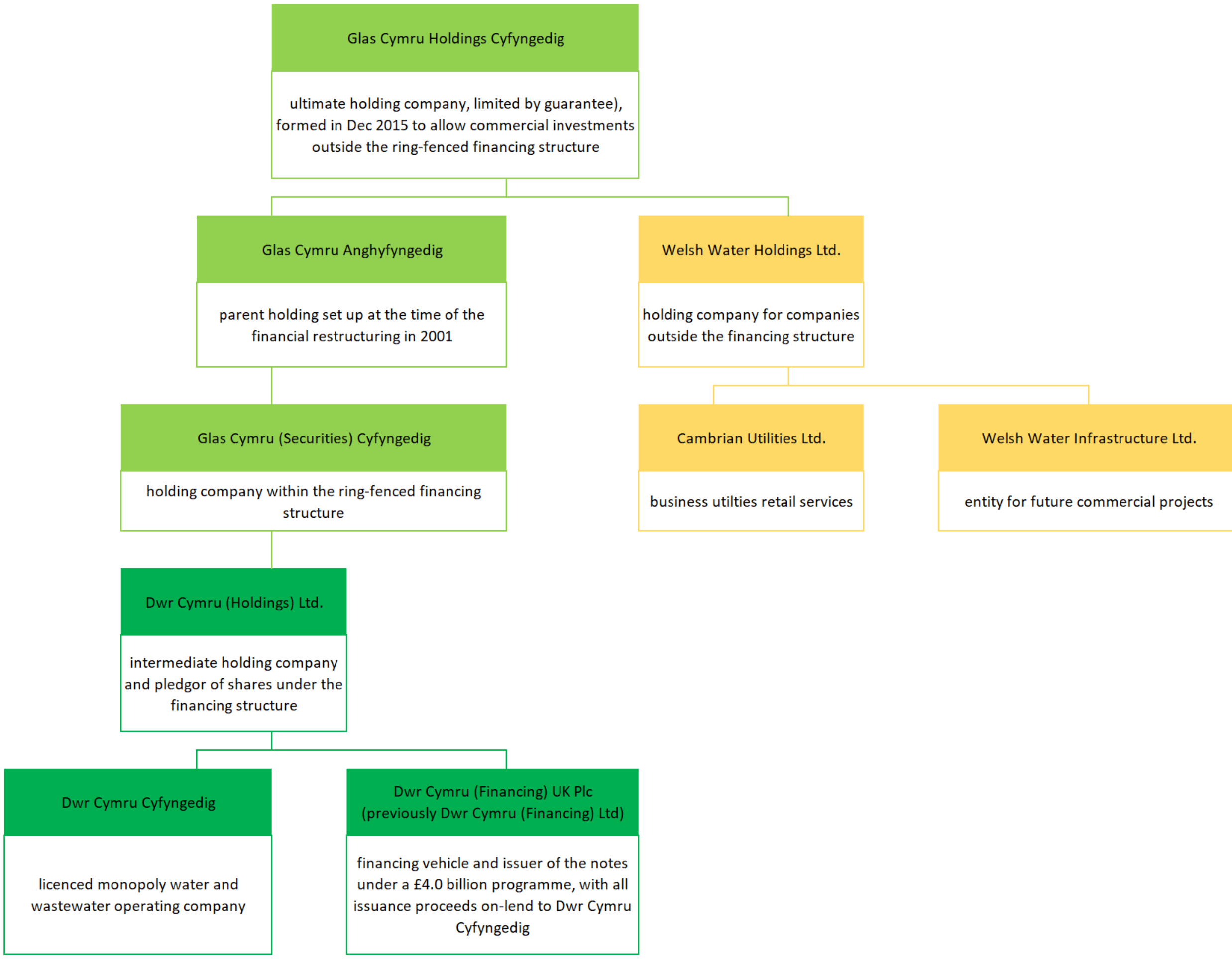
We also note that Welsh Water's covenant structure is slightly different from other highly covenanted transactions in the UK water sector as the protection offered by certain financial covenants is less critical for a company without equity shareholders.

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.

Because the covenants provide limited protection at current rating levels, we also consider developments within the wider group that could have credit implications. 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 12 highlights that currently all of the consolidated group's debt sits within the financing structure around the core operating company.

Exhibit 12
Simplified group and debt structure as at 31 March 2020



Inter company loans	2,984.3
Other debt:	
EIB/KfW	721.6
Finance Leases	424.1
Loan - Dwr Cymru Holdings	2.8
Local authority loans	0.3

Notes issued:

Class A (guaranteed by Assured Guaranty (London) Plc) - senior and pari passu with Class B

A1	351.1	2028	IL - RPI swapped in 2020 (£350m notional)
A4	446.8	2030	IL - RPI
A5	145.3	2031	IL - RPI
A6	148.5	2057	IL - RPI swapped in Dec 2006 (£100m notional)

Class B (no financial guarantee) - senior and pari passu with Class A

B1	325.0	2021	
B3	216.8	2026	IL - RPI
B4	128.3	2027	IL - RPI
B5	74.2	2057	IL - RPI
B6	346.8	2048	IL - RPI
B7	300.0	2036	
B8	300.9	2033	IL - RPI swapped in 2020 (£300m notional)

Class C - junior, subordinated to Class A & B

C3	200.6	2026	IL - RPI swapped in 2020 (£200m notional)

Source: Company's investor report

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 £4.0 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.

New junior notes add additional layer to the company's capital structure

In February 2020, Welsh Water issued £200 million subordinated notes, which rank junior to the existing debt issued by Dwr Cymru (Financing) UK Plc. Under the terms of its highly-covenanted financing structure the company is permitted to have a subordinated class of debt (referred to as Class C in the documentation) as part of its capital structure. At inception of its current financing arrangements in 2001, Welsh Water issued £250 million Class C notes, equivalent to around 12-13% of total debt at that time. However, all previously outstanding Class C notes were repaid in 2005 and 2010, respectively, and Welsh Water had not issued any junior class of debt until February 2020.

The Baa2 rating of the junior notes, two notches below Welsh Water's A3 CFR, reflects (1) their subordinated position relative to the senior debt, which ranks ahead in the cash flow waterfall; and (2) the limited decision-making ability of junior note holders so long as senior debt remains outstanding. The two-notch differential takes into account Moody's view that the senior and junior classes of debt have similar probabilities of default but the loss severity for the junior tranche will be significantly greater, post any default.

The re-introduction of junior debt into Welsh Water's capital structure does not result in any ratings uplift for the senior debt relative to the CFR. This is because the quantum of junior notes, at around 5% of aggregate senior and junior debt, is modest while the tenor of the notes, around six years, implies that they may not be a permanent part of the capital structure. The limited proportion of junior debt, in particular, means that they offer limited loss-absorption capacity for senior creditors, relative to sector peers with highly-covenanted financing structures. The senior debt rating, therefore, remains aligned with Welsh Water's CFR at A3.

ESG considerations

Not-for-dividend ownership structure supports credit quality

Our credit analysis for Welsh Water takes into account social and governance considerations associated with the wider group's organisational structure, which is a key determinant of its financial policy. Social considerations primarily relate to responsible production and demographic and societal trends, while governance considerations are linked to organisation structure and board structure, policies and procedures.

Welsh Water's ultimate parent, Glas Cymru Holdings Cyfyngedig, is a company limited by guarantee, owning Welsh Water on behalf of its customers. As such the group does not require any dividend distributions. Instead, profits made by the company have largely been used to reduce gearing – from around 90% of net debt to RCV in 2001 to below 60% today – and accumulate cash reserves.

Welsh Water's current target gearing level, adopted in 2015, of around 60% is one of the lowest in the UK water sector. Any future surplus generated in the context of this target may be returned to customers (as has been the case in the past), 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.

Given its organisational structure, resulting conservative financial policy as well as the Welsh Government's more cautious stance towards competition, our guidance for Welsh Water's AICR is currently materially less demanding than for its English peers.

Generally low exposure to impact of COVID-19

The rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook, falling oil prices, and asset price declines have created a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

We consider the UK water companies to have an overall low exposure to the impact of COVID-19 due to (1) the regulatory protections against consumption volumes or collected revenues being lower than expected; and (2) solid liquidity profiles that will act as a buffer against short-term stress.

Water consumption by non-household customers will likely be lower than expected in the regulatory year ending March 2021 and companies have been asked by the regulator to support non-household business as well as vulnerable household customers that are struggling to pay. We expect this to result in lower revenue collections, particularly from non-household customers, than assumed in the regulatory determination, primarily during the first half of the financial year ending March 2021. Under the regulatory framework, a revenue shortfall can be collected with a two year lag, i.e. in the regulatory year ending March 2023; however, given the unprecedented circumstances, some kind of mutualisation of the impact across the industry, including perhaps a longer tailed recovery cannot be excluded.

Through lower consumption and the impact on revenue, exacerbated by collection delays, the coronavirus outbreak will weigh on financial metrics, in particular interest cover ratios. However, taking into account the regulatory protections we expect the affect to be largely one of timing. In this context, access to cash and other readily available liquidity sources will be paramount in supporting overall credit quality, and Welsh Water currently has sufficient resources to cover its funding needs for the entire AMP7 period.

Liquidity Analysis

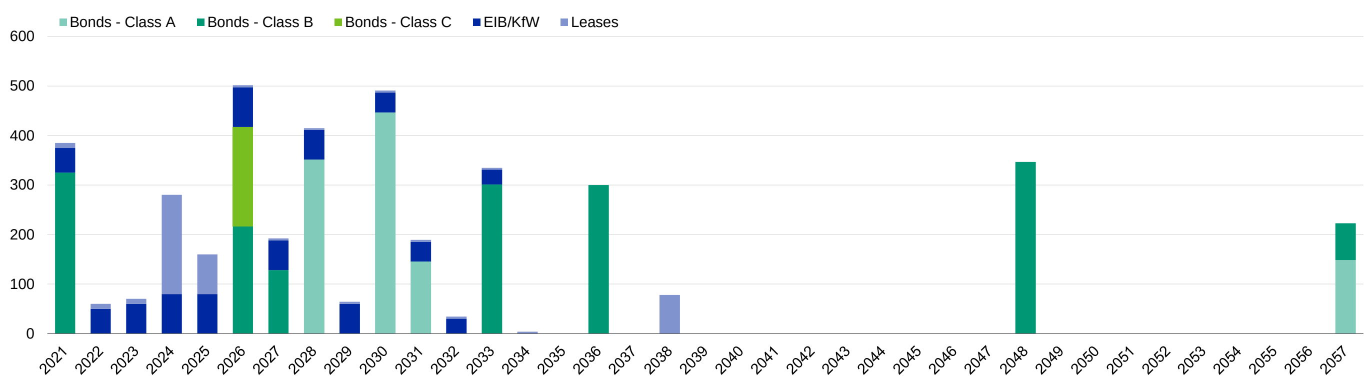
Welsh Water's liquidity is strong, underpinned by the stable and predictable cash flows generated by its regulated utility activity. As at 31 March 2020, the Glas group had a cash position of just over £667 million (including short-term deposits), mostly attributable to Welsh Water, and undrawn credit facilities of £170 million, available until November 2020. In May 2020, £60 million of the revolving credit facilities were renewed for two years with an option to extend for a further year, and in August 2020 another £20 million was renewed and increased to £30 million for two years (again with a one-year extension option). Management expects to renew the remaining £90 million of the now £180 million facilities as they fall due.

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.

Following the refinancing of the 2021 bond, which is fully funded, the next major debt maturities relate to the £211 million 4.377% RPI-linked bond, due in March 2026, and the newly issued £200 million junior bond, maturing in the same year.

Exhibit 13

Welsh Water's debt maturities are well spread out



Source: Company's investor report

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 on a historical basis and A2 on a forward-looking basis, with the former being one notch lower and the latter being one notch higher than the currently assigned rating of A3.

Exhibit 14

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

Regulated Water Utilities Industry [1][2]	Current FY 3/31/2020		Moody's 12-18 Month Forward View As of August 2020 [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	Aa	Aa
e) Scale and Complexity of Capital Programme & Asset Condition Risk	A	A	Aa	Aa
Factor 2 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	A	A
Factor 3 : Leverage and Coverage (40%)				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.5x	Ba	1.4x - 1.6x	Baa
b) Net Debt / Regulated Asset Base (3 Year Avg)	58.1%	Baa	58% - 60%	Baa
c) FFO / Net Debt (3 Year Avg)	9.5%	Ba	10% - 11%	Baa
d) RCF / Net Debt (3 Year Avg)	9.5%	Baa	10% - 11%	A
Rating:				
Scorecard-Indicated Outcome Before Notch Lift		Baa2		A2
Notch Lift	0.5	0.5	0.5	0.5
a) Scorecard-Indicated Outcome		Baa1		A2
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) At at 03/31/2020. (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 15

Category	Moody's Rating
DWR CYMRU CYFYNGEDIG	
Outlook	Stable
Corporate Family Rating	A3

Source: Moody's Investors Service

Appendix

Exhibit 16

Dwr Cymru Cyfyngedig

Selected peer comparison

	Dwr Cymru Cyfyngedig A3 Stable			Wessex Water Services Limited Baa1 Stable			United Utilities Water Limited A3 Stable			Severn Trent Water Limited Baa1 Stable		
(in GBP million)	FYE Mar-18	FYE Mar-19	FYE Mar-20	FYE Mar-18	FYE Mar-19	FYE Mar-20	FYE Mar-18	FYE Mar-19	FYE Mar-20	FYE Mar-18	FYE Mar-19	FYE Mar-20
Revenue	757	782	779	541	548	552	1,717	1,798	1,850	1,607	1,673	1,715
EBITDA	527	427	418	340	341	330	1,190	1,175	1,167	1,055	1,146	1,118
Regulated Asset Base (RAB)	5,471	5,673	5,907	3,142	3,264	3,206	11,089	11,465	11,791	8,920	9,349	9,412
Total Debt	3,388	3,811	4,158	2,183	2,243	2,352	7,695	7,803	8,411	5,968	6,378	6,447
Net Debt	3,100	3,310	3,490	2,147	2,243	2,310	7,195	7,477	7,910	5,956	6,365	6,432
Adjusted Interest Coverage Ratio	1.4x	1.5x	1.5x	2.0x	1.8x	1.6x	2.9x	2.9x	2.5x	1.7x	2.2x	1.9x
FFO / Net Debt	9.9%	9.4%	9.3%	11.8%	11.2%	10.3%	13.4%	13.1%	12.9%	13.0%	13.5%	13.3%
RCF / Net Debt	9.9%	9.4%	9.3%	7.5%	7.2%	6.5%	9.0%	8.1%	6.4%	9.5%	10.0%	9.5%
Net Debt / Regulated Asset Base	56.7%	58.3%	59.1%	68.3%	68.7%	72.1%	64.9%	65.2%	67.1%	66.8%	68.1%	68.3%

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 17

Dwr Cymru Cyfyngedig

Moody's adjusted debt breakdown

(in GBP million)	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19	FYE Mar-20
As Reported Total Debt	2,943	2,978	3,359	3,766	4,119
Pensions	57	95	80	96	87
Non-Standard Public Adjustments	(48)	(49)	(51)	(51)	(49)
Moody's Adjusted Total Debt	2,952	3,024	3,388	3,811	4,158
Cash & Cash Equivalents	(135)	(101)	(289)	(501)	(667)
Moody's Adjusted Net Debt	2,817	2,924	3,100	3,310	3,490

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 18

Dwr Cymru Cyfyngedig

Moody's adjusted FFO breakdown

(in GBP million)	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19	FYE Mar-20
As Reported Funds from Operations (FFO)	265	228	212	221	208
Pensions	2	8	7	7	12
Capitalized Interest	(4)	(10)	(16)	(16)	(14)
Alignment FFO	1	(18)	(40)	(35)	(25)
Unusual Items - Cash Flow	15	31	55	46	42
Non-Standard Public Adjustments	62	72	89	87	101
Moody's Adjusted Funds from Operations (FFO)	340	311	307	310	323

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 19
Dwr Cymru Cyfyngedig
Selected historical financial data, Moody's-adjusted

(in GBP million)	FYE Mar-16	FYE Mar-17	FYE Mar-18	FYE Mar-19	FYE Mar-20
INCOME STATEMENT					
Revenue	743	744	757	782	779
EBITDA	495	377	527	427	418
EBITDA margin %	66.6%	50.6%	69.6%	54.7%	53.7%
Interest Expense	133	154	193	186	179
Net income	57	(87)	(36)	(125)	(181)
BALANCE SHEET					
Cash & Cash Equivalents	135	101	289	501	667
Net Property Plant and Equipment	4,837	5,056	5,296	5,521	5,748
Total Assets	5,628	5,848	6,321	6,784	7,225
Total Liabilities	4,550	4,740	5,090	5,563	6,093
Total Debt	2,952	3,024	3,388	3,811	4,158
Net Debt	2,817	2,924	3,100	3,310	3,490
Total Equity	1,079	1,108	1,231	1,221	1,132
CASH FLOW					
Funds from Operations (FFO)	340	311	307	310	323
Cash Flow From Operations (CFO)	301	284	294	307	305
Dividends					
Retained Cash Flow (RCF)	340	311	307	310	323
Capital Expenditures	(257)	(315)	(409)	(452)	(453)
Free Cash Flow (FCF)	43	(32)	(116)	(145)	(148)
INTEREST COVERAGE					
(FFO + Interest Expense) / Interest Expense	3.6x	3.0x	2.6x	2.7x	2.8x
Adjusted Interest Coverage Ratio	1.5x	1.5x	1.4x	1.5x	1.5x
LEVERAGE					
Regulated Asset Base (RAB)	4,989	5,222	5,471	5,673	5,907
Net Debt / Regulated Asset Base	56.5%	56.0%	56.7%	58.3%	59.1%
FFO / Net Debt	12.1%	10.6%	9.9%	9.4%	9.3%
RCF / Net Debt	12.1%	10.6%	9.9%	9.4%	9.3%

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

Endnotes

1 Based on the company's disclosure for the last year of AMP6, the so-called 'blind year', we expect an additional small adjustment of £4.0 milion and £2.5 million on RCV and revenues, respectively, for totex performance in 2019/20, but this will only be recognised at the true-up in the 2024 price review.

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