



Moody's Investors Service

Credit Opinion: Dwr Cymru Cyfyngedig

Global Credit Research - 25 Sep 2009

Cardiff, United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	A3

Contacts

Analyst	Phone
Stefanie Voelz/London	44.20.7772.5454
Neil Griffiths-Lambeth/London	
Monica Merli/London	

Key Indicators

Dwr Cymru Cyfyngedig

	Mar-09	Mar-08	Mar-07	Mar-06
Net Debt / RCV	72.6%	70.3%	71.0%	76.9%
Adjusted ICR	1.7x	1.7x	1.4x	1.4x
FFO Net Interest Cover	3.1x	3.0x	2.7x	2.5x
FFO / Net Debt	10.3%	10.5%	9.4%	8.8%
RCF / Net Debt	10.3%	10.5%	9.4%	8.8%
RCF / Capex	77.6%	96.0%	88.3%	96.0%

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Company Profile

Dwr Cymru Cyfyngedig ("Welsh Water") is the sixth-largest UK water utility by regulatory capital value ("RCV"), providing water and sewerage services to approximately 1.2 million households and over 100,000 business customers in a region that covers most of Wales and certain adjoining areas of England. Welsh Water's ultimate parent company is Glas Cymru Cyfyngedig ("Glas Cymru"), a not-for-profit organisation. In the fiscal year 2008/09, Welsh Water had a RCV of GBP3,574 million and reported revenues of GBP657 million and operating profit of GBP155 million.

Rating Rationale

The A3 corporate family rating (CFR) consolidates the legal and financial obligations of Welsh Water, its funding vehicle Dwr Cymru (Financing) Limited and the three holding companies that are in the ring-fenced group. In line with our approach towards similar structured transactions (such as Anglian Water Services rated in 2002), Moody's rating assessment of Welsh Water is the result of the evaluation of three main factors, (i) the business risk profile of the company, (ii) its financial metrics and (iii) the structural enhancements of the bond covenant and security package.

Business Profile

Welsh Water's business risk profile is very low in line with that of the UK water sector as a whole, which is lower than for most other industries, due to its monopolistic nature and a well-established and transparent regulatory framework. Prices for the next regulatory period (April 2010 - March 2015, or "AMP5") are currently under review, and Ofwat, the UK water sector's economic regulator published its draft determination in July 2009. In the draft determination Welsh Water has been required to reduce prices over AMP5 by an average of 1.1% p.a. in real terms. This compares to an average annual price reduction of 0.2% p.a. for the industry as a whole and a 0.7% increase proposed in Welsh Water's final business plan.

For the next regulatory period Welsh Water will have to face relatively challenging efficiency targets, as the company has ranked below average for its operational efficiency in Ofwat's latest assessment of 2007/08 (lower Band C for water and lower Band B for sewerage services). However, the regulator also recognised Welsh Water's significant improvement in its operational performance over recent years, which will result in an uplift of 0.1% p.a. to its price limits. Nevertheless, ongoing cost pressures, e.g. in relation to rising power costs, are likely to influence the company's performance going forward.

The draft determination also proposes a weighted average cost of capital of 4.5% (real, post-tax) for the industry, which is below the company's final business plan assumptions of around 4.9%. As discussed below, Moody's considers that Welsh Water would have headroom to absorb the current regulatory proposals, if confirmed by Ofwat in its final determination for AMP5 in November 2009. This view takes into account the significant flexibility that the company has in managing its capital structure. This flexibility is a function of Welsh Water's ownership structure, whereby Moody's rating assessment also reflects Glas Cymru's sole purpose of acting as a holding company and ensuring that Welsh Water carries out its functions and responsibilities in accordance with the terms of its licence and other applicable statutory requirements.

Financial Profile

The current rating reflects the ongoing strengthening of the company's financial metrics since it adopted a highly leveraged structure in May 2001, resulting in an Adjusted Interest Coverage Ratio (defined by Moody's as Funds from Operations less Regulatory Capital Charges to Net Interest) of around 1.7x post-customer rebates and 1.9x pre-customer rebates, and a ratio of Net Debt to RCV around 70% over the past years. We note that the increase in gearing between March 2008 and March 2009 is primarily due to the volatility in RPI over the past year combined with timing differences affecting the RPI used to rebase index-linked debt versus the RPI used to write forward the RCV.

Moody's notes that given the absence of dividends due to the not-for-profit status of its ultimate parent company, Glas Cymru, Welsh Water would theoretically be able to continue to deleverage at a rapid pace as envisaged in the period since the financial structure has been put in place. However, the A3 CFR and stable outlook assume that the company's management will maintain leverage on the basis of Net Debt to RCV around 70%, as publicly communicated. The not-for-profit nature of its parent company, with no shareholders and therefore no dividend pressures, would allow Welsh Water to retain cash reserves and counteract negative economic pressures by ultimately reducing or eliminating the customer dividend. Thus, Welsh Water also retains significant flexibility to manage its large capital programme.

Welsh Water's capital expenditure programme is set to continue at a relatively high level over the next regulatory period, with a total capex programme (gross of grants and contributions) for AMP5 of GBP1.1 billion (according to Ofwat's draft determination and in 2007/08 prices), which corresponds to a real growth in the regulatory asset base of around 3%. The main focus will be on maintenance expenditure. The programme is around 15% lower than the GBP1.3 billion proposed in Welsh Water's final business plan.

Structural Considerations

The A3 CFR factors in some degree of uplift (albeit not a full notch) stemming from the structural enhancements of Welsh Water's financing structure, including (i) the presence of a liquidity facility of GBP 150 million, (ii) a first ranking fixed charge over the shares in the company and (iii) 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. Moody's notes that the degree of uplift is lower than for comparable transactions (such as Anglian or Southern Water) as the protection provided by the covenant structure is limited at Welsh Water's A3 rating level. We also add that Welsh Water's covenant structure is slightly different from the other transactions as the protection offered by certain financial covenants is less critical for a not-for-profit company without equity shareholders. Furthermore, the benefit of the security provided to bondholders remains limited by the regulated and essential nature of the services provided by Welsh Water as governed by its licence and the Water Industry Act 1991.

Liquidity

Welsh Water's liquidity profile is very strong, supported by (i) the absence of dividend requirements due to its not-for-profit status, (ii) the stable and predictable cash flows generated by its regulated utility activity, (iii) the existence of GBP139 million of cash and cash equivalents as well as (iv) GBP420m of undrawn committed bank facilities available at 31 March 2009. Moody's regards those sources of funds as sufficient to cover the group's needs over the next 12 months, including limited short-term debt repayments and capital investments. The next major debt maturity will occur in March 2011, when the company intends to repay its GBP125 million Class C Notes to avoid the embedded coupon step-up.

We add that additional comfort is taken from the existence of a GBP150m special liquidity facility which would be available to the company to service its debt in the event of a standstill being declared following a breach of financial covenants.

Rating Outlook

The stable outlook reflects Moody's expectation that the company will continue to demonstrate leverage around 70% of Net Debt to RCV going forward.

What Could Change the Rating - Down

- A materially unfavourable change in the regulatory framework
- Serious underperformance in operating or capital expenditure
- Significant increases in the sums rebated to customers resulting in the company failing to maintain its leverage at around 70%

What Could Change the Rating - Up

Ongoing deleveraging, resulting in a further reduction of the ratio of Net Debt to RCV below 65%

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