STANDARD & POOR'S

Global Credit Portal
RatingsDirect®

March 24, 2010

Dwr Cymru (Financing) Ltd.

Primary Credit Analyst:
Tania Tsoneva, London (44) 20-7176-3489; tania_tsoneva@standardandpoors.com

Secondary Credit Analyst:
Paul Lund, London (44) 20-7176-3715; paul_lund@standardandpoors.com

Table Of Contents

Dwr Cymru (Financing) Ltd.

Major Rating Factors

None

Strengths:
- Local monopoly position.
- Stable and predictable regulated cash flows up to 2015.
- Structural enhancements.
- Benign nonprofit ownership structure.
- Commitment to decrease leverage.

Weaknesses:
- High leverage.
- Regulatory reset risk.
- Challenging efficiency targets.
- Recurrent large capital investment program.

Rationale

The 'A' long-term debt ratings on the senior secured, MBIA-wrapped class A bonds, class B bonds, and Standard & Poor's underlying rating (SPUR), and the long-term 'BBB+' debt ratings on the junior class C bonds issued by U.K.-based special-purpose vehicle (SPV) Dwr Cymru (Financing) Ltd. (Dwr Cymru), reflect Standard & Poor's Ratings Services' view of various structural features designed to enhance cash flow certainty for bondholders. The debt ratings also reflect the underlying credit quality of Dwr Cymru Cyfyngedig (Welsh Water), the regulated water and wastewater business owned by nonprofit Glas Cymru Cyfyngedig (Glas Cymru).

Under our criteria, a rating on a monoline-insured debt issue reflects the higher of the rating and outlook on the monoline and the SPUR. Therefore, the rating on the Class A bonds, guaranteed by MBIA U.K. Insurance Ltd. (BB+/Negative/--), reflects the higher SPUR rating.

The debt ratings are underpinned by the stability of Welsh Water's regulated monopoly water and wastewater business. The rating strengths include the liquidity mandated within Dwr Cymru's financial structure, a strong overall covenant package, and strict limitations on business activities. The senior debt is structurally protected from the junior debt, which is subordinated and cannot force a default of the senior debt. Further support is provided by the trend of continuous deleveraging and the board's commitment to target net debt to regulatory capital value (RCV) of about 70%. At the same time, the nonprofit ownership structure of Glas Cymru, with its lack of shareholders, eliminates pressure to leverage the balance sheet through shareholder distributions.

These strengths are offset by the risks related to an aggressive--albeit strengthening--capital structure, on the back of high leverage and modest debt-protection measures. Additional constraining factors are the risks associated with the tariff reset by the water services regulator in England and Wales, the Office of Water Services (Ofwat), every five years, and the challenging regulator-induced efficiency targets required over the next regulatory period starting April 1, 2010.

Key business and profitability developments

On Nov. 26, 2009, Ofwat announced its determination for the next regulatory period starting April 1, 2010, which provides good visibility of earnings and cash flows over the next five years. We believe the determination provides Welsh Water with a tough set of allowances, requiring a 4% drop in cumulative revenue and operating efficiency cuts of about £39 million by 2014-2015. Management intends to achieve its cost targets through phased workforce reduction, power procurement savings, and power usage savings via schemes in progress.

Furthermore, Welsh Water has not been able to reach agreements for the continuation of its outsourced operating contracts with United Utilities PLC (BBB-/Stable/A-3) and Kelda Water Services (not rated), for the regulatory period to March 31, 2015. It is therefore terminating the contracts and bringing the employees working under them in-house. Over the past several years, the outsourced business model has focused on performance incentives and targeted costs. This allowed Welsh Water to achieve substantial cost savings and to move upward in peer performance ranking. Nevertheless, the restructuring eliminates the principal–agent problem, whereby the asset owner, Welsh Water, retains full license responsibility for the operational activities of third parties.

Key cash flow and capital-structure developments

Glas Cymru's cash flow protection measures are modest on the back of high, though declining leverage, but in our view, they should be viewed in the context of the credit enhancements under the corporate securitization structure. Headroom under covenants has increased significantly with senior and class C net debt to RCV of about 71% on Dec. 31, 2009, compared with a trigger level of 90%. We anticipate that senior interest coverage before and after capital maintenance will remain above the trigger levels of 2.0x and 1.0x, respectively, over the next regulatory period. The actual levels much depend on the company's ability to implement its cost-saving plan and maintain an adequate operating performance.

The next regulatory period marks the first time since Welsh Water was acquired by Glas Cymru in 2001 that its prefinancing cash flows after capital expenditures (capex) will turn positive. This supports the trend of gradual deleveraging, especially in the absence of pressure for customer dividends, which have already been rescinded for 2010-2011. We anticipate that Glas Cymru will be able to reach and sustain its committed leverage target of about 70% (net debt to RCV), which provides substantial headroom under the 90% trigger covenant. The actual pace of deleveraging depends on Welsh Water's ability to contain costs within the stipulated allowances, and to a lesser degree, on the rate of inflation.

Liquidity

Strong liquidity, as mandated by the borrowing documents, is a central feature of Glas Cymru's financial structure, and consequently that of Dwr Cymru. Covenants relating to liquidity include a requirement to have sufficient cash and bank lines for the next 12 months of capex. Welsh Water's steady and predictable operating cash flow stream and minimal near-term debt maturities provide further support. The next bond redemption maturity is £125 million of subordinated class C bonds in March 2011. In addition, a £150 million liquidity facility at Dwr Cymru is available if Welsh Water were unable to pay its interest bills during a standstill period. Actual unrestricted liquidity, excluding accounts for debt service and customer rebates, was £83.3 million on Dec. 31, 2009. On the same date, undrawn committed bank facilities totaled £345 million, and Dwr Cymru had £75 million unused headroom for financing capital projects under its £100 million facility with European Investment Bank (AAA/Stable/A-1+), signed in October 2008.

Outlook

The negative outlook reflects our view of the risks surrounding Welsh Water's ability to meet its efficiency targets and the potential impact on the pace of deleveraging. Any deterioration in Welsh Water's operational performance, following the change to an in-house business model, or an inability to contain costs within Ofwat's allowances, could affect our assessment of the company's business profile and may result in a downgrade.

Conversely, if Welsh Water builds a good track record as an asset operator, maintains an adequate operational performance, keeps within its cost allowances, and continues to deleverage, we will likely remove the negative outlook.

Business Description

Dwr Cymru (Financing) Ltd. is an SPV that is owned by Glas Cymru, a Welsh nonprofit company, and is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers, and, to a lesser extent, investors, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates any pressure for dividends and other shareholder returns.

The operating company, Welsh Water, is the sixth largest of the 10 regulated water and sewerage companies in England and Wales according to RCV, which for Welsh Water was £3.6 billion on March 31, 2009. It serves about 1.3 million properties, including more than three million people across most of Wales and some adjoining areas of England.

Rating Methodology

With regard to this corporate securitization, we recognize the various structural elements that add to the certainty and stability of cash flow. The financial and corporate structures have been established so that the different debt tranches have different default characteristics. An issuer-level corporate credit rating, therefore, is not meaningful for either Glas Cymru or Dwr Cymru (Financing) Ltd.

The senior lenders to Dwr Cymru (Financing) Ltd. rank in priority over the junior lenders, and nonpayment of interest to junior lenders would not constitute an event of default for the senior lenders. Accordingly, the default risk for the senior debt is lower than is typical of corporate utility financings, where junior debt is usually subordinated to senior debt in bankruptcy, but nonpayment of the scheduled interest on the junior debt would be an event of default for the senior debt. The financial analysis behind the 'A' ratings on the senior debt is based on financial measures for the senior debt only. The financial analysis underpinning the 'BBB+' ratings on the junior debt is based on financial measures for both the junior and senior debt.

Business Risk Profile: Excellent, Underpinned By A Supportive Regulatory Framework But Challenging Operating Targets

Welsh Water's excellent business risk profile is supported by:

- The generally supportive and transparent regulatory framework in the U.K. water sector, which ensures a high degree of stability and predictability of earnings and cash flows. The regulatory structure is designed to provide companies with high-quality cash flows that are sufficient to finance their operations, provided they meet specified, preagreed operational and financial targets. Welsh Water's tariff review for 2010-2015 is characterized by the largest price decrease of all the water and sewerage companies regulated by Ofwat, a capex program similar in size to that of the previous regulatory period, and challenging cost efficiency targets.
- Little competitive threat and high barriers to entry in the company's appointed area. In the absence of genuine competition, Ofwat has established surrogate competition through regulatory comparison. Ofwat's recent proposal aimed at introducing competition in the water markets, however, might materially affect the credit profile of rated utilities. (For more information, please refer to the article titled "Enhanced Competition Could Alter Standard & Poor's Assessment Of The U.K. Water Sector," published Dec. 12, 2008, on RatingsDirect.) According to its Strategic Position Statement, the Welsh Assembly Government still has doubts about the benefits of further competition in the water sector in Wales.
- Steady progress in meeting Ofwat's targets for operational performance. In 2008-2009, Welsh Water ranked fourth among its peers in Ofwat's Overall Performance Assessment, a holistic basket of service measures. Most notably, the company has been compliant with its challenging leakage target for 12 consecutive years and has reduced the number of serious pollution incidents. However, the regulator has assessed the serviceability of Welsh Water's water noninfrastructure as marginal due to a number of coliform failures.

These strengths are to some degree offset by:

- The risks associated with regulatory reset reviews, undertaken by Ofwat every five years. The next price control review determination has been completed and is effective from April 1, 2010, until March 31, 2015.
- Welsh Water's lower ranking on operational efficiency than its peers. This results in tougher efficiency targets for Welsh Water. The company has been classified in the lowest band for relative operating efficiency. This band determines the catch-up factors that will help Welsh Water close the gap between it and the most efficient 'frontier' companies.
- Lack of track record as an asset operator since the termination of the outsourced contracts with United Utilities and Kelda Water Services. The outsourced business model focused on performance incentives and targeted costs. This allowed Welsh Water to achieve substantial cost savings and to move upward in peer performance ranking. The transition to in-house operations, however, eliminates the risk of having external parties undertake all of the company's capital and operating expenditures while the legal responsibility remained with the utility.

Financial Risk Profile: Aggressive Capital Structure Mitigated By Stable Cash Flows And Sustained Deleveraging

The main weaknesses of Glas Cymru's aggressive financial profile are:

- High, though declining leverage after the acquisition in May 2001. The board has publicly announced its intention to reduce and maintain leverage at about 70% of net debt to RCV.
- Modest financial ratios for the 'A' rating category, which should be interpreted in light of Dwr Cymru (Financing) Ltd.'s credit enhancement features. Over the next few years, we anticipate that funds from operations (FFO) interest coverage of total debt and adjusted FFO to debt will likely average about 2.0x and 6.7%, respectively, assuming adequate cost management.

These weaknesses are partially mitigated by:

- Protective structural features. These include considerable cash reserves and liquidity facilities, which will allow for continued debt servicing under stress; a comprehensive security package (albeit limited by the standard restrictions applying to the sector); an intercreditor agreement minimizing the rights of junior lenders; and a tight covenant package, which provides the senior bondholders with significant powers to influence the company in times of stress.
- Substantial financial flexibility, which stems from Glas Cymru's nonprofit structure and unused borrowing capacity. Instead of a dividend, the company can choose whether to rebate the cash generated in excess of targeted financial reserves to customers. The headroom between the covenant triggers and the current leverage levels has widened, with net debt to RCV of about 71% on Dec. 31, 2009, significantly lower than the trigger level of 90%.
- Positive prefinancing cash flows, despite substantial capex commitments over the medium-to-long term. Over 2010–2015, Glas Cymru is likely to generate positive free operating cash flows for the first time, thereby lessening the need for ongoing borrowing. The outcome for this five-year period is based on a capex program of about £1.1 billion at base-year prices. The program is heavily maintenance focused.
- Insulation from volatile credit market conditions through a prudent treasury policy embedded in the common terms agreement for managing interest rate, counterparty, and liquidity risks. Currently, almost all borrowings are at fixed or index-linked rates of interest, partly through the use of interest rate and retail price index swaps. Refinancing risk is mitigated through long-dated borrowings and a restriction of no more than 20% of maturing debt in any two-year period.

Financial Statistics/Adjustments

Glas Cymru has reported under International Financial Reporting Standards since April 1, 2005. Due to the different accounting treatment of infrastructure renewals expenditure (IRE), Glas Cymru's debt coverage ratios have been somewhat lower than those of its peers reporting under U.K. generally accepted accounting principles. The implementation of our revised methodology for IRE accounting is intended to address this discrepancy and increase comparability among U.K. water companies, (for more details, see "Revised Methodology for Adjusting Amounts Reported by U.K. GAAP Water Companies For Infrastructure Renewals Accounting," dated 27 Jan. 2010).

We adjust reported debt for surplus cash balances, which are not restricted for debt service or customer rebates. At year-end March 2009, Glas Cymru had a post-tax pension deficit of £5.4 million on its defined benefit pension scheme. We deduct the indexation component of inflation-linked debt of £41.4 million from FFO, in line with our revised methodology on index-linked debt (see "New Methodology For Inflation-Linked Debt Has No Immediate Effect On Ratings On U.K. Regulated Utilities," published on April 8, 2009, on RatingsDirect).

Table 1

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts*

	--Fiscal year ended Mar. 31, 2009--						
Dwr Cymru (Financing) Ltd. reported amounts							
(Mil. £)	**Debt**	**Shareholders' equity**	**Operating income (before D&A)**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Cash flow from operations**	**Cash flow from operations**
Reported	2,759.7	(152.1)	288.4	288.4	154.9	189.5	189.5

Table 1

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts* (cont.)

Standard & Poor's adjustments							
Postretirement benefit obligations	5.4	(0.4)	0.3	0.3	0.3	0.6	0.6
Surplus cash and near-cash investments	(95.4)	--	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	8.6	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	(19.2)
Accrual on index-linked debt	--	--	--	--	--	0.2	(41.2)
Total adjustments	(90.0)	(0.4)	0.3	0.3	8.9	0.8	(59.8)

Standard & Poor's adjusted amounts

	Debt	Equity	Operating income (before D&A)	EBITDA	EBIT	Cash flow from operations	Funds from operations
Adjusted	2,669.7	(152.5)	288.7	288.7	163.8	190.3	129.7

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 2

Dwr Cymru (Financing) Ltd. Peer Comparison*

(Mil. £)	Dwr Cymru (Financing) Ltd.¶	Anglian Water Services Financing PLC	Southern Water Services Ltd.¶
	--Fiscal year ended March 31, 2009--		
Revenues	657.2	1,037.4	677.8
Net income from continuing operations	(102.9)	317.3	97.4
Funds from operations (FFO)	129.7	303.3	246.7
Capital expenditures (capex)	244.2	340.6	277.7
Cash and short-term investments	43.9	913.3	200.0
Debt	2,669.7	5,293.0	3,524.8
Preferred stock	0.0	0.0	0.0
Equity	(152.5)	1,469.9	761.0
Debt and equity	2,517.2	6,762.9	4,285.8
Adjusted ratios			
EBIT interest coverage (x)	0.9	1.4	1.6
FFO interest coverage (x)	1.7	1.8	1.9
FFO/debt (%)	4.9	5.7	7.0
Discretionary cash flow/debt (%)	(2.0)	(1.4)	(3.4)
Net cash flow/capex (%)	53.1	59.7	45.6
Total debt/debt plus equity (%)	106.1	78.3	82.2
Return on common equity (%)	106.2	21.7	12.4
Common dividend payout ratio (unadjusted) (%)	0.0	92.5	101.5

Table 2

Dwr Cymru (Financing) Ltd. Peer Comparison* (cont.)

*Fully adjusted (including postretirement obligations). ¶Excess cash and investments netted against debt.

Table 3

Dwr Cymru (Financing) Ltd. Financial Summary*

	--Fiscal year ended Mar. 31--		
(Mil. £)	**2009**	**2008**	**2007**
Revenues	657.2	622.9	578.0
Net income from continuing operations	(102.9)	1.9	33.3
Funds from operations (FFO)	129.7	97.2	114.2
Capital expenditures (capex)	244.2	173.2	166.2
Cash and short-term investments	43.9	39.1	158.0
Debt	2,669.7	2,569.1	2,595.9
Preferred stock	0.0	0.0	0.0
Equity	(152.5)	(42.2)	(45.9)
Debt and equity	2,517.2	2,526.9	2,550.0
Adjusted ratios			
EBIT interest coverage (x)	0.9	1.1	1.0
FFO interest coverage (x)	1.7	1.8	1.6
FFO/debt (%)	4.9	3.8	4.4
Discretionary cash flow/debt (%)	(2.0)	(2.5)	(1.8)
Net cash flow/capex (%)	53.1	56.1	68.7
Debt/debt and equity (%)	106.1	101.7	101.8
Return on common equity (%)	106.2	(4.3)	(53.2)
Common dividend payout ratio (unadjusted) (%)	0.0	0.0	0.0

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

Ratings Detail (As Of March 24, 2010)*	
Dwr Cymru (Financing) Ltd.	
Senior Secured (1 Issue)	A
Senior Secured (4 Issues)	A/Negative
Subordinated (1 Issue)	BBB+
Subordinated (1 Issue)	BBB+/Negative
Business Risk Profile	Excellent
Financial Risk Profile	Aggressive
Debt Maturities	
As of Sept. 30, 2009: 2010: £14.4 mil. 2011: £147.5 mil. 2012: £25.7 mil. 2013: £30.8 mil. 2014: £36.0 mil. Thereafter: £2.428 bil. Total: £2.683 bil.	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.