FitchRatings

FITCH AFFIRMS DWR CYMRU'S SENIOR SECURED DEBT AT 'A'/'BBB+'

Fitch Ratings-London-23 March 2011: Fitch Ratings has affirmed Dwr Cymru (Financing) Ltd's (Dwr Financing) senior secured ratings for its class A debt and class B debt (both wrapped and unwrapped) at 'A' and its class C debt at 'BBB+'. The Outlooks for the senior secured ratings are Stable.

Dwr Financing is Dwr Cymru Cyfyngedig's (Dwr Cymru) debt-raising vehicle. Dwr Cymru is the sixth-largest of the UK regulated monopoly providers for water and wastewater services by regulated asset value (RAV), operating in a supportive and transparent regulatory framework. Dwr Cymru is a not-for-profit organisation, which makes it unique amongst UK utility companies as there is no shareholder pressure to pay dividends and consequently it can reinvest all its financial surpluses into the business for the benefit of customers. Since the acquisition through Glas Cymru in 2001, leverage has gradually reduced to below management's longer-term gearing target of 70% net debt/RAV from 93%. This enabled Dwr Cymru to refinance its last outstanding class C bond of GBP125m through cheaper class B debt during the financial year to end-March 2011.

The group has a secured and covenanted financing structure, which benefits from structural enhancements including trigger mechanisms (such as customer dividend lock-up provisions), debt service reserve liquidity and security over the shares in Dwr Cymru.

Fitch forecasts pension-adjusted net debt/RAV between 65% and 70% for the combined class A and class B debt for the period to March 2015. Post-maintenance and post-tax interest cover (PMICR) is expected to range between 1.5x-1.6x. While gearing provides for increasing headroom in comparison to Fitch's ratio guidelines, PMICR forecasts are at adequate levels. Fitch's forecasts are based on the final determination of tariffs for the period from April 2010 to March 2015 (asset management plan 5, AMP5) published by Ofwat (the economic regulator for the UK water sector) in November 2009, Dwr Cymru's business plan and Fitch's conservative estimates.

In terms of operating expenditure, the final determination for AMP5 attributed catch-up efficiencies of 2.6% per annum for Dwr Cymru, which implies the least efficient position in the industry. However, power costs had a significant influence on the benchmarking data and these costs are effectively reset for the new price control period. In addition, to achieve prescribed operating cost efficiencies, management will cut 350 headcounts over AMP5 as part of a restructuring programme. It has also insourced day-to-day operations, cutting out contractor margins that were previously due for services from Kelda and United Utilities, and made efficiency gains through the re-tendering of a number of supply contracts. The company has, therefore, made good progress in meeting the efficiency challenge for operating expenditure, although some cost pressures are likely to materialise towards the end of the regulatory period.

In terms of capital expenditure, the final determination assessed Dwr Cymru with capital incentive scheme scores of 105% for water services and 106% for wastewater services (the lower the score, the more competitive the business plan of a company in comparison with its peers). This result matches the capital expenditure catch-up efficiency assessment, which indicates that limited additional improvements are required in comparison to the average water and sewage company. Where practical, these targets have been built into agreements with contractors.

Fitch perceives Dwr Cymru overall as a middle-ranking company in terms of operational and regulatory performance. The final determination clearly provides some challenges. However, the in-sourcing of day-to-day operations and restructuring of the organisation not only provides for risks but also opportunities, eg cost pressures imposed by the regulator may allow management to get buy-in from staff and unions to implement new working practices and management may reconsider the choice of key performance indicators and underlying drivers.

As of December 2010, the company had GBP204m in cash and cash equivalents available, as well as GBP100m of undrawn committed revolving credit facilities. These mature in September 2011 and June 2012, but are expected to be renewed in the near term. In addition, the European Investment Bank recently committed GBP100m of long-term financing. This funding position will provide sufficient liquidity for capital expenditure and operating requirements for most of AMP5. In accordance with transaction documentation, the group also maintains a GBP135m reserve liquidity facility, which would be available in circumstances of financial distress.

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Applicable criteria, 'Corporate Ratings Criteria', dated 13 August 2010, is available at www.fitchratings.com.

Applicable Criteria and Related Research:
Corporate Rating Methodology
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=546646