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Dwr Cymru (Financing) Ltd.

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Dwr Cymru (Financing) Ltd.

Rationale

None

Business Risk

- Mainly focused on low-risk, U.K.-water regulated monopoly activities.
- Transparent, credit supportive regulatory framework results in financial stability during regulatory periods.
- Adequate performer in terms of the range of regulatory measures set and monitored by Ofwat.
- Relatively weak profitability compared to peers.
- High regulatory reset risk as the final determination for the next regulatory period is expected by December 2014.

Financial Risk

- Relatively weak cash flow ratios.
- Declining leverage and improving headroom against the current company target of 70% adjusted debt to regulatory capital value (RCV).
- Various structural features designed to increase cash flow certainty for debt holders.

Outlook

The stable outlook reflects our view that Welsh Water will continue to reduce leverage and maintain headroom according to its current internal policy of 70% net debt to RCV, and generate at least neutral discretionary cash flows on average for the current regulatory period ending in April 2015. The current outlook also reflects our view that we expect Welsh Water to continue to deliver adequate operational performance and a good track record as an asset operator in both the short and medium term.

Downside scenario

We could lower our rating if we see weaker operational performance which could lead us to revise our assessment of the company's business risk profile to strong from excellent. We would consider lowering our rating if we see any evidence of pressure to increase balance sheet leverage, or if financial metrics are more aggressive than what we expected.

Upside scenario

At this stage, we consider that there is limited scope for higher debt ratings, as the financial covenants in the documentation for the medium-term note program allow Dwr Cymru to operate at high leverage.

Standard & Poor's Base-Case Scenario

Assumptions

- Revenues declining by 0%-1% in 2015 and low-single digit growth for AMP6, resulting from real price declines and our assumption that the retail prices index (RPI) will have a low single-digit percentage increase.

- Adjusted EBITDA margins of 47%-50% in 2015 and the upcoming regulatory period (2015-2020)
- Capital expenditure (capex) of about £300 million-£320 million in 2014-2015.
- No dividend payments in the current regulatory period.

Key Metrics

	March 2014a	2015e	2016e
EBITDA margin	50.1%	47%-48%	48%-49%
FFO/total debt	7.4%	6.1%-6.6%	6.2%-6.7%
DCF/total debt	-1.0%	0%-(3%)	1%-(1%)

Note: All figures are fully adjusted by Standard & Poor's. Debt adjusted for operating leases, pension deficit, surplus cash. FFO adjusted for capitalized interest and operating leases. a--Actual. e--Estimate.

Company Description

Dwr Cymru Cyfyngedig (Welsh Water) is the sixth largest of the 10 regulated water and sewerage companies in England and Wales, according to RCV, which was £4.5 billion as of March 31, 2014. It supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing) Ltd. is a financing vehicle that is owned by Glas Cymru, a Welsh nonprofit company. Dwr Cymru 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.

Structural Features

Table 1

Supporting Ratings

Institution/role	Rating
Barclays Bank PLC as swap counterparty	A/Negative/A-1
Lloyds TSB as swap counterparty and liquidity facility provider	A/Negative/A-1
HSBC Bank PLC as swap counterparty and liquidity facility provider	AA-/Negative/A-1+
National Australia Bank Ltd. as liquidity facility provider	AA-/Stable/A-1+
JP Morgan as liquidity facility provider	A/Negative/A-1
Royal Bank of Scotland as a swap counterparty	A-/Negative/A-2
MBIA U.K. Insurance Ltd. as guarantor of Class A debt	B/Stable

Table 2

Transaction Key Features

Closing date	10/05/2001
Collateral	Dwr Cymru (Financing) Ltd.'s debt is secured by first fixed and floating charges on assets to the extent permitted by the Water Industry Act 1991 and Welsh Water's Instrument of Appointment. Security includes Welsh Water's accounts receivable, contracts, bank accounts, and all assets except protected land. In addition, the other entities in the Glas Cymru structure--Glas Cymru, Dwr Cymru (Holdings) Ltd., and Glas Cymru (Securities)--guarantee Welsh Water's obligations.

Table 2

Transaction Key Features (cont.)	
Country of origination	U.K.
Financial covenants	Senior and Class C RAR: 95.0%
	Senior interest cover ratio: 1.6x
Trigger events	Senior interest cover ratio: 2.0x
	Senior post-maintenance interest cover ratio: 1.0x
	Senior and Class C RAR: 90%
Liquidity facility size (mil. £)	135
Revolving credit facility (mil. £)	140

RAR--Regulated asset ratio.

The Dwr Cymru (Financing) transaction is backed by the future cash flows generated by Welsh Water's fully regulated and relatively low-risk water assets. Dwr Cymru is a financing vehicle that onlent the proceeds of its issuance to Welsh Water, the regulated water and sewerage utility. Our ratings reflect our assessment of the business risk profile as "excellent" and the aggressive leverage and cash flow ratios within the ring-fenced group.

Standard & Poor's Ratings Services rates Dwr Cymru's long-term senior secured debt, the subordinated debt on its medium-term note program, the class A debt guaranteed by MBIA U.K. Insurance Ltd., and the outstanding class B debt. Under our criteria, ratings on monoline-insured debt issue reflect the higher of the rating and outlook on the monoline and Standard & Poor's underlying rating (SPUR). Therefore, the rating on the class A bonds guaranteed by MBIA U.K. Insurance Ltd. reflects the higher SPUR.

The ratings also reflect various structural features designed to increase cash flow certainty for debt holders, including restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Dwr Cymru to manage temporary cash flow shocks. In particular, debt holders benefit from:

- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control over Dwr Cymru at the earliest stage of financial or operational difficulty, or following material changes in business circumstances. The covenants minimize the borrower's probability of default, and create an additional credit cushion.
- Liquidity facilities of £135 million available to cover standstill provided by suitably rated counterparties, sufficient to cover finance charges and dedicated to be drawn in if the company enters standstill. The facilities remain undrawn and the amounts available unchanged.
- A strong covenant package to protect debt holders, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.
- Subordination of the class C debt, the nonpayment of which cannot create an event of default for the class A debt. Currently Dwr Cymru has no outstanding class C debt.

Business Risk

Our "excellent" business risk assessment of Welsh Water reflects the stable and predictable revenue and cash flow streams from the low-risk regulated water and waste water businesses, its natural monopoly position in its service area, and a generally supportive and transparent regulatory framework. The strength of the regulator (Ofwat) and its framework is reflected in our assessment of Ofwat having a "strong" regulatory advantage (see "Why U.K. Utilities' Regulatory Frameworks Merit A 'Strong' Regulatory Advantage Assessment," published on Dec. 11, 2013).

In our opinion, Welsh Water's operational performance remains weaker than its peers, based on the level of profitablity. That said, the company successfully achieved tough efficiency targets set in the current regulatory period and met all of its regulatory targets that Ofwat set over the past few years.

Like all water companies, Welsh Water is exposed to regulatory reset risk every five years. In May 2014, Ofwat announced the draft determination for Welsh Water, although it does not benefit from enhanced status. We have assessed the published draft determination for the next five year regulatory period, and although this can change following the final determination, we believe the targets and incentives set are achievable by the company and are unlikely to have a negative impact on the business risk.

S&P Base-Case Operating Scenario

- Growth of 2.3% in the U.K. in 2014 according to our forecasts.
- U.K. RPI slightly higher than our consumer price index forecasts of 2.3% in 2014 and 2.1% in 2015, due to index adjustment. Welsh Water's revenues and asset base in the U.K. are linked to and benefit from RPI.

Peer comparison

Table 3

Dwr Cymru (Financing) Ltd. -- Peer Comparison

Industry Sector: Water

	Dwr Cymru (Financing) Ltd.	Anglian Water Services Financing PLC	South East Water (Finance) Ltd.	Northumbrian Water Ltd.
Rating as of Sep. 1, 2014	**-/-/-**	**-/-/-**	**-/-/-**	**BBB+/Stable/--**
	--Fiscal year ended March 31, 2014--	**--Fiscal year ended March 31, 2014--**	**--Fiscal year ended March 31, 2014--**	**--Fiscal year ended Dec. 31, 2013--**
(Mil. £)				
Revenues	735.1	1,214.0	219.1	826.8
EBITDA	368.4	736.5	132.4	485.8
Funds from operations (FFO)	207.4	383.0	69.1	306.9
Net income from cont. oper.	155.3	349.1	59.6	171.1
Cash flow from operations	230.5	480.4	87.0	217.5
Capital expenditures	260.1	405.6	94.3	184.5
Free operating cash flow	(29.6)	74.8	(7.3)	33.0
Discretionary cash flow	(29.6)	(175.2)	(37.3)	(35.8)

Table 3

Dwr Cymru (Financing) Ltd. -- Peer Comparison (cont.)				
Cash and short-term investments	4.7	6.9	2.6	11.3
Debt	2,821.2	5,585.9	909.5	2,873.4
Equity	101.2	951.2	279.0	(680.4)
Adjusted ratios				
EBITDA margin (%)	50.1	60.7	60.4	58.8
Return on capital (%)	6.9	8.6	8.1	11.7
EBITDA interest coverage (x)	2.2	2.2	2.3	3.0
FFO cash int. cov. (X)	3.0	3.0	2.9	2.1
Debt/EBITDA (x)	7.7	7.6	6.9	5.9
FFO/debt (%)	7.4	6.9	7.6	10.7
Cash flow from operations/debt (%)	8.2	8.6	9.6	7.6
Free operating cash flow/debt (%)	(1.0)	1.3	(0.8)	1.1
Discretionary cash flow/debt (%)	(1.0)	(3.1)	(4.1)	(1.2)

N.M. - Not Meaningful.

Financial Risk

Welsh Water's rating is constrained by the group's relatively weak credit metrics. In particular, we expect adjusted funds from operations (FFO) to debt to be above 6% for the current and upcoming regulatory period, with a low degree of headroom, constrained by relatively low profitability and the negative impact of indexation on index-linked debt.

That said, Welsh Water has relatively lower balance sheet leverage, with S&P adjusted debt at 63% of RCV at the end March 2014. This is the result of the nonprofit ownership structure by Glas Cymru, which eliminates pressure to leverage the balance sheet through shareholder distributions. This, combined with the moderate capital investment program during AMP5 should result in discretionary cash flows (DCF) after capex and dividends that are at least neutral, on average. Welsh Water's capex profile for the current regulatory period has been heavily skewed towards the end, resulting in more negative discretionary cash flows compared to positive cash flows at the beginning of the period, which we expect to result in neutral DCF on average.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Adjusted FFO to debt of 6%-7% over 2014-2015.
- Increasing debt, but total leverage remaining under 60% debt to RCV.

Financial summary

Table 4

Dwr Cymru (Financing) Ltd. -- Financial Summary					
Industry Sector: Water					
	--Fiscal year ended Mar. 31--				
(Mil. £)	**2014**	**2013**	**2012**	**2011**	**2010**
Revenues	735.1	714.6	693.8	676.0	688.2
EBITDA	368.4	342.4	338.4	371.4	343.5
Funds from operations (FFO)	207.4	181.4	147.1	193.0	238.7
Net income from continuing operations	155.3	1.6	(104.0)	138.5	64.8
Cash flow from operations	230.5	203.5	180.7	224.4	238.7
Capital expenditures	260.1	232.3	149.2	189.4	263.4
Free operating cash flow	(29.6)	(28.8)	31.5	35.0	(24.7)
Discretionary cash flow	(29.6)	(28.8)	31.5	35.0	(52.7)
Cash and short-term investments	4.7	7.9	15.0	0.0	0.0
Debt	2,821.2	2,770.1	2,729.0	2,674.2	2,669.3
Equity	101.2	(73.9)	(77.5)	46.1	(89.1)
Adjusted ratios					
EBITDA margin (%)	50.1	47.9	48.8	54.9	49.9
Return on capital (%)	6.9	6.5	6.5	7.8	8.2
EBITDA interest coverage (x)	2.2	2.0	1.7	2.0	3.2
FFO cash int. cov. (x)	3.0	2.9	2.4	2.5	3.0
Debt/EBITDA (x)	7.7	8.1	8.1	7.2	7.8
FFO/debt (%)	7.4	6.5	5.4	7.2	8.9
Cash flow from operations/debt (%)	8.2	7.3	6.6	8.4	8.9
Free operating cash flow/debt (%)	(1.0)	(1.0)	1.2	1.3	(0.9)
Discretionary cash flow/debt (%)	(1.0)	(1.0)	1.2	1.3	(2.0)

N.M.--Not meaningful.

Liquidity

We assess Dwr Cymru's liquidity position as "strong" under our criteria, supported by our view that liquidity resources will exceed its funding needs by more than 1.5x in the next 12 months.

Principal Liquidity Sources

- A cash balance of about £95 million;
- FFO of about £240 million; and
- Access to £170 million of undrawn credit facilities comprising a revolving credit facility and the operating and maintenance reserve.

Principal Liquidity Uses

- Expected capital spending of approximately £320 million; and
- Upcoming short term debt maturities of approximately £30 million.

In addition to the above credit facilities which support its outstanding debt, the company must also maintain a liquidity facility which is available in the event of default along with the company being unable to pay interest charges. This amounted to £135 million as of June 30, 2014, equivalent to the next 12 months of cash interest payable. Drawing on the liquidity facility results in a distribution lock up.

If the liquidity facility providers are downgraded to below 'A-1', they must be replaced within 30 calendar days or the funds available under the facility must be fully drawn.

In November 2013, we downgraded Royal Bank of Scotland (RBS), one of the liquidity facility providers, to A-/A2 with a negative outlook.

Dwr Cymru has now replaced RBS and Lloyds TSB with JPMorgan (A/Negative/A-1) and BNP Paribas (A+/Negative/A-1).

Debt maturities

Table 5

Debt Maturity Schedule (Mil. £)	
Current portion of long-term debt	30
Debt due in 2nd year	26.7
Debt due in years 2 - 5	215.6
Debt due after year 5	2592.8

Covenant Analysis

Dwr Cymru continues to comply with the debt maturity limitations as mandated under the corporate securitization documentation. The next significant maturity is £325 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps. Dwr Cymru does not have any class C bonds on issue.

Dwr Cymru continues to perform well under the corporate securitization covenants and improve headroom under its covenants since the close of the transaction on May 10, 2001. On March 31, 2014, the senior and class C regulated asset ratio (RAR) was 63%, well within the trigger levels of 90%. This has been helped by consistently high inflation in the U.K. Although the same factor makes meeting interest cover ratio covenants more difficult as pay-as-you-go swaps are settled in cash each year, Dwr Cymru has still managed to maintain ratios under its trigger covenants during higher inflationary periods.

The table below shows financial covenants, Dwr Cymru's actual performance in the financial year until March 31, 2014 and the company's expectations.

Table 6

Key Covenants				
Financial covenant	**Restricted payment condition***	**Actual performance March 31, 2013**	**Actual performance March 31, 2014**	**Forecast performance March 31, 2015**
Senior and Class C regulated asset ratio (%)	90	63	63	60
Senior ICR (x)	2.0	4.1	3.6	3.5
Senior PMICR (x)	1.0	2.2	2.1	2.5

Table 6

Key Covenants (cont.)
*For ICR ratios, trigger event covenant is displayed. ICR--Interest cover ratio. PMICR--Post-maintenance interest cover ratio.

Reconciliation

Table 7

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)									
	--Fiscal year ended Mar. 31, 2014--								
Dwr Cymru (Financing) Ltd. reported amounts									
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
Reported	2,909.90	100.00	736.50	368.30	204.60	159.30	368.30	177.10	268.3
Standard & Poor's adjustments									
Interest expense (reported)	--	--	--	--	--	--	(159.30)	--	--
Interest income (reported)	--	--	--	--	--	--	6.30	--	--
Current tax expense (reported)	--	--	--	--	--	--	2.40	--	--
Postretirement benefit obligations/deferred compensation	1.00	1.23	--	1.50	1.50	1.30	(1.02)	4.08	--
Surplus cash	(89.68)	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	7.90	(7.90)	--	--
Non-operating income (expense)	--	--	--	--	6.30	--	--	--	--
Revenues - Other	--	--	(1.40)	(1.40)	(1.40)	--	(1.40)	--	--
EBITDA - Other	--	--	--	--	--	--	--	--	--
OCF - Other	--	--	--	--	--	--	--	49.30	--
Capital expenditures - Other	--	--	--	--	--	--	--	--	(8.2)
Total adjustments	(88.68)	1.23	(1.40)	0.10	6.40	9.20	(160.90)	53.38	(8.2)
Standard & Poor's adjusted amounts									
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditures**
Adjusted	2,821.2	101.2	735.1	368.4	211.0	168.5	207.4	230.5	260.1

Related Criteria And Research

Related Criteria

- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012
- Counterparty Risk Framework Methodology And Assumptions June 25, 2013

Related Research

- Why U.K. Utilities' Regulatory Frameworks Merit A 'Strong' Regulatory Advantage Assessment, Dec. 11, 2013
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 14, 2006

Ratings Detail (As Of September 1, 2014)	
Dwr Cymru (Financing) Ltd.	
Senior Secured	A
Senior Secured	A/Stable
Subordinated	BBB+

*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.

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