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Research Update:

Dwr Cymru (Financing) Debt Ratings Assigned Negative Outlook On Tough Operating Cost Targets; L-T Debt Ratings Affirmed

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Overview

- Dwr Cymru (Financing) Ltd.'s operating company Welsh Water faces tough operating cost efficiency targets.
- At the same time, the utility is bringing its outsourced operations in house.
- We are affirming the 'A' long-term ratings on the Class A and Class B debt, and the 'BBB+' long-term rating on the Class C debt, issued by U.K.-based special purpose vehicle Dwr Cymru (Financing) Ltd.
- We are assigning a negative outlook to the debt ratings to reflect our view of the risks of Welsh Water meeting the targets and sustaining its current operational performance.

Rating Action

On March 8, 2010, Standard & Poor's Ratings Services affirmed its 'A' long-term senior secured debt rating, and Standard & Poor's underlying rating (SPUR), on the MBIA-wrapped Class A bonds, and the Class B bonds issued by the U.K.-based special purpose vehicle Dwr Cymru (Financing) Ltd. (Dwr Cymru), which is owned by the nonprofit company Glas Cymru. We also affirmed the 'BBB+' long-term debt rating on Dwr Cymru's Class C bonds and £3 billion medium-term term note program. At the same time, we assigned a negative outlook to all debt ratings.

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.

Rationale

The rating actions reflect our view that the final determination by the Office of Water Services (Ofwat) for the next regulatory period (AMP5) to March 31, 2015, sets Welsh Water, Dwr Cymru's operating company, a tough set of allowances. Under the determination, Welsh Water's cumulative revenues must decrease by 4% and operating efficiency cuts must reach £39 million by 2014-2015. Management intends to achieve these cost targets through phased workforce reduction, power procurement savings, and power usage efficiencies 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 AMP5 period to March 31, 2015. Over the past several years, 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. 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.

The next regulatory period marks the first time since the acquisition in 2001 that Welsh Water's 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 its committed leverage target of about 70% (net debt to regulatory capital value {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.

The debt ratings are underpinned by the stability of Welsh Water's regulated monopoly water and wastewater business. The rating strengths of this corporate securitization 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 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 risk 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 every five years, and the challenging regulator-induced efficiency targets required over the next regulatory period starting April 1, 2010.

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. Undrawn committed bank facilities totaled £345 million on the same date.

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.

Related Research

- "Criteria methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009
- "Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates," Feb. 10, 2009
- "Principles Of Corporate And Government Ratings," June 26, 2007

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Dwr Cymru (Financing) Ltd.		
Senior Secured		
£100 mil. 4.473% Class A asset-backed sr secd bnds ser 3 due 03/31/2057*		
Local currency long-term rating	A/Negative	A
Underlying rating	A/Negative	A
£700 mil. Class A sr secd nts due 03/31/2031*		
Local currency long-term rating	A/Negative	A
Underlying rating	A/Negative	A
£528.6 mil. Class B1 thru B4 Bnds due 03/30/2027		
Local currency long-term rating	A/Negative	A
£50 mil. 1.375% index-linked Sub-Class B5 bonds ser 2 due 03/31/2057		

Local currency long-term rating	A/Negative	A
Subordinated		
£125 mil. sub Class C bnds due 03/31/2036	BBB+/Negative	BBB+
£3 bil. Med-term note Prog		
Senior secured	A/Negative	A
Subordinated	BBB+/Negative	BBB+

*Bond Insurance Provider: MBIA U.K. Insurance Ltd.

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.