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Summary:
Dwr Cymru (Financing) Ltd.

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Table Of Contents

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Rationale

The 'A' long-term debt ratings on the senior secured, MBIA-wrapped class A bonds, class B bonds, 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 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 the nonprofit company 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. 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. In our view, 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 modest debt-protection measures and high leverage. 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 current regulatory period (which began on April 1, 2010).

Key business and profitability developments

In our view, the regulatory framework for water utilities in England and Wales provides good visibility of earnings and cash flows over each regulatory period (the current period ends March 31, 2015). We believe that Ofwat's latest determination has set a tough set of allowances for Welsh Water, requiring a 4% drop in cumulative revenue and operating efficiency cuts of about £39 million by 2014-2015. Management intends to achieve these cost targets through bringing its operating contracts in-house, phased workforce reductions, power procurement savings, and power usage savings via schemes in progress.

Following Welsh Water's announcement that it is to terminate its outsourced operating contracts with United Utilities PLC (BBB-/Stable/A-3) and Kelda Water Services (not rated), the company has brought in-house nearly 1,600 of its former partners' employees. In the absence of an established track record as an asset operator, we see some uncertainties as to whether Welsh Water can maintain its adequate operational performance, as measured by the regulator, without the contribution of the outsourcing partners. At the same time, we understand that about 60% of Welsh Water's operating and capital expenditures (capex) remains subject to competitive tenders.

Key cash flow and capital-structure developments

Glas Cymru's cash flow protection measures are modest on the back of the high, albeit declining, leverage; although we believe that 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 June 30, 2010, 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 current regulatory period, which runs until March 31, 2015.

The current regulatory period marks the first time since Welsh Water was acquired by Glas Cymru in 2001 that its prefinancing cash flows after 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 for operational costs, and on the rate of inflation.

Liquidity

We view Glas Cymru's liquidity as strong. Covenants relating to liquidity include a requirement to have sufficient cash and bank lines for the next 12 months of capex. In addition, a £150 million liquidity facility at Dwr Cymru is available if Welsh Water is unable to pay its interest bills during a standstill period. Further support for liquidity derives from Welsh Water's steady and predictable operating cash flow stream, expected positive prefinancing cash flows from ordinary business during asset-management period 5 (the current regulatory period running from 2010-2015), and minimal near-term debt maturities. The next scheduled maturity--in March 2011--relates to the £12.1 million remaining subordinated class C notes following Dwr Cymru's early redemption of £112.9 million of these notes in June 2010. Actual unrestricted liquidity, excluding accounts for debt service and customer rebates, was £197.6 million on June 30, 2010, and is further bolstered by undrawn committed bank facilities totaling £100.0 million. The high degree of liquidity results from the company's prudent prefunding policy to secure facilities in advance of mandated investments. In line with this policy, Dwr Cymru issued £140.0 million long-dated, index-linked bonds at the end of March 2010.

We expect prefinancing cash flows to be mildly negative in the year to March 31, 2011, due to some of the restructuring charges being paid down. Management estimates--and has fully provided for in the reported accounts as of March 31, 2010--£29.5 million of exceptional costs to bring operating activities in-house.

Outlook

The negative outlook reflects our view of the risks surrounding Welsh Water's ability to meet its efficiency targets and the potential adverse effect of it not meeting these targets on cash flow debt-coverage measures, and to a lesser extent, 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 risk profile and may result in a downgrade.

Ratings stability depends on Welsh Water's success in building a good track record as an asset operator, maintaining an adequate operational performance, keeping within its cost allowances, and continuing to deleverage.

Related Criteria And Research

- Methodology: The Interaction Of Bond Insurance And Credit Ratings, Aug. 24, 2009
- U.K. Regulator's Proposals For The Water Sector In 2010-2015 Are Likely To Squeeze Rating Headroom, Aug. 13, 2009
- Principles-based Rating Methodology For Global Structured Finance Securities, May 29, 2007
- Exploring the Keys to Success for U.K. Water Corporate Securitizations, Dec. 14, 2006

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