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Transaction Update: Dwr Cymru (Financing) Ltd.

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Ratings Detail

Corporate Credit Rating
None

Table 1

Current Issue Rating*

Class	Current rating	Previous rating	Current balance (Mil. £)¶	Interest (%)	Final maturity
Class A1	A/Stable	N/A	350	6.015	2028
Class A4	A/Stable	N/A	345	RPI + 3.514	2030
Class A5	A/Stable	N/A	112	LPI + 3.512	2031
Class A6	A/Stable	N/A	115	4.473	2057
Class B1	A/Stable	N/A	325	6.907	2021
Class B3	A/Stable	N/A	168	RPI + 4.377	2026
Class B4	A/Stable	N/A	99	LPI + 4.375	2027
Class B5	A/Stable	N/A	57	RPI + 1.375	2057
Class B6	A/Stable	N/A	147	RPI + 1.859	2048
Total	N/A	N/A	1,718	N/A	N/A

*On March 31, 2011. ¶Outstanding amounts include accretion. N/A--Not applicable. RPI--Retail prices index.

Table 2

Transaction Participants

Borrowers	Dwr Cymru (Financing) Ltd.
Servicer	Dwr Cymru Cyfyngedig
Co-arrangers	RBS, HSBC
Borrower/issuer security trustee	Deutsche Trustee Co. Ltd.
Liquidity facility provider	RBS, HSBC, Lloyds TSB, National Australia Bank
Interest hedge provider	RBS, HSBC, Barclays, Lloyds TSB
Bank account provider	RBS
Principal paying agent	Deutsche Bank

Table 3

Supporting Ratings

Institution/Role	Ratings
Barclays Bank PLC as swap counterparty	AA-/Negative/A-1+
Lloyds TSB as swap counterparty and liquidity facility provider	A+/Stable/A-1
HSBC Bank PLC as swap counterparty and liquidity facility provider	AA/Stable/A-1+
National Australia Bank Ltd. as liquidity facility provider	AA/ Stable/A-1+
The Royal Bank of Scotland PLC as swap counterparty and liquidity facility provider	A+/Stable/A-1

Table 4

Financial Highlights*	
Free cash flow (Mil. £)	58
EBITDA (Mil. £)	372
Regulated asset value (Mil. £)	3,980
Debt to regulated asset value (%)	67

*Year ended March 31, 2011

Table 5

Transaction Key Features	
Closing date	10/5/2001
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.
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.

Rationale

This transaction update follows Standard & Poor's Ratings Services' full review of the Dwr Cymru (Financing) Ltd. transaction. All ratings have been affirmed as a result of the review and the outlook on the debt ratings has been revised from negative to stable. We continue to view the business risk profile as excellent.

The 'A' long-term senior secured debt rating and Standard & Poor's underlying rating (SPUR) on the MBIA-wrapped Class A bonds and Class B bonds, and the long-term 'BBB+' subordinated debt rating on the medium-term note program, available to U.K.-based special-purpose vehicle (SPV) Dwr Cymru (Financing) Ltd. (Dwr Cymru), reflect our 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). Welsh Water is a regulated water and sewerage utility that supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England.

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. (B/Negative/--), reflects the higher SPUR rating.

The debt ratings are underpinned by our view of Welsh Water's excellent business risk profile, based on the stability of the company'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 a 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 risk to the financial risk profile from 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 throughout the current regulatory period (asset management period 5, or AMP5) to March 31, 2015.

Outlook

The stable outlook reflects our view that, despite the tough efficiency targets, Welsh Water will keep within its cost allowances. It also reflects our opinion that, irrespective of the change to an in-house business model, Welsh Water will be able to maintain at least adequate operational performance and a good track record as an asset operator. We anticipate that the company will continue to deleverage and will observe its internal committed policy of 70% net debt to RCV.

Downward rating pressure could result from weaker operational performance and/or deviation from cost allowances, which could lead us to revise our assessment of the company's business risk profile to strong from excellent.

The related adverse effect on operating margins could weaken cash flow coverage of debt, and ultimately, result in a downgrade. In addition, any change in the customer rebate policy, or evidence of pressure to increase balance sheet leverage, could have negative consequences for the rating.

At this stage, we believe 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.

Surveillance Analysis

On account of positive free operating cash flows (after capital expenditures), the absence of customer rebates for the year, and consistently high inflation, Dwr Cymru's leverage has fallen to 67% net debt to RCV as of March 31, 2011, from 93% at the time of the initial implementation of the corporate securitization in 2001. This is less than the company's committed leverage target of about 70%, and considerably lower than its trigger and default covenants of 90% and 95% net debt to RCV, respectively. We anticipate that the trend of deleveraging will continue, although we understand that some headroom under the net debt to RCV covenant is reserved to account for potential differences in inflation indexes at the end of AMP5.

Furthermore, we anticipate that the pre-maintenance interest coverage ratio--which was down in financial 2011 (ended March 31, 2011) from the previous year due to higher cash settlements on swaps linked to the retail prices index (RPI)--will gradually strengthen from 3.1x and will exceed 3.5x in the medium term.

In our view, the transaction's ability to meet debt service payments has improved since our last review. The improvement is due to the following factors:

- We continue to view the business risk profile as excellent, although weaker than some of Welsh Water's peers due to its below-average ranking on operating efficiency and some aspects of serviceability.
- We understand that the transition to an in-house model of business operations, from an outsourced model previously, has proceeded smoothly.
- We see increased certainty that Welsh Water will be able to meet what we view as tough cost allowances set by the Office of Water Services (Ofwat) for AMP5.
- Dwr Cymru continues to perform with strong headroom under various stress scenarios.

Strengths, Concerns, And Mitigating Factors

Strengths

- 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, AMP4; 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 aims to introduce competition in the water markets. However, we think this might materially affect the credit profile of rated utilities. (For more information, refer to "Enhanced Competition Could Alter Standard & Poor's Assessment Of The U.K. Water Sector".) According to its Strategic Position Statement, the Welsh 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 over the previous regulatory period, AMP4. We will review the outcome of the regulator's first comprehensive ranking of Welsh Water's operational performance under the new customer satisfaction mechanism, applicable for AMP5, as and when the reports are released. Nevertheless, we note that Welsh Water was placed third in the annual league table on customer service for 2010-2011, based on independent research conducted quarterly on behalf of the regulator, which we view as positive.

Concerns

- The risks associated with the regulatory reset reviews undertaken by Ofwat every five years. The company is currently in the second year of a five-year regulatory period 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.
- High, albeit declining leverage after the implementation of the corporate securitization in May 2001. The board has publicly announced its intention to reduce and maintain leverage at about 70% of net debt to RCV.
- Low financial ratios for the 'A' rating category, which should be interpreted in light of Dwr Cymru's credit enhancement features. Based on preliminary results for the year ended March 31, 2011, Dwr Cymru's Standard

& Poor's-adjusted funds from operations (FFO) interest coverage of total debt and adjusted FFO to debt stand at about 2.1x and 6.5%, respectively. Due to a substantial peak of investment activity, we anticipate that credit metrics could tighten in the year ending March 31, 2012, but should recover and exceed 8% FFO to debt and 2x FFO to interest cover in the last three years of AMP5.

Mitigating factors

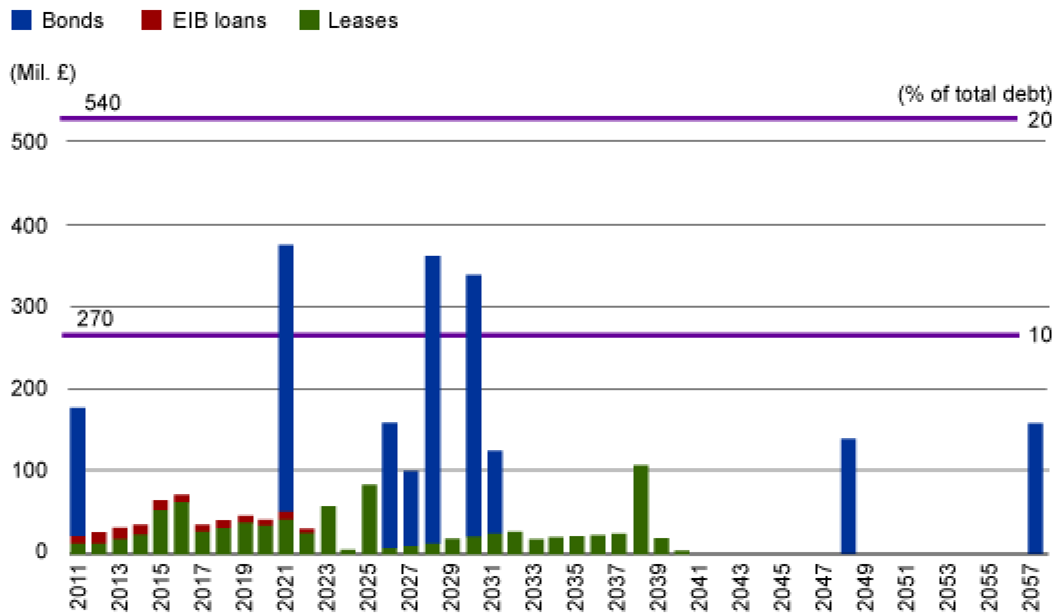
- Protective structural features. These include considerable cash reserves and liquidity facilities, which allow for continued debt servicing under stress; a comprehensive security package (albeit limited by the standard restrictions that apply to the sector); an intercreditor agreement minimizing the 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.
- Positive free operating cash flows, despite substantial capex commitments over the medium to long term. Over 2010–2015, we think that Glas Cymru is likely to generate positive free operating cash flows for the first time, thereby lessening the need for ongoing borrowing. We base our forecast for this five-year period on a capex program of about £1.1 billion at 2007-2008 prices, and the assumption that capex 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 RPI 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.
- Some flexibility in the revenue-setting regime, provided by Ofwat's "Interim Determination of K" (IDoK) mechanism. The mechanism allows a company to reapply for a revenue increase in the middle of a five-year period if its performance is affected by unexpected changes (under specified circumstances). We regard this adjustment to price limits as providing some protection against cash flow-erosion risk during each five-year regulatory period, although this mechanism does not cover all costs, nor does it cover erosion in the RCV due to deflation. For example, the recent significant increase in energy costs was not covered by the IDoK mechanism.

Performance Of The Dwr Cymru (Financing) Transaction

Amortization schedule

Dwr Cymru continues to comply with the debt maturity limitations as mandated under the corporate securitization documentation. Following the early redemption of all Class C bonds before their scheduled maturity on March 31, 2011, Dwr Cymru faces limited near-term maturities. The next significant maturity is £325.0 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps.

Dwr Cymru (Financing) Ltd. Debt Maturity Profile



EIB—European Investment Bank.
Source: Dwr Cymru (Financing) Ltd.

Key covenants performance

Table 6 shows financial covenants, Standard & Poor's base-case forecast for 2011, and Dwr Cymru's actual performance in the year to March 31, 2011.

Table 6

Key Covenants*

Financial covenant	Restricted payment condition*	Standard & Poor's base-case forecast 2011	Actual performance March 31, 2011	Company forecast performance March 31, 2011	Covenant status
Senior and Class C RAR	90.0%	72.0%	67.0%	72.0%	Met
Senior ICR	2.0x	3.4x	3.4x	3.4x	Met
Senior PMICR	1.0x	2.2x	3.1x	2.2x	Met

*For ICR ratios, trigger event covenant is displayed. ICR--Interest cover ratio. PMICR--Post-maintenance interest cover ratio.

Dwr Cymru has outperformed our base-case forecasts for net debt to RCV on account of consistently high inflation in the U.K. The company's performance on the post-maintenance interest cover ratio covenants is better than we forecast due to a slow start of the AMP5 investment program.

We have rerun various sensitivities as part of our review of Dwr Cymru. The outcomes do not contradict our rating assessment, in our opinion, as the stresses that we applied are appropriate for the current rating level. Dwr Cymru performs adequately under our sensitivities. Given considerable headroom under its covenants at present, we believe that Dwr Cymru is not likely to reach trigger levels, and even less likely to reach default levels under any of the sensitivity scenarios.

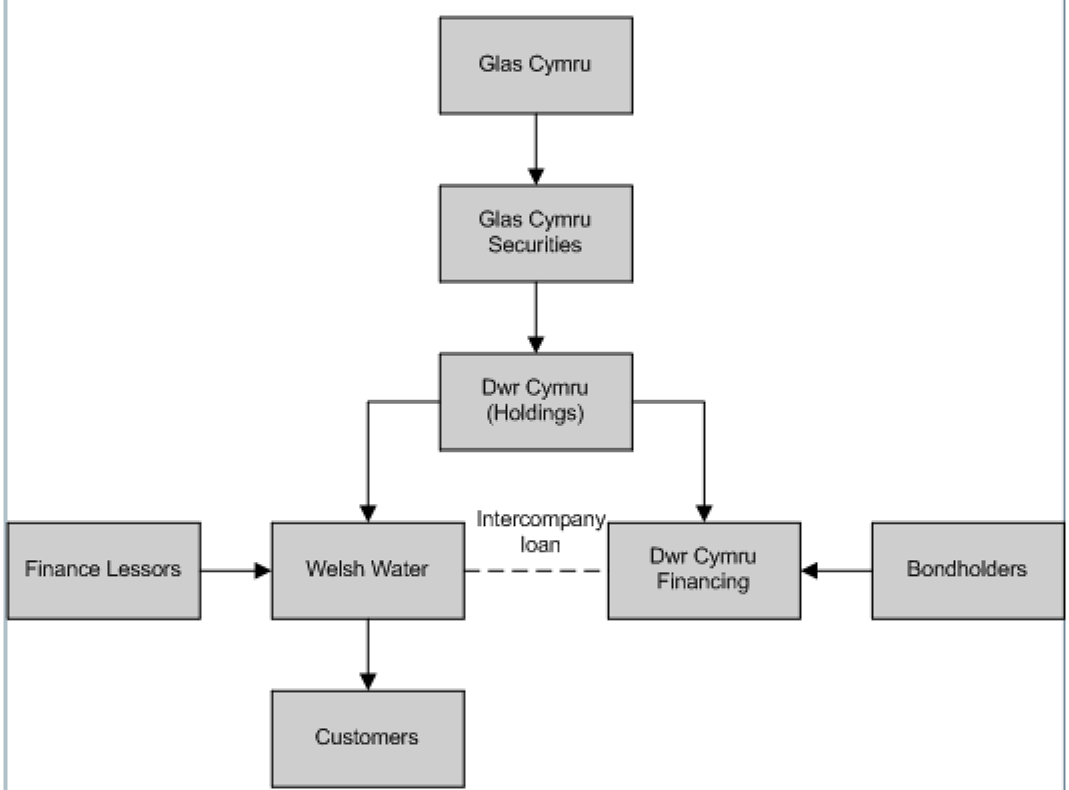
In addition to our base case, we have applied the following sensitivities:

- Standard & Poor's base case with the exception of 1% deflation for the duration of the transaction.
- Standard & Poor's base case with the exception of 1% inflation for the duration of the transaction.
- Standard & Poor's base case assuming a 5% increase of operating costs each year.
- Standard & Poor's base case assuming 10% higher capex (not included in RCV) each year.
- Standard & Poor's base case assuming 2.5% lower revenues each year.
- Standard & Poor's base case plus stressed funding costs, that is, adding 200 basis points to Dwr Cymru's assumptions for all new financing and refinancing costs.
- A combination of low inflation, and operating expenditures (opex) and capex overspending.
- A combination of low inflation, a drop in revenues, and opex and capex overspending.
- A combination of deflation, capex and opex overspending.

Transaction Structure

The structure of the transaction is shown in the following chart.

Glas Cymru Financing Structure



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Business Description

Dwr Cymru is an SPV 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.

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 £3,980 million on March 31, 2011. It supplies water and wastewater services to 1.3 million properties across most of Wales and some adjoining areas of England.

Business Profile

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 Welsh Water a relatively tough set of allowances, requiring a 4% drop in cumulative revenues and operating efficiency cuts of about 20% in real terms. Although we view Welsh Water's cost allowances as challenging, we believe that they should be manageable. Our opinion is supported by the Welsh Water's satisfactory performance in the financial year ended March 31, 2011, and the substantial portion of contracted costs for this regulatory period.

Furthermore, at the time of the latest determination, Welsh Water had 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). Following this, the company transitioned to an in-house from a mostly outsourced business model. We understand that this transition proceeded smoothly in the first year of the regulatory period to March 31, 2011.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Principles of Credit Ratings, Feb. 16, 2011
- Counterparty And Supporting Obligations Methodology And Assumptions, Dec. 6, 2010
- Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates, Feb. 10, 2009
- Enhanced Competition Could Alter Standard & Poor's Assessment Of The U.K. Water Sector, Dec. 12, 2008
- Methodology For Rating And Surveilling European Corporate Securitizations, Jan. 23, 2008
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 14, 2006

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