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Research Update:
Dwr Cymru (Financing) Outlook Revised To Stable On Ability To Meet Operating Cost Targets; Debt Ratings Affirmed

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Overview

- Dwr Cymru (Financing) Ltd.'s operating company, Welsh Water, has performed broadly within budgets and ahead of operating cost allowances in the first year of the AMP5 regulatory period.
- In the current environment, we see a greater likelihood of Welsh Water achieving its efficiency targets over the next four years.
- We are therefore revising the outlook on U.K.-based special purpose vehicle Dwr Cymru (Financing) to stable from negative, and affirming the 'A' long-term ratings on its Class A and Class B debt.
- The stable outlook reflects our view that Welsh Water will be able to maintain adequate operational performance and cost control.

Rating Action

On June 14, 2011, Standard & Poor's Ratings Services revised to stable from negative its outlook on the debt ratings on U.K.-based special purpose vehicle Dwr Cymru (Financing) Ltd. (Dwr Cymru), which is owned by the nonprofit company Glas Cymru. At the same time, we affirmed our '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 Dwr Cymru. We also affirmed the 'A' senior secured and 'BBB+' subordinated ratings on Dwr Cymru's £3 billion medium-term note program. There is currently no Class C debt outstanding.

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.

Rationale

The rating actions reflect our increased certainty that Dwr Cymru's operating company, Welsh Water, will be able to meet what we deem to be tough cost allowances set by the Office of Water Services (Ofwat) for the current regulatory period (AMP5) to March 31, 2015. Our opinion is supported by Welsh Water's satisfactory performance in the financial year ended March 31, 2011, when it managed to exceed its regulatory cost target by £22 million.

In addition, Dwr Cymru has implemented the majority of its restructuring plan, and we understand that the transition to an in-house model of business operations, from an outsourced model previously, has proceeded smoothly. Furthermore, Welsh Water has contracted a substantial portion of its costs for this regulatory period. This leads us to believe that the achievement of a 20% reduction in real costs in AMP5 is more likely than we previously thought.

We continue to see Welsh Water's business risk profile as excellent, although weaker than some of its peers due to its below-average ranking on operating efficiency and some aspects of serviceability. In financial 2011 (ended March 31), we recognize that various operational indicators improved year on year. However, on account of unprecedented weather patterns in the winter months, the company fell behind its leakage target and suffered a greater number of unplanned supply interruptions. Nevertheless, 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. We will review the outcome of the regulator's first comprehensive ranking of Welsh Water under the new customer satisfaction mechanism as and when the reports are released.

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 regulatory capital value (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 its committed leverage target of about 70% and considerably in excess of 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 from the previous year due to higher cash settlements on swaps linked to the retail prices index--will gradually strengthen from 3.1x and will exceed 3.5x in the medium term.

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 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 over the current regulatory period 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.

Related Criteria And Research

- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology And Assumptions: Recognizing The Sustainable Cash Cost Of Inflation-Linked Debt For Corporates, Feb. 10, 2009
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 14, 2006

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/Stable	A/Negative
Underlying rating	A/Stable	A/Negative
£700 mil. Class A sr secd nts due 03/31/2031*		
Local currency long-term rating	A/Stable	A/Negative
Underlying rating	A/Stable	A/Negative

£528.6 mil. Class B1 thru B4 Bnds due 03/30/2027		
Local currency long-term rating	A/Stable	A/Negative
£50 mil. 1.375% index-linked Sub-Class B5 bonds ser 2 due 03/31/2057		
Local currency long-term rating	A/Stable	A/Negative
Subordinated		
£3 bil. Med-term note Program		
Senior secured	A/Stable	A/Negative
Subordinated	BBB+/Stable	BBB+/Negative

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

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