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Peer Comparison: U.K. Water Corporate Securitizations

Industry Characteristics

This comparative study indicates how we view the relative performance of three water securitizations, Dwr Cymru (Financing) Ltd., Anglian Water Services Financing PLC (AWS Financing), and Southern Water Services (Finance) Ltd. (SWS Finance), since their financial restructurings.

Business Profile Assessments

Financial Risk

Group E-Mail Address

Each of the three issuers has senior secured debt rated 'A-' and subordinated secured debt rated 'BBB'. They also have large tranches of senior secured debt rated 'AAA', which is wrapped by monoline insurers.

Dwr Cymru Financing's parent company is Glas Cymru Cyfyngedig and the water utility is Dwr Cymru Cyfyngedig (Welsh Water). Hereafter, the parent and utility will be collectively referred to as the Dwr Cymru group. The water utility associated with AWS Financing is Anglian Water Services Ltd. (AWS), for SWS Finance the utility is Southern Water Services Ltd. (SWS).

We focus our review on the regulatory and operating performance of the utilities and the financial and ownership profile of the issuing entities.

Industry Characteristics

Each company has modestly outperformed both its financial and operating objectives since its restructuring and, as a result, is in a slightly stronger overall position than originally forecast. While the three restructurings are very similar and still in their infancy, we have been able to identify differences between the structures and their respective performances.

The most visible improvement has been in operating performance, with AWS and the Dwr Cymru group ranking first and second, respectively, in the Office of Water Services' (Ofwat) 2003/2004 operating performance assessment study. SWS has also improved its operating performance as it ranks toward the upper quartile (seventh) in Ofwat's listing. All of these rankings have improved markedly over the past few years.

In terms of Ofwat's draft determination for the 2005-2010 regulatory review period, both AWS and SWS received draft price increase limits well below those requested, about one-third and one-half, respectively. The Dwr Cymru group, on the other hand, received a determination that was much closer to its assumption, as it was able to provisionally secure approximately three-quarters of its requested price increase.

The Dwr Cymru group's ownership structure, which excludes shareholders, is viewed as being more prudent from a credit perspective as it eliminates potential pressure for dividends and other shareholder returns.

In terms of financial performance, all three companies have slightly outperformed both their interest and leverage financial ratios since restructuring. Given the highly structured nature of the entities and the stability of the underlying water business, we do expect there to be substantial changes in financial performance, outside of any harsh determinations at the periodic regulatory reviews.

Since restructuring, the entities have very similar structural protections, such as liquidity sources and covenant packages.

Business Profile Assessments

Draft determination.

Ofwat's draft price limit determinations for 2005-2010 have been perceived to be quite challenging, especially for AWS, as illustrated in the comparisons in table 1. The draft determination announced in August 2004, however, has had no immediate effect on the ratings. The preliminary determinations are subject to change due to a period of company and regulator consultation followed by the government's opportunity to fine tune its guidance on drinking water and environmental improvements, which may affect capital expenditures.

The regulator's final determinations will be finalized in December 2004, and could be affected by these processes. As such, we consider that it will only be possible to determine the ultimate impact on credit quality once the new tariffs and output obligations have been finalized.

Table 1 U.K. Water Corporate Securitizations/Ofwat Draft Annual Price Increases						
--Financial Year April 1-March 31--						
(%)	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	Average
AWS						
Determination	2.4	(0.6)	2.3	1.2	2.1	1.5
Request	5.4	2.0	4.7	5.2	5.9	4.6
The Dwr Cymru group						
Determination	13.2	2.4	3.0	2.6	1.5	4.5
Request	21.5	3.0	2.5	2.5	1.5	5.9
SWS						
Determination	7.5	4.1	1.8	5.1	1.7	4.0
Request	17.0	5.6	5.6	5.5	5.5	7.7

Source-- Future water and sewerage charge 2005-2010 Draft Determinations Summary, Ofwat, August 2004.

Ofwat's draft price increase determinations are lower than those requested by the companies due primarily to lower capital spending allotments and tougher mandated efficiency improvements. The large price increase requests were largely a result of continued high levels of expected capital expenditures, which are due primarily to greater and increasingly more stringent environmental and water quality compliance standards.

Although Ofwat's determination of lower capital expenditure requirements will require a lower level of borrowing over the next five years, it will largely push necessary spending into future years. We will evaluate changes to capital spending programs made by the government and any subsequent changes in price limits to determine if the companies will be disadvantaged.

Ofwat's average customer bill reduction related to efficiency improvement approximates £25 per household, which equates to roughly 7.5% of the Dwr Cymru group's customer bill and 8.0% for AWS and SWS; only the Dwr Cymru group anticipated such a large efficiency mandate as its proposal was in line with Ofwat's determination. Requests made by the Dwr Cymru group and SWS sought a large price increase in 2005/2006, followed by lower, more constant increases in subsequent years. AWS, which took a more level approach to price increases, received the most negative price determination.

	Company Business Plan	Draft Determination	Difference
	(Mil. £)	(Mil. £)	(Mil. £)
AWS	1,783	1,380	403
The Dwr Cymru group	1,307	1,102	205
SWS	2,041	1,452	589

Source--Future water and sewerage charge 2005-2010 Draft Determinations Summary, Ofwat, August 2004

Operating performance.

For AWS and the Dwr Cymru group, the competitive tendering and outsourcing programs and focus on running a single-purpose water utility have delivered very positive results. Both companies have achieved significant cost reductions via the contracting-out exercise and renewed focus on costs and have exceeded their own targets since restructuring. AWS and the Dwr Cymru group rank first and second, respectively, in Ofwat's 2003/2004 operating performance assessment study. However, despite the early success of the outsourcing programs, the procurement policies should be judged over a longer period. There are some inherent risks with having other parties undertake the company's capital and operating expenditures, particularly when legal responsibility remains with the utility.

AWS continually evaluates whether the greatest value from its operating efforts is sourced from keeping work in-house or from the market. The Dwr Cymru group seems more committed to the contracting-out exercise, having recently announced preferred partners for contracts extending for up to 15 years. These contracts include the vast majority of the company's capital expenditure and operating programs. The Dwr Cymru group's operating performance has undergone a significant turnaround since 2001, when it began to outsource virtually all operations; before 2001, it was long regarded by Ofwat as one of the least efficient performers in the sector.

SWS, whose operations remain in-house, has also improved its operating performance in the past few years and currently ranks toward the upper quartile (seventh) in Ofwat's listing. SWS' operating performance has improved as a result of lower operating costs and substantial capital expenditure to enhance the quality of its network assets. The bulk of SWS' capital expenditure has been directed toward addressing the condition and performance of its wastewater assets, the performance of which had until recently been considered below average by Ofwat.

Ownership structure.

The distinguishing feature of Glas Cymru Cyfyngedig is its status as a company limited by guarantee and a not-for-profit entity. The company does not have shareholders, and it is therefore the customers who ultimately benefit or suffer from good or bad company performance. As it does not pay dividends, excess cash generated within the business above targeted financial reserve levels can be rebated to customers or used to deleverage the business. While reducing debt is clearly a credit positive, lowering customer bills can also, to some extent, affect credit positively, as it limits customer loss and regulatory risk.

Although the lack of traded shares reduces the company's potential funding sources, being a listed U.K. company does not automatically equate to additional financial flexibility. Apart from the Dwr Cymru group, all U.K. water and wastewater companies (including AWS and SWS) use the equity model of ownership and therefore have shareholders who have a commercial

approach to requiring a return on investment. That is not to say that the Dwr Cymru group does not have a commercial approach, but the incentives on management are applied in different ways. Importantly, each management team has significant credit and operating objectives by which it is measured and incentivized.

Financial Risk

The financial policies behind AWS Financing, Dwr Cymru Financing, and SWS Finance are clearly aggressive, characterized by high debt levels. At the time of the restructurings, the return of capital to shareholders significantly removed equity from the financial structure (indeed, the Dwr Cymru group no longer has shareholders). However, stable revenues, strong covenant requirements, and extensive liquidity facilities substantially mitigate financial risks.

Given the highly structured nature of the entities and the revenue stability of the underlying water business, we do not expect there to be substantial changes in financial performance, outside of any harsh determinations at the periodic regulatory reviews. The nature of the structure provides natural stabilizers to the level of financial leverage.

Material upside is unlikely because business outperformance will likely lead to higher distributions to owners due to the lack of incentive to reduce leverage well below covenant levels. However, the companies still seek to maintain sufficient financial covenant cushions to withstand any shocks to their business. Material downside is made less likely given that business underperformance would be met by limitations on distributions and other sanctions, which in most cases should lead to a correction of the underperformance.

In addition, we do not consider there to be much incentive for the companies to aim for debt protection measures that are materially higher than covenant levels (besides the necessary headroom to operate the business comfortably), and we expect cash to be returned to shareholders to the greatest extent possible.

Profitability.

In terms of financial performance, all three companies have slightly outperformed both their projected interest and debt leverage financial ratios since their respective restructurings. Slightly surpassing expectations is not entirely unexpected as in each case the restructuring was undertaken under appropriately conservative assumptions.

Due to revenue certainty and outsourced operating contracts, we do not expect there to be significant variability in financial performance. Onerous capital spending programs, however, will persist, which will continue to lead to negative free cash flow (this will most likely increase debt) and create pressure on cash flow ratios to interest and debt ratios, which are already low, reflecting the companies' elevated debt balances.

Liquidity and financial flexibility.

Financial flexibility is limited for such highly geared structures, with limited additional borrowing capacity and a narrow debt-servicing cushion. However, mandated liquidity facilities, debt service reserves, and unused borrowing capacity aid flexibility.

In light of this limited financial flexibility and the importance of the companies completing their capital expenditure programs (and the need to borrow to do so), it is imperative that some advance funding of the companies' capital expenditure programs is in place. As such, the companies are required to have adequate financial resources in place comfortably ahead of spending needs. This requirement removes some capital markets uncertainty and allows for debt to be issued at opportune times. In addition to prefunded

capital expenditure, liquidity is also available in the form of a debt service reserve facility covering 12 months of interest payments, a cash reserve, and a further facility covering a modest amount of operating and capital maintenance costs. Each capital structure includes long-dated legal debt maturities, which reduce refinancing risk, and a high level of interest rate hedging, which adds to cash flow stability.

Structural features.

Each entity uses a ringfenced structure established around the water utility, a special-purpose financing vehicle, and at least one intermediate holding company. The ringfence structure seeks to protect the interests of the underlying water business by using bankruptcy-remote intermediate holding companies, financial and business covenants, a pledge of security (to the extent allowable in the U.K. water industry), and regulatory oversight from Ofwat of the utility's operations.

The advantage derives from the interplay between the covenant package, the intercreditor arrangements, and the corporate structure. It is the combination of these factors that makes the ringfence effective and provides the rating benefit.

For each of these three companies, this package of structural elements has, cumulatively, sufficiently mitigated the high credit risks associated with aggressive financial debt restructuring and has enabled the utilities to achieve investment-grade ratings on senior debt. These features include:

- Timely access to adequate liquidity;
- A series of early warning signals to identify deteriorating financial performance;
- Limitation of investment in non-water utility businesses;
- Conservative debt management policies, including hedging;
- Use of intercreditor agreements to protect rights of senior noteholders;
- Equity support in the form of retained distributions in times of cash flow pressure;
- A security package as a defensive measure; and
- Oversight by independent third parties.

Covenants.

The business and financial covenants of each company are very similar (see table 3). All three companies have identical debt service reserves and noteholder standstill conditions, as well as relatively similar interest and debt leverage distribution lock-up ratios. The covenants place a number of limitations on the companies, providing considerable coverage for potential risks and shocks to the structures and their underlying water and wastewater business. Similar business covenants consist mainly of restrictions on business activities and the prevention of creating subsidiaries or selling major assets.

Table 3 U.K. Water Corporate Securitizations/Liquidity and Key Covenants Comparison			
	AWS Financing	Dwr Cymru Financing	SWS Finance
Debt reserve (months)	12	12	12
Prefunded capital expenditure or working capital availability (months)	12	12	12
Other covenanted liquidity	10% of next 12 months' operating and maintenance	Nil	10% of next 12 months' operating and maintenance
Distribution lock-up	>85% total debt/RAV	As for trigger events	>85% total debt/RAV
Trigger events (sample)	<1.3x senior interest coverage post capital maintenance*	<1.1x senior interest coverage post capital maintenance*	<1.3x senior interest coverage post capital maintenance*
	>75% senior debt/RAV	<2.0x senior interest coverage	>75% senior debt/RAV
	>90% total debt/RAV	>90% total debt/RAV	>90% total debt/RAV
Events of default (sample)	<1.6x senior interest coverage	<1.6x senior interest coverage	<1.6x senior interest coverage
	>95% total debt/RAV	>95% total debt/RAV	>95% total debt/RAV
*There are slight differences in the definition of capital maintenance expenditure for each company.			

Table 4 U.K. Water Corporate Securitizations Peer Comparison			
	AWS Financing	Dwr Cymru Financing	SWS Finance
–Year ended March 31, 2004–			
Key financial data (Mil. £)			
Revenues	767.0	470.0	455.0
EBITDA	475.0	259.0	282.0
Net income	269.0	44.0	85.0
Total assets	6,142.0	2,877.0	3,760.0
Total debt	3,923.0	2,383.0	2,095.0
Net debt	3,451.0	2,158.0	1,999.0
Funds from operations (FFO)	402.0	138.0	193.0
Capital expenditure (capex)	277.0	278.0	208.0
Financial ratios (%)			
Senior interest coverage post capital maintenance (x)	1.5	1.6	1.8
Net debt/RAV	82.0	84.0	86.0
Net senior debt/RAV	71.0	72.0	70.0
Gross capex/total assets	4.5	9.7	5.5
Net cash flow/total capex	22.0	51.7	56.4
Total debt/total capital	70.6	93.0	66.9
Operating data*			
2003/2004 Ofwat performance assessment score	421.0	419.0	391.0
Cost of operations (£/property)	32.0	43.0	32.0
Cost per customer (£/property)	72.0	87.0	61.0
Leakage (ml/day)	192.0	234.0	92.0

*Operating data applies to the underlying water utilities. RAV –Regulatory asset values.

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