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RESEARCH

Dwr Cymru (Financing) Ltd.

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Primary Credit Analyst: William Ferara, London (44) 20-7176-3519; bill_ferara@standardandpoors.com
Secondary Credit Analyst: Hugues De La Presle, Paris (33) 1-4420-6666; hugues_delapresle@standardandpoors.com

Credit Rating(s)	
Senior Secured	
£100 mil 4.473% Class A asset-backed bnds ser 3 due 03/31/2057	
Local Currency	AAA
Guarantor	MBIA UK Insurance Ltd.
£3 bil Sr Secd/Sub/Jr Sub multi curr med-term note prog : sr secd	
Local Currency	A-
£50 mil 1.375% index-linked sub-Class B5 bnds ser 2 due 03/31/2057	
Local Currency	A-
£528.6 mil Class B1 thru B4 bnds due 03/30/2027	
Local Currency	A-
£700 mil Class A nts due 03/31/2031	
Local Currency	AAA
Guarantor	MBIA Assurance S.A.
Subordinated	
£125 mil sub Class C bnds due 03/31/2036	
Local Currency	BBB
£3 bil Sr Secd/Sub/Jr Sub multi curr med-term note prog : sub	
Local Currency	BBB

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Business risk profile:

2

Financial risk profile:

Aggressive

Major Rating Factors:

Strengths:

- Positive structural features such as debt tranching, protective covenants, and mandated liquidity
- Substantial revenue and cash flow predictability during the current regulatory period through March 31, 2010
- Strong efficiency and service performance measures
- Aligned customer, regulatory, and management interests

Weaknesses:

- High leverage
- Large, ongoing mandatory capital-expenditure program
- Negative discretionary cash flows
- Uncertainty about periodic regulatory tariff reviews

Rationale

The 'AAA' long-term debt rating on U.K.-based special-purpose vehicle Dwr Cymru (Financing) Ltd.'s (Dwr Cymru) guaranteed senior secured (class A) bonds is based on the financial guarantee provided by MBIA Assurance S.A. (MBIA; AAA/Stable/--). The 'A-' rating on Dwr Cymru's senior secured (class B) bonds, and the 'BBB' rating on the entity's junior (class C) bonds, reflect a combination of the underlying credit quality of the Dwr Cymru Cyfyngedig (Welsh Water) regulated water and wastewater business in Wales, and various structural features designed to enhance cash flow certainty for bondholders. Dwr Cymru is a special-purpose vehicle for Welsh Water, which is owned by Glas Cymru Cyfyngedig, a Welsh nonprofit company, limited by guarantee.

Rating strengths include the liquidity mandated within the group's financial structure, a strong overall covenant package, and strict limitations on business activities. The ratings are also supported by a competitively priced long-term outsourcing plan, and the stability provided by Welsh Water's monopoly water and wastewater business. The senior debt further benefits from the existence of junior debt, which is subordinated and cannot force a default of the senior debt.

These strengths are offset by the risk related to a very aggressive--albeit strengthening--capital structure, negative discretionary cash flows, and only moderate debt–protection measures. Additional constraining factors are the ongoing need to raise debt to finance capital expenditures, the risk associated with periodic tariff resets, and a relatively new procurement policy and ownership incentive structure.

The Glas Cymru Cyfyngedid group has outperformed its financial and operational objectives and, consequently, is in a stronger overall position than it had originally forecast on completion of Dwr Cymru's £1.9 billion refinancing of Welsh Water in May 2001. Moreover, the regulatory environment for U.K. water utilities remains generally supportive following a recent tariff review by the Office of Water Services (Ofwat), the economic regulator for water and sewerage services in England and Wales. Welsh Water's tariff review is characterized by relatively modest price increases, a capital-expenditure program similar in size to that of the previous regulatory period, and manageable efficiency targets.

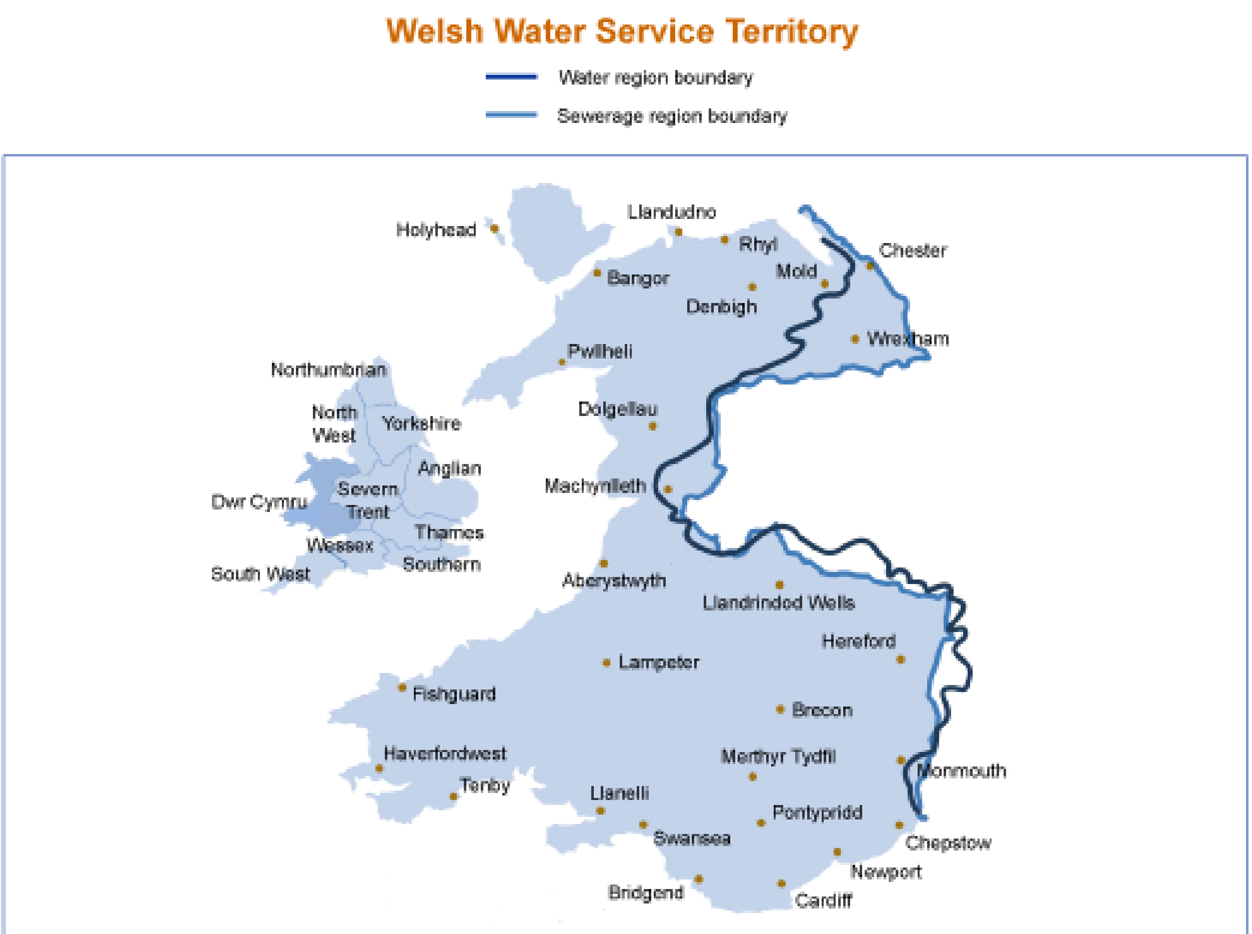
Glas Cymru's aggressive leverage results in only moderate debt-protection measures, although these are increasingly stronger than the levels expected by Glas Cymru at the time of the refinancing. Total net debt to regulated asset value (RAV) at Dec. 31, 2006, was about 76%, compared with 93% at refinancing in May 2001. Senior interest coverage before and after capital maintenance are projected at 3.1x and 1.9x, respectively, for the fiscal year ending March 31, 2007--both of which are well above the trigger levels of 2x and 1.1x, respectively.

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' enhancement capital expenditures. The steady, predictable net cash flow stream produced by Welsh Water, and minimal near-term debt maturities, provide further support; and there is a £150 million liquidity facility at Dwr Cymru Financing in case Welsh Water in unable to pay its interest bills during a standstill period. Actual liquidity, in the form of cash and cash equivalents, was slightly less than £147.7 million at Dec. 31, 2006. Undrawn, unconditional available bank facilities totaled £380 million at the same date.

Business Description

Glas Cymru was established in 2000 for the sole purpose of acquiring the regulated water and wastewater utility, Welsh Water, which it did in May 2001. The acquisition structure broke new ground in the U.K. utility sector--its distinguishing feature remaining the absence of shareholders. Rather, Glas 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 these also bear some underperformance risk. The group's ownership structure eliminates potential pressure for dividends and other shareholder returns.



Rating Methodology

With regard to this hybrid corporate and structured finance entity, Standard & Poor's Ratings Services recognizes the various structural elements that add to cash flow certainty and stability. The financial and corporate structures have been established so that the different debt tranches have different default characteristics. An issuer-level corporate credit rating, therefore, is not meaningful for Glas Cymru or Dwr Cymru.

The senior lenders to Dwr Cymru rank higher than the junior lenders, and nonpayment of interest to junior lenders would not constitute an event of default for the senior lenders. Accordingly, the default risk for the senior debt is lower than is typical of corporate utility financings, where junior debt is usually subordinated to senior debt in bankruptcy, but nonpayment of scheduled interest on junior debt would be an event of default for the senior debt. The financial analysis behind the 'A-' rating on the senior debt is largely based on financial measures for senior debt only. The financial analysis underpinning the 'BBB' rating on the junior debt is largely based on financial measures for both junior and senior debt.

Business Risk Profile

Strategy

Glas Cymru's is focused on its regulated water business. The company aims to be among the top operational performers in the industry, and to maintain a stable financial profile and attractive long-term investment. Glas Cymru intends to finance future investments in the business efficiently and retain scope to return money to its customers through a sustained "customer dividend".

Regulation

Welsh Water's regulatory environment is generally supportive, and there are strong links between environmental and economic regulators. The five-year regulatory framework used by Ofwat to set water and wastewater tariffs provides a substantial degree of predictability about Welsh Water's revenues until March 31, 2010. The regulatory structure is designed to provide companies with transparent and predictable cash flows that are sufficient to finance their operations, provided that specified, preagreed operational and financial targets are met.

Welsh Water's tariff review for the period 2005-2010 is characterized by relatively modest price increases, a capital-expenditure program similar in size to that of the previous regulatory period, and manageable efficiency targets. Welsh Water has benefited from Ofwat's methodology of allowing all companies the same return on capital regardless of their capital structure, as had been assumed at the time of the restructuring. For the 2005-2010 regulatory period, Ofwat's posttax cost of capital allowance is 5.1%. Welsh Water's customer bills should increase by an average of 3.6% per year more than retail price inflation (RPI) during the review period, compared with the sector average of 4.3%. In recognition of Welsh Water's improved operational performance over the past few years, Ofwat embedded an additional 0.1% into the company's price limits. The tariff review assumes:

- Annual average operating efficiency improvements of 1.7% for water and 1.9% for sewerage,
- Capital-maintenance efficiency improvements of 6.7% for water and 4 .3 % for sewerage, and
- Capital-enhancement efficiency improvements of 5.7% for water and 8.8% for sewerage.

The outcome is based on a capital-expenditure program of slightly less than £1.2 billion--similar to that of the previous five-year period.

Markets

Welsh Water is the sixth largest of the U.K.'s ten regulated water and sewerage companies, representing about 8% of the sector's assets. It serves about 1.3 million properties and more than 3 million people across most of Wales and some adjoining areas in England (see map). Welsh Water's market is moderate in size and has only modest growth prospects. Households represent more than 75% of the company's revenue base, which reduces exposure to economic volatility and business trends. Moreover, about 80% of domestic customers pay a fixed tariff regardless of consumption volumes. Welsh Water does not suffer from nonresidential customer concentration, as its 25 largest customers (by volume) account for less than 5% of total sales. The largest customer group by revenues is the metals manufacturing and metals products sector, which accounts for less than 2% of total revenues.

Operations

Welsh Water's operating performance has undergone a significant turnaround since 2001 when it began to outsource virtually all operations. Before 2001, the group had long been regarded by Ofwat as one of the least efficient performers in the sector. Welsh Water exhibits strong service performance measures. Key regulatory measures and benchmarks for service levels and water and environmental quality continued to perform well in the first six months of the fiscal year to March 31, 2007, although sewage flooding incidents have increased. The company has also achieved significant cost reductions through its competitive outsourcing exercise and has outperformed its own targets in this respect since the restructuring. Welsh Water was ranked third in Ofwat's "Overall Performance Assessment" for the year to March 31, 2006--the fifth year in a row that Welsh Water has been in the top three in the sector. There were no water use restrictions, despite summer rainfall being only 60% of the long-term average.

Despite the early success of the outsourcing program, Welsh Water's procurement policy should be judged over a longer period, as there remain inherent risks in external parties undertaking all of the company's capital and operating expenditures--particularly when legal responsibility remains with the utility. Outsourcing contracts extending for up to 15 years to cover the vast majority of the company's capital-expenditure and operating programs commenced in April 2005. The largest of these are with United Utilities PLC (A-/Stable/A-2) for water and wastewater operations, Kelda Group PLC (A/Watch Neg/A-1) for wastewater operations, and various engineering firms for wastewater capital-investment projects. The company also appointed Hyder Consulting as network development consultant, effective Jan. 1, 2006, for a period of up to 14 years. The company's capital-expenditure program focuses on water-mains replacement, wastewater treatment quality improvements, and the alleviation of sewer flooding.

Competitive position

Welsh Water faces little competitive threat, because there has been limited movement by the U.K. government or regulator to introduce competition. Customers in the industry that consume 50 megaliters per year or more can switch supplier, although limited switching actually takes place. In the absence of genuine competition, Ofwat has established "surrogate competition" through regulatory comparison. Strong competition in the U.K. water sector will be very difficult to implement, however, and, accordingly, the credit profile of Welsh Water is unlikely to be materially affected by competition over the medium term.

Financial Risk Profile

Accounting

Glas Cymru adopted IFRS from April 1, 2005, having previously reported under U.K. GAAP. The transition had no effect on the company's senior debt interest coverage ratio or its gearing ratio. The transition to IFRS has resulted in:

- The pension deficit being brought onto the balance sheet;,
- A change in net assets (primarily owing to deferred tax and pension adjustments);,
- The elimination of the amortization of negative goodwill;, and
- Changes relating to the infrastructure renewals charge and the fair value of financial instruments.

The company is no longer permitted to discount deferred tax. As a result, the transition to IFRS increased the deferred taxation liability by £308 million, and liabilities relating to the fair value of financial instruments have added some £69 million to the balance sheet. In addition, the amortization of £46.9 million of negative goodwill is no longer recognized under IFRS.

Standard & Poor's adjustments to Dwr Cymru's reported figures are summarized in table 1.

Table 1

Reconciliation Of Dwr Cymru 2006 Reported Amounts With Standard & Poor's Adjusted Amounts*								
Mil. £								
Dwr Cymru reported amounts								
	Short- and long-term debt	**Operating income (before D&A)**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Interest expenses**	**Operating cash flows**	**Operating cash flows**	**Capital expenditures**
	2,369.5	292.3	292.3	194.8	154.0	125.6	125.6	165.7
Standard & Poor's adjustments								
Operating leases	1.9	0.4	0.1	0.1	0.1	0.3	0.3	0.3
Postretirement benefit obligations	4.6	(0.3)	(0.3)	(0.3)	0.3	0.6	0.6	--
Reclassification of nonoperating income (expenses)	--	--	--	6.7	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	31.1	--
Other	(6.7)	--	--	--	--	--	--	--
Standard & Poor's total adjustments	(0.1)	0.1	(0.2)	6.5	0.4	0.9	32.0	0.3

Standard & Poor's adjusted amounts								
	Debt	Operating income (before D&A)	EBITDA	EBIT	Interest expenses	Operating cash flows	Funds from operations	Capital expenditures
	2,369.4	292.4	292.1	201.3	154.4	126.5	157.6	166.0

*This table illustrates the adjustments made by Standard & Poor's to the company's reported amounts for the year ended March 01, 2006. The first section headed "Dwr Cymru reported amounts" describes and shows amounts as reported by the company. The second section, headed "Standard & Poor's adjustments," shows our adjustments to these reported amounts. The third section, headed "Standard & Poor's adjusted amounts," describes and shows the amounts we use to calculate the fully adjusted ratios appearing elsewhere in this report. Please note that two reported amounts (operating income before D&A, and operating cash flows) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and operating cash flows and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Corporate governance/Risk tolerance/Financial policies

Glas Cymru's acquisition and refinancing of Welsh Water was the first in a series of highly leveraged U.K. water utility financings. It used a very aggressive financial structure, elements of which--such as debt tranching and liquidity requirements--mitigate the risks of such high leverage, as does the stable nature of the underlying business. The company's financial policy remains aggressive, however.

Cash flow adequacy

The underlying water and wastewater business generates relatively stable and predictable cash flows, with few variables, through April 2010. This is particularly true with regard to revenue predictability (through known tariffs), operating costs (through outsourcing), and interest expenses (through fixed and hedged interest rates). From April 2010 onward there is less certainty, particularly with regard to the level of regulated revenues and outsourced contract costs. One of the group's key operating challenges and risks will be meeting its mandated operating- and capital-efficiency targets. Profitability ratios are very modest--particularly when calculated on a total interest basis--and are unlikely to change materially over the next few years. The operating cash flow trend mirrors the earnings trend, with funds from operations (FFO) likely to increase slowly, but steadily, on the back of regulated earnings growth. Senior interest coverage before and after capital maintenance are projected at 3.1x and 1.9x, respectively, for fiscal 2007--both of which are well above the trigger levels of 2x and 1.1x, respectively. FFO interest coverage of senior debt and FFO to total debt will likely increase only moderately from about 2.5x and 6%, respectively, during the next few years. These ratios are modest for the rating category--even for a water utility--but they should be interpreted in light of Glas Cymru's credit-enhancing structural features.

Welsh Water's cash flow profile is characterized by a large ongoing capital-expenditure requirement and negative annual net cash flows. For the regulatory period 2005-2010, the cost of Welsh Water's capital-expenditure program is projected at slightly less than £1.2 billion--a similar figure to that of the previous regulatory period. The annual average spend of nearly £240 million represents about 8% of Welsh Water's RAV, which is average for a U.K. water utility. It is unlikely that Glas Cymru will be required to pay cash taxes on its trading income for a number of years, given U.K. taxation rules.

Capital structure/Asset protection

At Dec. 31, 2006, Glas Cymru's total net debt was about £2.4 billion, or about 76% of its RAV, which compares with 93% at refinancing in May 2001. Net senior debt is about £2.3 billion, which is about 72% of RAV. In Glas Cymru's case, RAV is the best measure of asset value, given that Ofwat allows a return on RAV. The company has continued to improve its capital structure through the early redemption of £425 million of bonds (£300 million senior and £125 million junior) in June 2005, further European Investment Bank (AAA/Stable/A-1+)) borrowings, and entering into new finance leases. All these financings provide flexible access to funds at competitive rates. On Dec. 15, 2006, a further £25 million of the £100 million EIB loan facility was drawn down, representing the fourth drawdown of the facility since it was agreed on 5 Dec. 5, 2005. At Dec. 31, 2006, undrawn EIB, revolving credit facilities and cash totaled £528 million, giving the company a high degree of liquidity. Finance leases totaled about £740 million at the same date.

Debt ratios have improved, owing to Glas Cymru's use of surplus funds to deleverage, and could improve further if the financial benefits of regulatory outperformance exceed the increased level of customer rebates. Underperformance could cause leverage to increase, however. Glas Cymru has established a very long-dated debt-maturity profile given the long life of water and wastewater assets (which are naturally suited to long-term debt). This reduces refinancing risk, but increases the risk that Ofwat's reassessment of the cost of capital every five years could be out of step with Glas Cymru's locked-in long-term interest rate (although this was not the case at the recent regulatory review). Glas Cymru does not have shareholders, and therefore will not pay a dividend. Accordingly, excess cash generated within the business over and above targeted financial reserve levels can be rebated to customers. In fiscal 2006 customer dividends increased to £19 per customer, at a total of £25 million (compared with about £23 million in fiscal 2005).

Glas Cymru's financial flexibility stems from its reserves and unused borrowing capacity. Its highly leveraged financing structure does leaves little new borrowing capacity, however. The absence of traded shares reduces the company's potential funding sources compared with those of the rest of the U.K. water sector, although, as has been demonstrated in recent years, a listed equity base does not necessarily add significant financial flexibility. In view of the measures taken to lower business volatility in the Glas Cymru structure, the company could, arguably, manage with less flexibility than other water companies.

Glas Cymru retains a forward-funding program to ensure that cash is raised, or facilities set up, comfortably ahead of requirements. This is aimed to ensure access to the debt markets at opportune times and offset the potential adverse effects of any short-term market disruption. The company further demonstrated this strategy with the issuance of £150 million of index-linked bonds in late 2006, to repay revolving credit facility drawdowns and prefund capital-expenditure requirements.

Table 3

Dwr Cymru (Financing) Ltd. Financial Summary*		
	--Fiscal year ended March 31--	
	2006	**2005**
Total revenues	553.5	494.1
Net income continuing	16.1	5.5
Funds from operations (FFO)	157.6	94.7
Capital expenditures	166.0	222.1
Cash and investments	0.0	235.0
Debt	2,369.4	2,518.3
Preferred stock	0.0	0.0
Common equity	(79.20)	(95.30)

Total capital	2,290.2	2,423.0
Adjusted ratios		
EBIT interest coverage (x)	1.3	1.0
FFO interest coverage (x)	1.9	1.5
FFO/debt (%)	6.7	3.8
Discretionary cash flow/debt (%)	(1.67)	(5.05)
Net cash flow/capital expenditures (%)	94.9	42.7
Debt/total capital (%)	103.5	103.9
Return on average equity (%)	(18.45)	(5.77)
Common dividend payout ratio (unadjusted) (%)	0.0	0.0

*Fully adjusted (including postretirement obligations).

Table 2

Dwr Cymru (Financing) Ltd. Peer Comparison*			
	--Fiscal year ended March 31, 2006--		
	Dwr Cymru (Financing) Ltd.	Anglian Water Services Financing PLC	Southern Water Services Ltd.
(Mil. £)			
Total revenues	553.5	865.7	541.5
Net income from cont. oper.	16.1	246.9	61.4
Funds from operations (FFO)	157.6	559.8	222.9
Capital expenditures	166.0	239.9	258.8
Cash and investments	0.0	501.5	240.9
Debt	2,369.4	4,080.0	2,789.4
Preferred stock	0.0	0.0	0.0
Common equity	(79.2)	1,584.9	729.8
Total capital	2,290.2	5,664.9	3,519.2
Adjusted ratios			
EBIT interest coverage (x)	1.3	2.0	1.5
FFO interest coverage (x)	1.9	2.7	1.9
FFO/debt (%)	6.7	13.7	8.0
Discretionary cash flow/debt (%)	(1.67)	(0.03)	(3.38)
Net cash flow/capital expenditures (%)	94.9	105.9	68.8
Debt/total capital (%)	103.5	72.0	79.3
Return on common equity (%)	(18.45)	15.6	8.5
Common dividend payout ratio (unadjusted) (%)	0.0	125.8	73.0

*Fully adjusted (including postretirement obligations).

Additional Contact: Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com