STANDARD & POOR'S

RATINGSDIRECT®

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Dwr Cymru (Financing) Ltd.

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Dwr Cymru (Financing) Ltd.

Major Rating Factors

Strengths:

- Local monopoly position
- Stable and predictable regulated cash flows
- Positive structural enhancements
- Benign nonprofit ownership structure
- Commitment to decrease leverage

Weaknesses:

- High leverage
- Regulatory reset risk
- Recurrent large capital investment program
- Negative discretionary cash flows

None

Rationale

The 'A' long-term debt ratings on the senior secured class A and B bonds 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. reflect 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).

The senior secured class A bonds issued by Dwr Cymru (Financing) Ltd. retain an unconditional and irrevocable guarantee provided by MBIA U.K. Insurance Ltd. or MBIA Assurance S.A. (both BBB+/Negative/--). Under Standard & Poor's Ratings Services' criteria, a rating on a monoline-insured debt issue reflects the higher of the rating and outlook on the monoline and Standard & Poor's underlying rating (SPUR). Therefore, the long-term debt ratings on the bonds reflect the SPUR of 'A'.

The debt ratings are underpinned by the stability provided by Welsh Water's regulated monopoly water and wastewater business. Rating strengths also include the liquidity mandated within the group'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 continuous trend of deleveraging and the management's commitment to target net debt to regulatory capital value (RCV) of about 70%. At the same time, the nonprofit ownership structure, with its lack of shareholders, eliminates pressure to leverage the balance sheet through shareholder distributions.

These strengths are offset by the risk related to an aggressive--albeit strengthening--capital structure, negative discretionary (i.e. prefinancing) cash flows, and only moderate debt-protection measures. Additional constraining factors are the ongoing need to raise debt to finance capital expenditures and the risk associated with the regulatory review and tariff reset every five years.

Key business and profitability developments

Welsh Water is focused on its regulated water and wastewater activities in its appointed area. The company has made steady progress with the key performance measures set for this regulatory period through March 31, 2010, by the water and sewerage regulator in England and Wales, the Office of Water Services (Ofwat). Standard & Poor's expects this trend to continue as significant resources are committed to tackle leakage and to improve security of supply and water quality. Furthermore, the business model of competitive outsourcing, which was put in place after Glas Cymru's acquisition of Welsh Water in 2001, has achieved substantial operational efficiencies through incentives on target costs.

Ofwat is in the midst of the price review applicable to the water utilities for the next regulatory period, which starts April 1, 2010. The regulator is to announce its final determination of allowances for price limits, capital expenditure, cost of capital, and levels of service, among others, in November 2009.

Key cash flow and capital-structure developments

Glas Cymru's debt-protection measures are moderate but increasingly stronger than expected at the time of Dwr Cymru (Financing) Ltd.'s £1.9 billion refinancing of Welsh Water in 2001. Total net debt to RCV at Sept. 30, 2008, was about 71%, compared with 93% at refinancing in May 2001. Standard & Poor's expects that senior interest coverage before and after capital maintenance will remain well above the trigger levels of 2.0x and 1.1x, respectively, through the end of this regulatory period on March 31, 2010. In its 25-year "Strategic Direction Statement," published in November 2007, Glas Cymru's management has committed to further decrease leverage to an optimum level of about 70% (net debt to RCV).

We expect Welsh Water's discretionary cash flows after capital expenditures and customer rebates to remain negative in the foreseeable future due to the recurrent large capital expenditure. The mandated £1.2 billion investment program (in 2002/2003 prices) for this regulatory period is heavily back loaded, requiring investments of about £600 million over the two years until March 31, 2010. Yet, Glas Cymru operates a forward-looking prefunding policy, which combined with strong liquidity and prudent treasury management, insulates the company from volatile credit market conditions.

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 (Financing) Ltd. Covenants relating to liquidity include a requirement to have sufficient cash and bank lines for the next 12 months of capital expenditures. The steady, predictable operating cash flow stream produced by Welsh Water and minimal near-term debt maturities provide further support. The next expected bond redemption maturity is £125 million of subordinated class C bonds in March 2011. In addition, a £150 million liquidity facility at Dwr Cymru (Financing) Ltd. is available if Welsh Water were unable to pay its interest bills during a standstill period. Actual unrestricted liquidity, excluding accounts for debt service and customer rebates, was £72.0 million at Sept. 30, 2008. Undrawn committed bank facilities totaled £345 million at the same date.

Business Description

Dwr Cymru (Financing) Ltd. is a special-purpose vehicle that is owned by Glas Cymru, a Welsh nonprofit company, 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 pressures 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 was £3.53 billion at March 31, 2008. It serves about 1.3 million properties, including more than 3 million people across most of Wales and some adjoining areas in England.

Rating Methodology

With regard to this hybrid corporate and structured finance entity, Standard & Poor's 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 (Financing) Ltd.

The senior lenders to Dwr Cymru (Financing) Ltd. rank in priority over 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' ratings on the senior debt is based on financial measures for senior debt only. The financial analysis underpinning the 'BBB+' ratings on the junior debt is based on financial measures for both junior and senior debt.

Business Risk Profile: Excellent, Underpinned By Supportive Regulation And Strong Competitive Position

Welsh Water's excellent business risk profile is supported by:

- The generally supportive and transparent regulatory framework in the U.K. water sector, ensuring 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 that they meet specified, preagreed operational and financial targets. Welsh Water's tariff review for the 2005-2010 period is characterized by above-average price increases for the water sector, a capital expenditure program similar in size to that of the previous regulatory period, and manageable efficiency targets.
- Little competitive threat and high barriers to entry in its appointed area. In the absence of genuine competition, Ofwat has established surrogate competition through regulatory comparison. The recent proposal by Ofwat aimed at introducing competition in the water markets, however, might affect materially the credit profile of rated utilities. (For more information, please refer to the article titled "Enhanced Competition Could Alter Standard & Poor's Assessment Of The U.K. Water Sector," published Dec. 12, 2008, on RatingsDirect.)
- Focus on efficiency and cost control through target cost incentives built in the outsourcing contracts with its

partners, including United Utilities PLC (A-/Stable/A-2) and Kelda Group Ltd. (BBB/Watch Neg/A-2). That said, Welsh Water to an extent shares with partners the effect of rising energy costs and bears the risk of nonpayment of customer bills. Welsh Water's procurement policy should be judged over a longer period because inherent risks remain in having external parties undertake all of the company's capital and operating expenditures--particularly when the legal responsibility remains with the utility.
- Steady progress in meeting Ofwat's targets for operational performance and efficiency. In 2007/2008, Welsh Water ranked fifth among its peers in Ofwat's Overall Performance Assessment, a holistic basket of service measures. Most notably, the company has been compliant with its challenging leakage target for 11 consecutive years and has reduced serious pollution incidents, though sewer flooding incidents due to wet weather continue to be a challenge.

These strengths are to some degree offset by Welsh Water's:

- Regulatory reset risk following the regulatory reviews, undertaken by Ofwat every five years. The next price control review is ongoing and should be effective from April 1, 2010.
- Sizable recurrent investment program mandated by the regulator to maintain preagreed service levels. This results in generally negative free operating cash flows and the need for ongoing borrowing. The outcome for this five-year period is based on a capital expenditure program of slightly less than £1.2 billion at base-year prices--which is heavily back loaded.

Financial Risk Profile: Aggressive Capital Structure Mitigated By Stable Cash Flows And Sustained Deleveraging

The main weaknesses of Glas Cymru's aggressive financial profile are:

- High, though declining, leverage after the acquisition in May 2001. The board has publicly announced its intention to reduce and maintain leverage at about 70% of net debt to RCV.
- Modest financial ratios for the 'A' rating category but they should be interpreted in light of Dwr Cymru (Financing) Ltd.'s credit enhancement features. Over the next few years, funds from operations (FFO) interest coverage of total debt and FFO to total debt will likely increase only moderately from about 1.7x and 4.1%, respectively, in 2007/2008.

These weaknesses are partially mitigated by:

- Protective structural features. They include considerable cash reserves and liquidity facilities, which would allow for continued debt servicing under stress; a comprehensive security package (limited by the standard restrictions applying to the sector, though); 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 rebates excess cash generated within the business above targeted financial reserve levels to its customers. The headroom between covenant triggers and current leverage levels has widened, with net debt to RCV significantly below the trigger level of 90%; at Sept. 30, 2008, net debt to RCV was about 71%.
- Forward-funding program to ensure that cash is raised, or facilities set up, comfortably ahead of requirements.

After completing a £100 million loan with the European Investment Bank in October 2008, Glas Cymru has funding in place at least until the end of this regulatory period in March 31, 2010.

- 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, 97% of 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 maturating debt in any two-year period.

Financial Statistics/Adjustments

Glas Cymru has reported under International Financial Reporting Standards since April 1, 2005. Due to the different accounting treatment of infrastructure renewals expenditure, Glas Cymru's debt coverage ratios are somewhat lower than those of its peers reporting under U.K. generally accepted accounting principles. For more information, please refer to the article titled "U.K. Water Utilities Have Successfully Navigated The Uncharted Seas Of IFRS," published Dec. 13, 2006, on RatingsDirect.

We adjust reported debt for bond issue costs and surplus cash balances, which are not restricted for debt service or customer rebates. In order to smooth timing differences, we adjust cash interest paid for accruals of interest between financial years. At year-end March 2008, Glas Cymru had a pretax pension surplus of £2.0 million on its defined benefit pension scheme.

Table 1

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)*

	--Fiscal year ended March 31, 2008--						
Dwr Cymru (Financing) Ltd. reported amounts							
	Debt	**Shareholders' equity**	**Operating income (before D&A)**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Cash flow from operations**	**Cash flow from operations**
Reported	2,648.5	(41.7)	295.4	295.4	173.1	67.5	67.5
Standard & Poor's adjustments							
Postretirement benefit obligations	--	0.0	(3.3)	(3.3)	(3.3)	3.0	3.0
Surplus cash and near cash investments	(85.0)	--	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	12.2	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	25.7
Other	5.6	--	--	--	(0.8)	38.9	8.5
Total adjustments	(79.4)	0.0	(3.3)	(3.3)	8.1	41.9	37.2
Standard & Poor's adjusted amounts							
	Debt	**Equity**	**Operating income (before D&A)**	**EBITDA**	**EBIT**	**Cash flow from operations**	**Funds from operations**
Adjusted	2,569.1	(41.7)	292.1	292.1	181.2	109.4	104.7

Table 1

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)* (cont.)

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 2

Dwr Cymru (Financing) Ltd. Peer Comparison*

(Mil. £)	Dwr Cymru (Financing) Ltd.	Anglian Water Services Financing PLC	Southern Water Services (Finance) Ltd.
Senior secured underlying debt rating¶	A	A-	A-
	--Fiscal year ended March 31, 2008--		
Revenues	622.9	969.2	618.7
Net income from continuing operations	4.2	311.7	87.4
Funds from operations (FFO)	104.7	419.5	277.2
Capital expenditures	173.2	414.1	415.6
Cash and short-term investments	39.1	170.0	201.8
Debt	2,569.1	4,882.8	3,307.4
Preferred stock	0.0	0.0	0.0
Equity	(41.7)	1,457.5	811.4
Debt and equity	2,527.4	6,340.3	4,118.8
EBIT interest coverage (x)	1.1	1.4	1.4
FFO interest coverage (X)	1.7	2.0	2.0
FFO/debt (%)	4.1	8.6	8.4
Discretionary cash flow/debt (%)	(2.5)	(2.5)	(6.8)
Net cash flow/capital expenditure (%)	60.5	77.9	50.4
Total debt/debt plus equity (%)	101.6	77.0	80.3
Return on common equity (%)	(9.6)	21.1	11.0
Common dividend payout ratio (unadjusted) (%)	0.0	32.1	77.6

*Fully adjusted, as appropriate; detailed adjustments can be found in each company's full report--article type "Analyses"--on RatingsDirect. ¶At March 4, 2009.

Table 3

Dwr Cymru (Financing) Ltd. Financial Summary*

	--Fiscal year ended March 31--			
(Mil. £)	2008	2007	2006	2005
Revenues	622.9	578.0	553.5	494.1
Net income from continuing operations	4.2	33.3	16.1	5.5
Funds from operations (FFO)	104.7	114.2	141.5	94.8
Capital expenditures	173.2	166.2	165.7	220.2
Cash and short-term investments	39.1	158.0	14.0	235.0
Debt	2,569.1	2,595.9	2,367.8	2,517.1
Equity	(41.7)	(45.9)	(79.2)	(95.3)
Debt and equity	2,527.4	2,550.0	2,288.6	2,421.8
EBIT interest coverage (x)	1.1	1.0	1.3	1.0

Table 3

Dwr Cymru (Financing) Ltd. Financial Summary* (cont.)				
FFO interest coverage (x)	1.7	1.6	1.9	1.5
FFO/debt (%)	4.1	4.4	6.0	3.8
Discretionary cash flow/debt (%)	(2.5)	(1.8)	(1.7)	(5.0)
Net cash flow/capital expenditure (%)	60.5	68.7	85.4	43.0
Debt/debt and equity (%)	101.6	101.8	103.5	103.9
Return on common equity (%)	(9.6)	(53.2)	(18.5)	(5.8)
Common dividend payout ratio (unadjusted) (%)	0.0	0.0	0.0	0.0

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

Ratings Detail (As Of March 4, 2009)*	
Dwr Cymru (Financing) Ltd.	
Senior Secured (5 Issues)	A
Subordinated (2 Issues)	BBB+
Business Risk Profile	1 2 $\boxed{3}$ 4 5 6 7 8 9 10
Financial Risk Profile	Aggressive
Debt Maturities	
As of March 31, 2008 2009: £21.7 mil. 2010: £11.3 mil. 2011: £142.1 mil. 2012: £23.5 mil. 2013: £28.5 mil. Thereafter: £2.42 bil.	

*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.

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