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### Dwr Cymru (Financing) Ltd.

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#### Corporate Credit Rating

#### Business Profile

1 **2** 3 4 5 6 7 8 9 10

#### Financial policy:

Aggressive

#### Major Rating Factors

##### Strengths:

- Structural features, such as debt tranching, protective covenants, and mandated liquidity;
- Substantial revenue and cash flow predictability during the current regulatory period, which ends in 2010;
- Strong efficiency and service performance measures; and
- Alignment between the interests of customers, regulator, and management.

##### Weaknesses:

- High debt leverage;
- Large ongoing mandatory capital expenditure program and negative free cash flow; and
- Regulatory uncertainty surrounding periodic reviews.

#### Rationale

The 'AAA' ratings on Dwr Cymru (Financing) Ltd.'s guaranteed senior (class A) bonds are based on the financial guarantee provided by MBIA Assurance S.A. (MBIA; AAA/Stable/--). The 'A-' ratings on the senior (class B), the 'BBB' ratings on the junior (class C) bonds, and the 'A-' underlying rating on the class A 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 Financing is a special-purpose financing vehicle for Welsh Water, which is owned by Glas Cymru Cyfyngedig, a Welsh not-for-profit company limited by guarantee.

Rating strengths include the liquidity mandated within the financial structure, a strong overall covenant package, strict limitations on business activities, 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 at the rating level by the risk entailed in a very aggressive, albeit strengthening, capital structure, moderate debt protection measures, an ongoing need to raise debt to finance the capital expenditure program, periodic tariff resets, and a relatively new procurement policy and ownership incentive structure.

The group has outperformed its financial and operational objectives and, as a result, is in a stronger overall position than originally forecast when the £1.9 billion refinancing of Welsh Water by Dwr Cymru Financing was completed in May 2001. Moreover, the regulatory environment for U.K. water utilities remains generally supportive following sector regulator OFWAT's recent tariff review. Welsh Water's

tariff review is characterized by relatively modest price increases, a capital spending program similar in size to that of the previous regulatory period, and manageable efficiency targets. Welsh Water has benefited from OFWAT's approach to allow 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 post-tax cost of capital allowance is 5.1%.

Welsh Water's competitive procurement strategy has delivered very positive results since it contracted out virtually all operations. In 2004, Welsh Water achieved its best-ever results, which placed it second in the Overall Performance Assessment by OFWAT. The company has also achieved significant cost reductions through the competitive contracting-out exercise. Outsourcing contracts of up to 15 years to cover the vast majority of the company's capital expenditure and operating programs will commence in April 2005.

Glas Cymru's aggressive leverage results in moderate debt protection measures, although they are marginally ahead of the levels anticipated at the time of the refinancing. Net debt to regulated asset value (RAV) at Dec. 31, 2004, was about 83%, compared with 93% at refinancing in May 2001. Funds from operations (FFO) interest coverage of senior debt in fiscal 2004 was 2.5x and is forecast to remain at about this level in the medium term. FFO to total debt is low at about 7% and may only increase moderately in the next few years.

### **Liquidity**

Strong liquidity, as mandated by the company's borrowing documents, is a central feature of the Glas Cymru financial structure, and consequently that of Dwr Cymru Financing. Covenants relating to liquidity include a requirement to have sufficient cash and bank lines for the next 12 months' enhancement capital expenditure. Actual liquidity, in the form of cash and cash equivalents, was £440 million at Dec. 31, 2004. Undrawn, unconditionally available bank and lease facilities totaled an additional £184 million.

## **■ Business Description**

Glas Cymru was established in 2000 for the sole purpose of acquiring Welsh Water, which it did in May 2001. The Glas Cymru acquisition structure broke new ground for the U.K. utility sector. Its distinguishing feature is the lack of shareholders; instead, Glas Cymru is controlled by "members" who have no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers, and to a lesser extent investors, although they also bear some underperformance risk. The group's ownership structure eliminates potential pressure for dividends and other shareholder returns.

## **■ Rating Methodology**

In this hybrid corporate and structured finance credit, recognition is given to the various structural elements that add to cash flow certainty and stability. The financial and corporate structure has been established so that the different tranches of debt have different default characteristics. An issuer-level corporate credit rating, therefore, is not meaningful for Glas Cymru or Dwr Cymru Financing. The senior lenders to Dwr Cymru Financing rank above 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 in typical corporate utility financings, where junior debt is typically 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 was largely, although not entirely, based on financial measures for senior debt only. The financial analysis underpinning the 'BBB' rating on the junior debt was largely based on financial measures for both junior and senior debt.

## **■ Business Profile**

### **Regulation**

Welsh Water's regulatory environment is generally supportive, and there are good 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 certainty to Welsh Water's revenues

until March 31, 2010. The regulatory structure is designed to provide companies with transparent and predictable cash flows sufficient to finance their operations, provided that specified, pre-agreed operational and financial targets are met. The most recent regulatory reset, which was announced in December 2004 and will become effective in April 2005, is important for Welsh Water because it is the company's first review since the restructuring.

Welsh Water's customer bills will increase by an average of about 3% more than retail price inflation (RPI) per year in 2005-2010. In recognition of Welsh Water's better operational performance over the past few years, OFWAT embedded an additional 0.1% per year for the regulatory period into the company's price limits. The tariff review assumes annual average operating efficiency improvements of 1.8% for water and 2.0% for sewerage, and annual average capital efficiency improvements of 1.2%. The outcome is based on a capital expenditure program of slightly less than £1.2 billion, a level similar to that of the previous five-year period.

### **Markets And Operations**

Welsh Water is the sixth largest of the U.K.'s 10 water and sewerage companies. It serves about 1.3 million properties and more than three million people across most of Wales and some adjoining areas in England. Welsh Water's market is of moderate size and has only modest growth prospects. Positively, more than 75% of the company's revenue base originates from households, which reduces the company's 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 revenue is the metals manufacturing and metals products sector, which accounts for less than 2% of total revenue.

Welsh Water's operating performance has undergone a significant turnaround since 2001 when it began to outsource virtually all operations. Beforehand, it was long regarded by OFWAT as one of the least efficient performers in the sector. Welsh Water has accomplished a notable improvement in service performance measures and achieved its best-ever result in OFWAT's Overall Performance Assessment in 2003-2004, coming in second place. The company has also achieved significant cost reductions through the competitive contracting-out exercise and has outperformed its own targets since the restructuring.

Despite the early success of the outsourcing program, Welsh Water's procurement policy should be judged over a longer period as there are some inherent risks with having other parties undertake all 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 will commence in April 2005. The largest outsourced contracts are with United Utilities PLC (A-/Stable/A-2) for water and wastewater operations, Kelda Group PLC (A/Stable/A-1) for wastewater operations, and various engineering firms for wastewater capital investment projects. The company's capital expenditure program focuses on water mains replacement, wastewater treatment quality improvements, and a reduction in the frequency of storm spills into local waterways.

### **■ Financial Policy: Aggressive**

Glas Cymru's acquisition and refinancing of Welsh Water was the first of the highly leveraged U.K. water utility financings. It used a very aggressive financial structure. Elements of the structure, 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.

Glas Cymru does not have shareholders, and so it will not pay a dividend. Excess cash generated within the business over and above targeted financial reserve levels can therefore be rebated to customers--targeted at £18 per customer per year (about £23 million) to 2010--and used to deleverage the business.

### **■ Financial Profile**

#### **Accounting**

Glas Cymru reports under U.K. GAAP and is not required to present its consolidated accounts in accordance with International Financial Reporting Standards (IFRS) because it is not a listed company. Standard & Poor's understands that Dwr Cymru Financing plans to adopt IFRS from April 1, 2005. The group is currently examining the impact of the transition to IFRS on its accounts, with items likely to be affected including derivatives and hedging. The company's hedging policy, which is mandated by bond covenants, ensures at least 85% of debt is either fixed-rate or indexed to inflation.

### **Profitability And Cash Flow**

The underlying water and wastewater business generates a relatively stable and predictable earnings and cash flow stream with few "moving parts" through April 2010. This is especially true of revenue certainty (through known tariffs), operating cost certainty (through outsourcing), and interest expense certainty (through fixed and hedged interest rates). One of the key operating challenges and risks will be whether the group can meet its mandated operating and capital efficiency targets. Thereafter, there is less certainty, particularly in the level of regulated revenues and outsourced contract costs.

Profitability ratios are very modest, particularly when calculated on a total interest basis. Pretax interest coverage on all debt in fiscal 2004 was 1.3x and for the senior (class A and class B) debt, the ratio was 1.6x. These ratios are unlikely to change materially over the next few years.

The operating cash flow trend mirrors the earnings trend. FFO was slightly less than £140 million in 2004, and should grow slowly but steadily, on the back of regulated earnings growth. FFO coverage of senior interest was 2.5x in fiscal 2004 (fully factoring in the indexation on the index-linked bonds reduces FFO coverage to 1.8x) and FFO interest coverage of all debt was 2.0x in 2004. Senior interest coverage post capital maintenance was 1.6x in 2004, up slightly from that projected at the time of the refinancing. FFO to total debt is low at about 7% and may only increase moderately in 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 2005-2010 regulatory period, Welsh Water's capital program is expected to be nearly £1.2 billion, which is similar in size to the previous regulatory period. The annual average spend of about £220 million represents about 8% of Welsh Water's RAV, which is average for a water utility. It is unlikely that Glas Cymru will be required to pay cash taxes for a number of years, given U.K. taxation rules.

### **Capital Structure And Financial Flexibility**

At Dec. 31, 2004, Glas Cymru's total net debt was nearly £2.2 billion, or about 83% of its RAV, which compares with 93% at refinancing in May 2001. Net senior debt is about £1.9 billion, which is slightly more than 70% of RAV. Standard & Poor's believes that RAV is the best measure of asset value, given that OFWAT allows a return on RAV.

Debt leverage ratios have improved, owing to the company's use of surplus funds to deleverage, and they may improve further if the financial benefits of regulatory outperformance exceed the increased level of customer rebates. The company intends to increase its level of customer rebates to £18 per customer per year (about £23 million) during the regulatory period, from £9 per customer in fiscal 2004. Underperformance could see leverage increase. The long life of water and wastewater assets is naturally suited to long-life debt, and Glas Cymru has established a debt profile with an average life of about 15 years. 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.

Glas Cymru's financial flexibility stems from its reserves and unused borrowing capacity. Its highly geared financing structure does not leave much new borrowing capacity, however. The lack of traded shares reduces the company's potential funding sources compared with the rest of the sector, but, as the U.K. water sector has seen in recent years, a listed equity base does not necessarily add significant financial flexibility. Owing to the measures to lower business volatility in the Glas Cymru structure, the company can arguably manage with less flexibility than other water companies.

Glas Cymru's management has shown a preference for a forward funding program to ensure that cash is raised or facilities are in place comfortably ahead of needs. It believes that a forward funding program will ensure Glas Cymru's access to the debt markets at opportune times and will not be adversely affected by short-term market disruption.

<b>Table 1 Dwr Cymru (Financing) Ltd. 2004 Peer Comparison</b>			
<b>(Mil. £)</b>	<b>Dwr Cymru (Financing) Ltd.</b>	<b>Anglian Water Services Financing PLC</b>	<b>Southern Water Services (Finance) Ltd.</b>
Senior secured debt rating	A-	A-	A-
Revenues	470	767	455
EBITDA	259	475	282
Net income	44	269	85
Total assets	2,877	6,142	3,760
Total debt	2,383	3,923	2,095
Net debt	2,158	3,451	1,999
Funds from operations (FFO)	138	402	193
Capital expenditure	278	277	208
Senior interest coverage post capital maintenance (x)	1.6	1.5	1.8
Net debt/regulated asset value (RAV) (%)	84	82	86
Net senior debt/RAV (%)	72	71	70

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