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Oman Power and Water Procurement Co. SAOC

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Oman Power and Water Procurement Co. SAOC

Major Rating Factors

Sovereign Credit Rating
A/Negative/--

Strengths:

- "Almost certain" likelihood of extraordinary support from the Sultanate of Oman, its full owner, reflecting an "integral" link with and "critical" role for the government.
- Monopoly bulk buyer and seller of electricity and associated desalinated water in Oman.
- Fully regulated low-risk agency function with no direct operations.
- Very little third-party debt outstanding and no external long-term funding requirements.

Weaknesses:

- Weak profitability.
- Increased counterparty risk as distribution companies are privatized.
- Seasonal working capital swings that require tight liquidity management.

Rationale

The ratings on Oman Water and Power Procurement Co. SAOC (OPWP) are based on an equalization with the long-term sovereign credit rating on the Sultanate of Oman (A/Negative/A-1). The equalization reflects our opinion that there is an "almost certain" likelihood that the government of Oman would provide timely and sufficient extraordinary support to OPWP in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our rating approach is based on our view of OPWP's:

- "Critical" role as the monopoly buyer and supplier of bulk electricity and desalinated water in Oman. OPWP was set up by the government in 2004 as an intermediary between electricity producers and distributors. Its legal role is to secure the production capacity and output to meet "all reasonable demands" for electricity, and to secure the production of desalinated water. This includes the critical function of forecasting the demand and supply of electricity and related water in Oman over a seven-year period.
- "Integral" link with the Omani government, given the company's public policy role and 100% state ownership through the Ministry of Finance and government-owned Electricity Holding Co. SAOC (EHC). The government created OPWP specifically to act as a government agency according to Article 14 of the Law for the Regulation and Privatization of the Electricity and Related Water Sector (Sector Law), and OPWP must remain wholly government-owned. OPWP's obligations are not explicitly guaranteed, but under Article 67 of the Sector Law, the Ministry of Finance must provide adequate financing to enable OPWP to undertake its assigned activities.

These strengths are somewhat offset by OPWP's inherently low profitability, which mainly results from its agency role, seasonal working capital requirements, and a potential increase in counterparty risks as Oman's distribution companies are privatized.

Our assessment of OPWP's stand-alone credit profile (SACP) at 'a-' reflects our view of the company's "strong" business risk profile and "intermediate" financial risk profile. The SACP is supported by OPWP's monopoly position, although it has no production facilities, and by its regulated payment model. These supports are partly offset by reliance on funding from its owners to meet seasonal swings in cash flows, and weak balance-sheet profitability that stems partly from its agency role and the accounting treatment of leases. OPWP requires no external long-term debt financing, which results in strong credit ratios.

For 2012-2014, we anticipate revenue growth of 10%-12% for OPWP, based on the regulatory payment model, and EBITDA margins of between 25% and 30%. We believe OPWP will continue to report net accounting losses of Omani rial (OMR) 2 million-OMR3 million ($5.2 million to $7.8 million) over the short term, before returning to profitability in the long term. The treatment of leases in the financial statements and accounting losses in the statutory financial accounts do not affect the company's cash flow generating ability. We consider that OPWP's financial risk profile depends largely on its ability to generate sufficient cash flow and maintain adequate and timely liquidity.

We consider a key factor for the financial risk profile to be OPWP's ability to maintain sufficient committed lines to meet temporary liquidity shortfalls caused by seasonal working capital swings brought about by seasonal tariff fluctuations year on year. The company currently funds deficits through cash balances, intercompany loans, and a OMR25 million facility with Bank Muscat. OPWP has no capital expenditure requirements or significant debt repayments.

OPWP's funds from operations (FFO) are stable but modest, reflecting its low-risk regulated earnings structure. OPWP's capital and reserves totaled OMR4.1 million in 2011, down from OMR7.6 million in 2010 as a result of lease accounting, and trade receivables and payables dominate its balance sheet.

The only material noncurrent assets comprised OMR17.8 million in advance payments (fixed capacity payments under a contract with a generation company). These assets are funded by an interest-free long-term shareholders' fund. OPWP doesn't need external long-term debt financing because it has no other fixed assets. ´

S&P base-case operating scenario

OPWP's revenues are fully regulated by Oman's Authority for Electricity Regulation (AER), under a transparent cost-recovery tariff that allows full pass-through of procurement costs under normal circumstances. We anticipate revenue growth of 10%-12% over 2012 to 2014, based on the regulatory payment model, and EBITDA margins to remain at between 25% and 30% over the same time frame. We anticipate that OPWP will continue to report net accounting losses of between OMR2 million-OMR3 million over the short term. However, these losses should be gradual because losses should decline as depreciation and interest costs associated with OPWP's adoption of International Financial Reporting Standards Interpretations Committee update No. 4 (IFRIC 4) decline over time. We therefore anticipate a return to profitability in the long term.

The treatment of leases in the financial statements and accounting losses in the statutory financial accounts do not impact the cash flow generating ability of the company. We consider OPWP's financial risk profile to be largely predicated on the company's ability to generate sufficient cash flow and arrange sufficient liquidity in a timely manner to meet working capital deficits brought about by seasonal tariff swings year on year.

S&P base-case cash flow and capital-structure scenario

We consider the key determinant of OPWP's financial risk profile to be the company's ability to maintain sufficient committed lines to meet temporary liquidity shortfalls due to seasonal working capital swings. Liquidity funding sources comprise existing cash balances, intercorporate loans, and an overdraft of OMR25 million with Bank Muscat. OPWP has no capital expenditure requirements or significant debt repayments.

The company's FFO is stable but modest, reflecting its low-risk regulated earnings structure. OPWP's capital and reserves totaled OMR4.1 million in 2011, down from 7.6 million in 2010 as a result of IFRIC 4. Its balance sheet was also dominated by trade receivables and payables. The only material noncurrent assets comprised OMR17.8 million in advance payments (fixed capacity payments under a contract with a generation company), funded by an interest-free long-term shareholders fund. OPWP doesn't need external long-term debt financing since it has no fixed assets aside from the advance payments.

Liquidity

We regard OPWP's liquidity as "adequate," as defined in our criteria. The ratio of its liquidity sources to liquidity uses, as of Dec. 31, 2011, was 1.6x.

Liquidity sources comprise:

- Cash balances of OMR20.9 million; and
- Our expectations of FFO of OMR34 million for 2012.

Liquidity uses comprise:

- Maximum loan repayments under the working capital facilities of an estimated OMR33 million.

The company has no capital expenditure requirements or long-term debt; demand on its liquidity sources arises mainly from timing differences between payments to generation and desalination companies and receipts from electricity and water suppliers. OPWP also has a seasonal pattern of cash flows as tariffs increase significantly in the summer months. These working capital needs are usually covered by existing cash balances and short-term funding from EHC, including access to a OMR25 million overdraft, which it uses sparingly. This facility expires in July 2013 and needs to be renewed annually.

We believe prudent management of seasonal working capital needs is the key issue for OPWP's SACP. This is because of the potential for a drain on liquidity resources in certain months. We believe this, combined with reliance on an uncommitted credit facility, restricts us from assessing OPWP's liquidity as "strong".

Outlook

The negative outlook on OPWP reflects that on Oman. If the ratings on Oman were to change, the ratings on OPWP would change. We currently do not expect our view of OPWP's "critical" role for and "integral" link with the Omani government to change, meaning that the ratings on OPWP would remain equalized with those on Oman. We also anticipate that the tariff regime will remain supportive and that OPWP will not engage in any nonregulated activities without approval from the regulator, AER.

The ratings on OPWP could come under pressure should the company deviate from its current practices and start to engage in long-term borrowing other than to cover working capital swings. This could lead us to reconsider our view of OPWP's agency role and, in particular, the likelihood of government support.

Business Description

OPWP was established in 2004 by Royal Decree as part of the Law for Regulation and Privatization of the Electricity and Related Water Sector ("Sector Law"). The aim of the Law was to separate and unbundle the government's assets in the electricity and related water sector into functional corporate entities with a view to eventual privatization. However, while a number of entities have already been privatized, OPWP is one of only two entities required by the Sector Law to remain 100% owned by the government, reflecting its singular and strategically important role.

OPWP's purpose is to be Oman's sole bulk buyer and seller of electricity and related desalinated water. It acts as the interface between generation companies and suppliers, buying bulk electricity and desalinated water from licensed operators under purchase agreements, and selling this on to distributors/suppliers under bulk supply agreements. OPWP has no production facilities of its own and acts purely in a broker capacity on behalf of the government. This is reflected in its balance sheet, which comprises mainly trade payables (procurement costs) and trade receivables (amounts due from suppliers).

OPWP's second core responsibility is to provide accurate long-term forecasts for electricity and related water demand to the Omani government, which it does under detailed seven-year plans that it updates annually. OPWP is also responsible for ensuring sufficient capacity to meet this demand, at the lowest possible cost. If OPWP forecasts a supply shortfall, it is required to arrange open and fair auctions to attract local and overseas investors, allowing it to build new capacity.

Government Support And GRE Methodology Impact

The rating on OPWP is equalized with that on Oman in accordance with our criteria for GREs. We consider the likelihood of extraordinary government support to OPWP in the event of stress to be "almost certain." This is based on our assessment of the company's "integral" link with the Omani government and its "critical" role for the country.

We consider OPWP to be a policy-based arm of the government, which established it to be the monopoly buyer and seller, as well as importer and exporter, of bulk electricity and related water in Oman. The company's functions and duties are governed by the Sector Law, whose aim is to separate and unbundle the government's assets in the electricity and related water sector into functional corporate entities, with a view to eventual privatization. Article 74 of the Sector Law defines OPWP's role, which includes to "secure production capacity and output to meet all reasonable demands for electricity in the Sultanate of Oman" and to "secure the production of desalinated water". This includes forecasting and planning the country's long-term electricity supply and demand.

The government of Oman fully owns OPWP via a direct 0.01% stake through the Ministry of Finance and 99.99% indirectly through EHC, a government-owned entity that holds the government's interests in the electricity sector. Seven of the nine generation and desalination companies are now privately owned and the transmission and distribution companies are likely to be privatized over time. Article 14 of the Sector Law requires OPWP to remain 100% government owned, however, reflecting its strategically important mandate.

OPWP does not engage in borrowing other than for working capital purposes and to bridge liquidity gaps. The government does not explicitly guarantee OPWP's obligations. Nevertheless, a "keep-well" obligation by the Ministry of Finance enshrined in Article 67 of the Sector Law obliges the government to "secure the availability of adequate finance to enable [OPWP] to undertake the activity assigned".

OPWP's board of directors is appointed by EHC and the Ministry of Finance, and EHC provides accounting services and liquidity facilities to the company.

Business Risk Profile: Strong; Supported By A Unique Role, Protective Ownership, And Regulatory Framework

The major supports for OPWP's strong business risk profile are:

- Its monopoly position within the electricity and related water sector in Oman. As long as OPWP retains its exclusive right to procure and sell bulk electricity and related water in Oman, it will face no direct competition.
- The fully regulated nature of its revenues. OPWP's revenues are fully regulated by AER, which prohibits OPWP from engaging in nonregulated activities without its approval and operates independently from the government. It regulates OPWP's revenues through a transparent cost-recovery system that allows full pass-through of procurement costs under normal circumstances. OPWP's maximum allowed revenue (MAR) equals the costs of power and water procurement (including consumer price index-adjusted allowed costs) including license fees and the previous year's adjustments. The MAR's main component is a bulk supply tariff that OPWP sets and the regulator approves each year. AER must give OPWP at least 10 years' notice to terminate its license, which can also be revoked, although this would essentially require negligence or fraud by OPWP.
- Low business risk as a government agency, without generation or supply activities of its own. OPWP is not allocated a capital plan. Its agency-type function is to manage power and water contracts, while the EHC manages its treasury and accounting. OPWP's role is limited to planning and forecasting future requirements for electricity generation and water desalination, procuring capacity in a timely manner, and promoting efficiency in the electricity and related water sectors.
- Continually strong demand. Average electricity demand increased 12% and peak demand 10% in 2011, slightly below OPWP's forecast but continuing on a strong upward path. In the Salalah system, average demand increased 5% and peak demand 2%, both well below forecast. The forecasts for 2012-2018 reflect expected average and peak demand growth rates of about 8% per year in the main grid and 10% per year in the Salalah system.
- Sufficient capacity in the network in 2010 and 2011, and so far in 2012, which means the absence of material outages and OPWP's avoidance of related fines under its license terms during these periods.

These supports are partly offset by:

- Sector privatization. The government's aim in setting up OPWP was to separate and unbundle the government's assets in the electricity and related water sectors into functional corporate entities, with a view to eventual privatization. Most of the generation companies have already been privatized, and while we believe that the distribution companies will be privatized over time, OPWP is, however, required by law to remain government-owned. One risk of privatization is that OPWP's counterparty risks could increase. But given that potential private-sector entities would be licensed by the regulator and partly rely on a government subsidy, we expect counterparty risk for OPWP to be low.
- Lower subsidies. The government has historically paid about 30%-40% of the amount that the generation

companies charge OPWP as a subsidy to protect the end consumer from the full costs of production. The government aims to gradually implement cost-reflective tariffs by reducing the subsidies over time to be consistent with privatization and improve efficiency in the system. We understand that the risk of additional payment will be borne fully by the distribution companies, and not by OPWP. If OPWP were to absorb any of the reduction in subsidy, this would be a negative rating factor; however, we consider it unlikely that the government would expect this to occur, given OPWP's limited financial capacity.
- Unpredictable market growth in Oman. OPWP risks fines from the regulator--AER--if it fails to adequately plan for projected demand. If OPWP secures too much capacity for Oman's needs, the regulator would allow the associated costs to be passed through as long as the capacity had previously been approved under a seven-year plan.
- Poor profitability. Despite its monopoly position, OPWP has been reporting net losses, reflecting its adoption of IFRIC 4. OPWP is allowed a margin on its purchase costs above its estimated direct costs. This, therefore, allows OPWP "normal profit" if its cost performance is exactly in line with expectations, absent the impact of IFRIC 4.
- Any outperformance, in the form of lower direct costs, would allow OPWP to earn additional profit, while unanticipated increases in direct costs would reduce profit. Nevertheless, these amounts are low and do not provide the company with a significant unrestricted cash buffer.

Financial Risk Profile: Intermediate; With No Need For Long-Term Debt

The main strengths of OPWP's intermediate financial risk profile are:

- No long-term debt. OPWP has a predominantly short-term balance sheet comprising mainly accounts payable and receivable, reflecting procurement costs from generators and desalinators, and receivables from electricity suppliers and water departments. OPWP has no production facilities and incurs no capital expenditures. As such, it has no requirement for long-term external financing. Its conventional credit metrics are therefore strong.
- Adequate liquidity. OPWP's ownership by the Omani government and Article 67 of the Sector Law effectively ensure that OPWP will have sufficient liquidity to finance its functions at all times. Sources of liquidity have been centralized at EHC, which provides funding to all its subsidiaries in the electricity sector.

These strengths are moderated by:

- Reliance on shareholders for funding. EHC currently provides all of OPWP's funding. While undiversified funding sources could constitute a risk, in the case of OPWP this is mitigated by the government's ownership of EHC and the provisions in the Sector Law. We also note that OPWP previously obtained funding from the commercial banking sector on relatively favorable terms, and we consider this to be possible in the future, if required.
- Our view that OPWP's financial risk profile does not depend on our standard corporate/industrial financial matrix. We consider liquidity management to represent OPWP's main financial risk; therefore we consider the financial risk profile to be largely predicated on OPWP's ability to arrange sufficient liquidity in a timely manner to meet working capital deficits. We also consider that OPWP does not borrow. Any changes in this regard, could cause us to review our assessment of OPWP's financial risk profile.

Financial Statistics/Adjustments

OPWP reports under International Financial Reporting Standards. Its accounts are prepared on a going-concern basis and audited by Deloitte & Touche (M.E.). OPWP has adopted IFRIC 4, "Determining whether an arrangement contains a lease." Application of IFRIC 4 requires OPWP to recognize certain long-term power purchase agreements (PPAs) as finance leases in its 2011 statutory accounts. This brings the associated fixed assets onto its balance sheet and creates implied depreciation and interest charges.

Note 2.1 of the company's 2011 annual statutory accounts refers to the fact that the company's current liabilities at OMR12.5 million exceed its current assets of OMR10.9 million. Accordingly, the financial statements are prepared on a going-concern basis. The note also says that the parent company has confirmed it will provide the necessary financial support to enable the company to continue to operate as a going concern for the foreseeable future and to discharge its liabilities to other parties as they fall due.

The adverse current ratio is due to the lease treatments of various long-term arrangements. For example, the company has informed us that if the lease treatment is excluded, the current liability will reduce to OMR48.6 million and the current ratio as of Dec. 31, 2010, would have been 1.06x.

Standard & Poor's recognizes that the PPAs on OPWP's balance sheet result in a zero-risk weighting on the present value of future capacity payments, since PPA costs are fully recoverable under the regulated bulk supply tariff. We also consider that cash inflows from revenue are linked to payment obligations under long-term arrangements and the treatment of leases in the financial statements does not impact the company's ability to generate cash flow.

We make no material adjustments to OPWP's accounts, except for that for operating leases (see table 1). This reflects the company's limited scope and agency-type function. We apply a discount rate of 5% to the operating leases.

Table 1

Reconciliation Of Oman Power and Water Procurement Co. SAOC Reported Amounts With Standard & Poor's Adjusted Amounts

	--Fiscal year ended Dec. 31, 2011--									
Oman Power and Water Procurement Co. SAOC reported amounts										
(Mil. OMR)	**Debt**	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	149.0	4.2	349.7	36.1	16.1	20.1	60.0	60.0	--	0.1
Standard & Poor's adjustments										
Operating leases	2,149.4	--	--	68.8	68.8	68.8	17.7	17.7	--	1,565.8
Reclassification of nonoperating income (expenses)	--	--	--	--	0.1	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	--	(20.0)	(20.0)	--	--

Table 1

Reconciliation Of Oman Power and Water Procurement Co. SAOC Reported Amounts With Standard & Poor's Adjusted Amounts (cont.)

Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(23.2)	--	--
Total adjustments	2,149.4	0.0	0.0	68.8	68.8	68.8	(2.3)	(25.5)	0.0	1,565.8

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Adjusted	2,298.4	4.2	349.7	104.9	85.0	88.9	57.7	34.5	0.0	1,565.9

OMR--Omani rial.

Table 2

Oman Power and Water Procurement Co. SAOC Peer Comparison

Industry Sector: Multi Utility Company

	Oman Power and Water Procurement Co. SAOC	Saudi Electric Co.	Abu Dhabi National Energy Co. PJSC
Rating as of May 17, 2012	A/Negative/--	AA-/Stable/--	A/Stable/--
(Mil. $)	**--Fiscal year ended Dec. 31, 2011--**		
Revenues	908.2	8,148.8	6,584.7
EBITDA	272.5	3,130.4	3,995.4
Net income from continuing operations	(8.9)	590.0	202.5
Funds from operations (FFO)	89.7	4,021.1	2,127.0
Capital expenditures	4,065.1	7,478.3	1,606.8
Free operating cash flow	(3,915.2)	(3,102.3)	183.1
Discretionary cash flow	(3,915.2)	(3,245.6)	(149.0)
Cash and short-term investments	54.5	1,947.3	704.6
Debt	5,969.2	14,543.8	21,900.8
Equity	10.8	13,832.9	3,427.5
Adjusted ratios			
EBITDA margin (%)	30.0	38.4	60.7
EBITDA interest coverage (x)	1.2	10.2	2.9
EBIT interest coverage (x)	1.0	1.8	1.9
Return on capital (%)	5.5	2.0	9.8
FFO/debt (%)	1.5	27.6	9.7
Free operating cash flow/debt (%)	(65.6)	(21.3)	0.8
Debt/EBITDA (x)	21.9	4.6	5.5
Total debt/debt plus equity (%)	99.8	51.3	86.5

Table 3

Oman Power and Water Procurement Co. SAOC Financial Summary

Industry Sector: Multi Utility Company

	--Fiscal year ended Dec. 31--				
(Mil. OMR)	**2011**	**2010**	**2009**	**2008**	**2007**
Revenues	349.7	311.5	264.2	238.6	214.0
EBITDA	104.9	53.8	43.0	1.0	1.0
Net income from continuing operations	(3.4)	(2.8)	(0.5)	1.1	1.3
Funds from operations (FFO)	34.5	37.6	18.8	2.5	2.9
Capital expenditures	1,565.9	0.0	0.2	0.2	0.0
Free operating cash flow	(1,508.2)	8.1	46.8	(7.5)	(8.0)
Discretionary cash flow	(1,508.2)	8.1	45.7	(8.5)	(8.0)
Cash and short-term investments	21.0	2.7	25.2	1.7	6.2
Debt	2,298.4	771.9	181.0	0.0	0.0
Equity	4.2	7.6	10.4	11.2	11.1
Adjusted ratios					
EBITDA margin (%)	30.0	17.3	16.3	0.4	0.5
EBITDA interest coverage (x)	1.2	1.4	1.8	61.5	76.6
EBIT interest coverage (x)	1.0	0.9	1.0	72.2	114.4
Return on capital (%)	5.5	7.0	23.5	11.0	13.1
FFO/debt (%)	1.5	4.9	10.4	N.M.	N.M.
Free operating cash flow/debt (%)	(65.6)	1.1	25.8	N.M.	N.M.
Debt/EBITDA (x)	21.9	14.3	4.2	0.0	0.0
Debt/debt and equity (%)	99.8	99.0	94.6	0.0	0.0

OMR--Omani rial. N.M.--Not meaningful.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Corporate Criteria: Analytical Methodology, April 15, 2008

Ratings Detail (As Of May 17, 2012)	
Oman Power and Water Procurement Co. SAOC	
Sovereign Credit Rating	A/Negative/--
Sovereign Credit Ratings History	
20-Jul-2011	A/Negative/--
07-Mar-2011	A/Watch Neg/--
07-May-2008	A/Stable/--

*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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