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## Summary:

# Oman Power and Water Procurement Co. SAOC

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## Table Of Contents

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Rationale

Outlook

Standard & Poor's Base-Case Scenario

Business Risk

Financial Risk

Liquidity

Other Credit Considerations

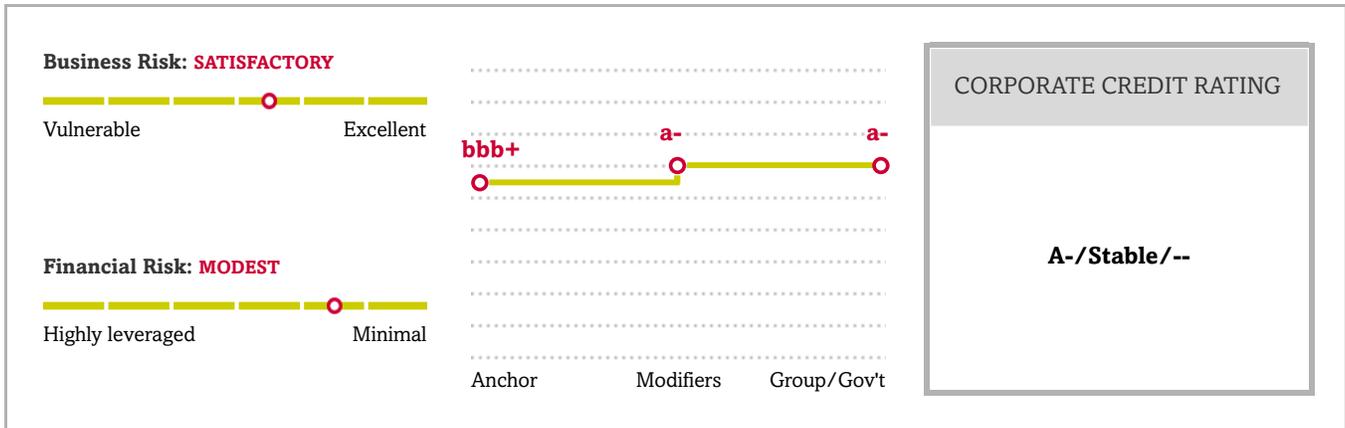
Government Influence

Ratings Score Snapshot

Related Criteria And Research

## Summary:

# Oman Power and Water Procurement Co. SAOC



## Rationale

### Business Risk

- Monopoly bulk buyer and seller of electricity and associated desalinated water in Oman.
- Wholly owned by the Sultanate of Oman.
- Fully regulated, low-risk agency function with no direct operations.
- Weak net profitability.
- Increased potential for counterparty risk following any privatization of distribution companies.

### Financial Risk

- Seasonal working capital swings that require tight liquidity management.
- Very little third-party debt outstanding and no external long-term funding requirements.
- Adequate liquidity.

## Outlook

Standard & Poor's Rating Services' stable outlook on Oman-based monopoly bulk buyer and seller of electricity and water, Oman Power and Water Procurement Co. SAOC (OPWP), reflects that on the Sultanate of Oman (A-/Stable/A-2). If we lower or raise our ratings on Oman, we would take a similar rating action on OPWP. We currently do not expect our view of OPWP's "critical" role for and "integral" link with the Omani government to change, meaning that we will likely continue equalizing our ratings on OPWP with those on Oman.

### Downside scenario

A downgrade of Oman would likely result in a downgrade of OPWP, in accordance with our criteria for rating government-related entities (GREs), such as OPWP. The ratings on OPWP could come under pressure if the company deviated from its current practices and started 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. We view it as unlikely that OPWP would start to engage in such long-term borrowing.

## Upside scenario

There is limited upside to the ratings on OPWP, in our view. The most likely trigger for an upgrade of the company would be an upgrade of Oman.

## Standard & Poor's Base-Case Scenario

### Assumptions

- Revenue growth of about 3.5% in our forecast years, based on the regulatory payment model and Qatar's GDP growth rate.
- EBITDA margins remaining close to 50%.
- For our forecast years, we consider a risk weight of 10% for the power purchase agreements (PPAs) (accounted for as leases under International Financial Reporting Standards [IFRS]). The present value of these lease liabilities for 2014 is about Omani rial (OMR) 1,739 million, of which OMR117.22 million attributed to finance leases. We risk weight the entire amount of leases (operating and finance).
- We anticipate that OPWP will report positive pretax net profits as of 2016, excluding the impact of updates to IFRS that could affect the company's lease reporting.

### Key Metrics

	2014a	2015f	2016f	2017f
EBITDA margin (%)*	54.4	53-58	53-58	53-58
FFO/debt (%)*	52.3	52-58	53-59	58-63
Debt/EBITDA (x)	0.8	0.8-1.0	0.7-0.9	0.7-0.9
EBITDA/interest (%)*	1.8	1.8-2.0	1.8-2.0	1.8-2.0

a--Actual. f--Forecast. \*Standard & Poor's adjusted. FFO--Funds from operations.

## Business Risk

Our assessment of OPWP's business risk profile as "satisfactory" primarily incorporates our view of the regulated nature of its operations. In addition, we view industry risk as "very low" and country risk as "moderately high." The major supports for OPWP's satisfactory business risk profile are:

- OPWP's "satisfactory" competitive position, given 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.
- Our view of OPWP's regulatory regime as supportive. The Authority for Regulation regulates OPWP's revenues through a transparent cost-recovery system that allows full pass-through of procurement costs under normal circumstances. The authority must give OPWP at least 10 years' notice to terminate its license, and although the license can be revoked, the conditions that would trigger this would essentially require negligence or fraud by OPWP.
- Its low-risk agency function and no direct operations. OPWP's agency-type function focuses on the management of power and water contracts, while treasury and accounting are outsourced to Electricity Holding Co. (EHC). The lack of direct electricity or related water operations reduces OPWP's overall business risk. OPWP's role is limited to planning and forecasting future requirements for electricity generation and water desalination to procure capacity in

a timely manner, and promoting efficiency in the electricity and related water sectors.

- Continuously strong demand. According to OPWP's seven-year plan for 2014-2020, peak demand is forecast to increase by 11% per year, to 9,133 megawatts (MW) in 2020 from 4,455MW in 2013. In Salalah, peak demand is expected to grow at 10% per year, from 420 MW in 2013 to 800 MW in 2020. Increasing personal income, housing starts, and continuing government investment in infrastructure projects are major contributors to continued high growth in electricity demand. Over the seven-year horizon, the Directorate General of Water (DGW) expects peak water demand to increase at an average annual rate of 8.4%, and average demand at 9.2% per year.

These supports are partly offset by:

- Higher debt for OPWP because of Oman's sporadic increase in gas pricing to \$3 per mmbtu at year-end 2014. The increase in gas pricing paves the way for greater introduction of cost reflective tariffs in the country. We recognize that OPWP is insulated somewhat from the gas price rise because of the regulatory model, which allows full pass-through of such fuel increases to the distribution companies. The latter are in turn partly subsidized by the government, consequently ensuring that payment flow disruption to OPWP is minimized as a result of the fuel price hike. That said, at this stage it is unclear precisely what the impact of higher prices has had on payment quality from end-users (commercial and manufacturing entities) to distribution companies and the effect this has had on the government subsidy that goes to the distribution companies, although we are closely monitoring this. We also consider that the fuel price hike is the principal factor for OPWP's increase in peak monthly working capital deficit over the course of 2015 (which we now estimate at OMR38 million over June-September). We understand that the ministry of oil and gas, the ministry of finance, the regulator, EHC, and OPWP will coordinate more closely with regard to any future announcement of fuel price increases, avoiding situations where OPWP needs to tap additional debt sources at short notice and manage its liquidity more effectively.
- The expiration of two leases in 2017, which could affect net profit. OPWP aims to ensure that existing leases are rolled over in the medium to long term, with similar counterparties. We understand that under accounting standards likely to be implemented by about 2018, OPWP may have to report all its leases as finance leases. This could reduce reported profit in the short term by more than we currently anticipate. OPWP's losses in 2012 resulted from its adoption of IFRIC 4, which led to higher-than-average depreciation and interest charges on financial leases. We expect such charges and their impact to subside over the long term, resulting in improved profitability. OPWP's EBITDA margins and returns on capital are average relative to those of regional peers.
- Likely higher debt under the new regulatory regime, noting OPWP's additional responsibilities under its license in relation to water. The license agreement governing OPWP's operations has been widened over the course of the past year to include procurement of sufficient water to meet demand in the main Omani corridors it covers under the power activities. We anticipate less seasonality when it comes to water activities and therefore less volatility in working capital because of OPWP's entry into this area of activity. However, we anticipate the need for additional funding as a result of the license change, and also as a result of the gas price hike implemented late last year. We understand OPWP has recently negotiated a new OMR50 million working capital facility from HSBC, in addition to the OMR85 million with Bank of Muscat.
- Risks from sector liberalization, including higher counterparty risks from privatized generation and distribution companies. The regulator's licensing process and government's subsidy of such private-sector entities mean this risk would likely be low.
- Possible introduction of a pooling system: Another important development under discussion between OPWP and the Authority for Energy Regulation in Oman is the potential for introduction (from 2018) of a pooling system for sale of spot capacity by generators. Some of the generation projects who may not be selling their capacity to OPWP (for instance, because the Power Purchase Agreements were not renewed on expiry) may choose under the system to provide their capacity to such a pooling system. In turn, various users of power in Oman may choose to tap into

this pooling system for their power needs. At present, the details on how such a system would operate remain scarce. We will closely review its development and any subsequent impact this would have on the monopoly position of OPWP as sole procurer of power from the generation companies.

- Unpredictable market growth in Oman. OPWP risks fines from the regulator 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. OPWP is working with the regulator on contingency measures in the event that the planned projects are not completed on time. The electricity supply companies are also pursuing demand-side management initiatives in cooperation with the regulator.

Lower-than-expected indirect costs would allow OPWP to earn additional profit, while unanticipated increases in indirect costs would reduce profit. Nevertheless, these amounts are low and do not provide the company with a significant unrestricted cash buffer.

## Financial Risk

Our assessment of OPWP's financial risk as "modest" stems partly from our view that OPWP will not need any material additional long-term debt. We consider liquidity management to be OPWP's main financial risk. Consequently, we consider OPWP's financial risk profile to be largely predicated on OPWP's ability to arrange sufficient liquidity in a timely manner to meet working capital deficits.

The main strengths 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 or capital expenditures. As such, it doesn't require long-term external financing for such purposes. That said, OPWP's activities have widened markedly over the past two years to include the Salalah network, water procurement, and most recently, its procurement activities have been subject to higher fuel prices. As such, the peak working capital deficit has increased so far in 2015. This has prompted OPWP to consider longer term funding solutions to meet its growing working capital funding needs.
- Adequate liquidity. OPWP's government ownership and Article 51 of the Sector Law effectively ensure that OPWP always has sufficient liquidity. OPWP has procured an OMR50 million short-term facility from HSBC, in addition to the OMR85 million from Bank Muscat, to meet its working capital requirement.

These strengths are moderated by:

- Some reliance on shareholders for funding, considering OPWP's funding requirements are currently backed by letters of comfort from EHC. Although 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 has recently obtained funding from commercial banks on relatively favorable terms, and we consider this to be possible in the future, if required.

## Liquidity

We regard OPWP's liquidity as "adequate," as defined in our criteria. We expect that the company's sources of liquidity will exceed its uses by the minimum threshold of 1.1x for the "adequate" designation under our criteria.

### Principal Liquidity Sources

- Assumed cash balances of OMR6 million;
- Our assumption of FFO of OMR20 million–OMR30 million; and
- An unused facility of OMR36 million available from an overdraft facility of OMR50 million from Bank of Muscat, supported by a letter of comfort from the shareholders.

### Principal Liquidity Uses

- Debt maturities of OMR14 million
- Maximum loan repayments under the working capital facilities, which we estimate to be OMR38 million.

We note that OPWP's working capital funding needs have increased in 2015. As such, the company has negotiated an OMR50 million, six-month short-term loan with HSBC and continues to have about OMR50 million of liquidity from EHC available to group entities in times of need. Furthermore, we understand the company will shortly be seeking to secure longer term funding (about three years) of a relatively sizable nature to meet its working capital needs on a more permanent basis.

## Other Credit Considerations

We include a one-notch positive adjustment in our rating on OPWP, to reflect our "positive" comparable ratings analysis. Our view of the comparable ratings analysis reflects that OPWP is at the higher end of the "satisfactory" business risk category, given its regulated utility characteristics and its importance to the government as the sole bulk buyer and seller of power and water in Oman.

## Government Influence

In accordance with our criteria for government-related entities (GREs), our view of an "almost certain" likelihood of government support is based on our view of OPWP's:

- "Integral" link with the Omani government, given the company's public policy status and 100% state ownership through EHC. We view OPWP as a policy-based arm of the government, undertaking an agency role in the electricity and water sector, one that could not be readily undertaken by a private sector entity. OPWP must remain wholly owned by the government indefinitely, under Article (14) of Sector Law. OPWP's obligations are not explicitly guaranteed, but under Article (67) of the Sector Law, the Ministry of Finance must provide adequate finance to enable OPWP to undertake its operations.
- "Critical" policy-based role as sole bulk buyer and supplier of electricity and desalinated water in Oman. Without OPWP as intermediary, generators and suppliers would need to interact directly, which is currently against public policy as it would entail material risks. OPWP also performs the critical role of forecasting demand and supply of electricity and related water in Oman. This reflects OPWP's unique and strategically important role as the sole bulk

buyer and seller of electricity and related desalinated water in Oman.

## Ratings Score Snapshot

### Corporate Credit Rating

A-/Stable/--

### Business risk: Satisfactory

- **Country risk:** Moderately high
- **Industry risk:** Very low
- **Competitive position:** Satisfactory

### Financial risk: Modest

- **Cash flow/Leverage:** Modest

Anchor: bbb+

### Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Positive (+1 notch)

### Stand-alone credit profile : a-

- **Related government rating:** A-
- **Likelihood of government support:** Almost certain (no impact)

## Related Criteria And Research

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

<b>Business And Financial Risk Matrix</b>						
<b>Business Risk Profile</b>	<b>Financial Risk Profile</b>					
	Minimal	<b>Modest</b>	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
<b>Satisfactory</b>	a/a-	<b>bbb+</b>	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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