

## Thames Water Utilities Cayman Finance Ltd.

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# Thames Water Utilities Cayman Finance Ltd.

## Major Rating Factors

### Strengths:

- Supportive U.K. water regulatory framework
- Improved regulatory and operational performance
- Positive structural features designed to protect debtholders and enhance cash flow certainty

None

### Weaknesses:

- Aggressive capital structure and dividend distribution
- Negative free operating cash flow generation for the foreseeable future
- Limitations on security
- Some uncertainty around the regulatory reset for 2010/2015

## Rationale

The 'BBB+' long-term rating on the class A bonds issued by Thames Water Utilities Cayman Finance Ltd. (TWUCF) and Thames Water Utilities Finance Ltd. (TWUF) reflect the underlying credit quality of Thames Water Utilities Ltd. (TWUL), the regulated water and wastewater business covering Greater London and the Thames Valley; and the structural features of its corporate securitization, designed to protect debtholders and enhance cash flow certainty.

These strengths are partially offset by TWUL's aggressive capital structure; negative free cash flow generation; limitations on security; and the uncertainties associated with the 2010 regulatory review.

As the largest U.K. regulated water and wastewater utility, TWUL benefits from the industry's stable and transparent regulatory framework and limited exposure to competition, which are offset to a degree by the uncertainties linked to the underway regulatory review. Moreover, while TWUL has significantly improved its regulatory and operating performance in 2007/2008 (12 months to March 2008), some further progress is required for the company to meet its revised 2010 regulatory targets.

In the year to end-March 2008, TWUL improved its regulatory performance on the back of an increase in capital expenditures to close to £1 billion. The company met in particular its leakage target for the second year running and significantly improved the environmental performance of its wastewater works. TWUL moreover succeeded in reducing operating costs by 7% excluding depreciation.

TWUL has an aggressive financial structure. While debt to RCV (regulated capital value) was 68% in March 2008 (with funds from operations--FFO--coverage of net debt of 13%), we expect it to gradually increase to 75% by 2010. It could then increase to 85% from 2010 with the issuance of subordinated class B debt, which can take place at that time with limited restrictions. Moreover, in light of its heavy capital expenditures, TWUL's free operating cash flow will remain negative for the foreseeable future.

TWUL's leverage is partially offset by protective structural features, especially:

- The ring-fencing of TWUL, TWUCF, and TWUF from the rest of group;
- The subordination of the class B debt, which cannot create an event of default for class A debt;
- Prudent debt management policies with covenanted spread of maturities and interest rate hedging;
- Liquidity support through dedicated facilities;
- A strong covenant package including limitations on additional debt and restrictions on distributions;
- Having three independent directors at TWUL;
- Three levels of financial covenants (distribution lock-up, trigger events, and events of default); and
- An automatic 18-month standstill after an event of default.

These provide creditors with significant control over TWUL at the earliest stage of financial and/or operational difficulty. Conversely there are limitations on security, as the bulk of TWUL's assets is "protected land".

### Liquidity

Strong liquidity, as mandated by the borrowing documents, is a central feature of Thames Water's financial structure. The liquidity available to the financing group provides additional cash to the operating business and credit enhancement to the rated debt.

Liquidity support is provided through dedicated facilities:

- A £200 million working capital facility, corresponding to the highest estimated intra-year working capital swing; and
- A £550 million capital expenditure facility, corresponding to 12 months of forecast capital expenditure.

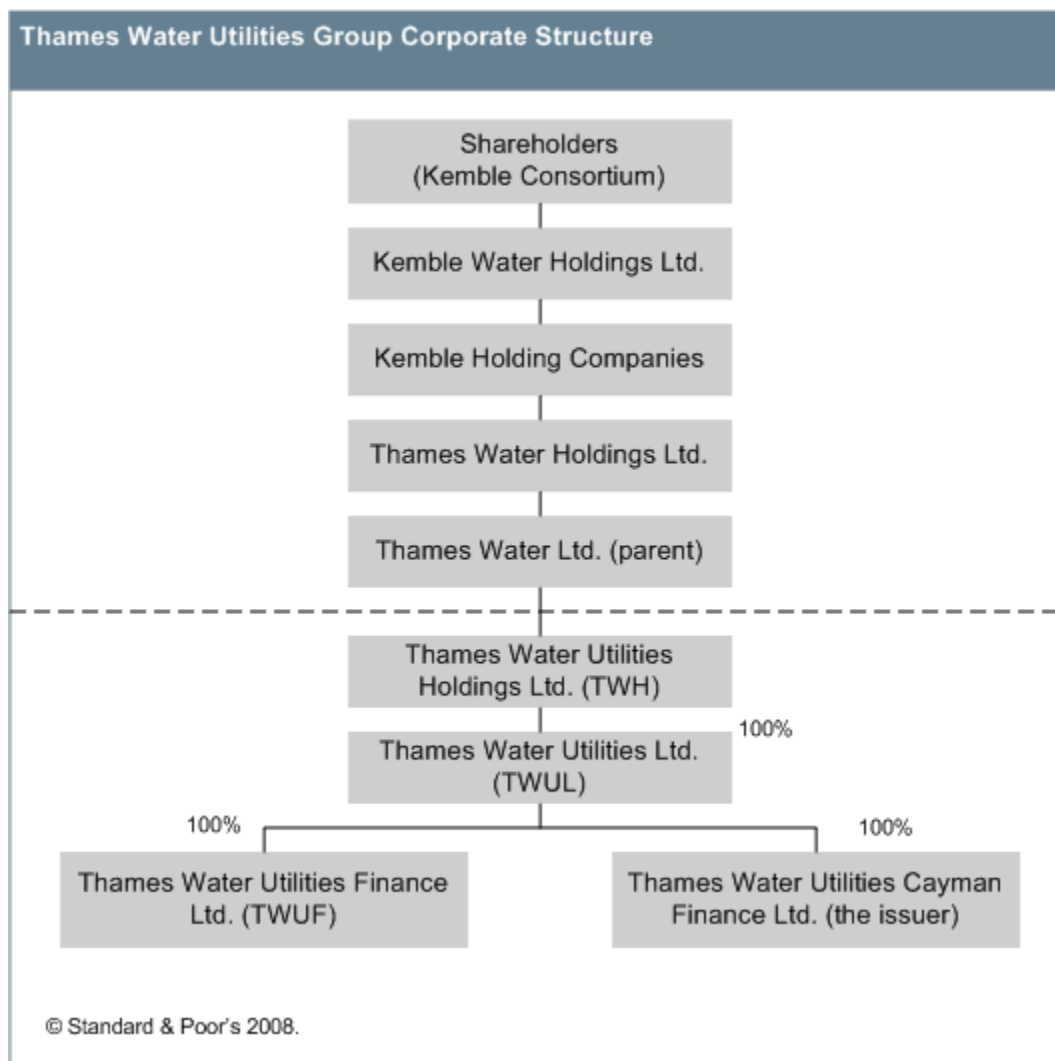
Drawings under the working capital and capital expenditure facilities, which stood at £250 million as of end-March 2008, have now been repaid following the recent issue by TWUCF of additional class A bonds.

The steady, predictable cash flow stream produced by TWUL and minimal near-term debt maturities provide further support.

In addition, covenants relating to liquidity include a requirement to have a debt service reserve (DSR) account and facilities that together cover the next 12 months of forecast cash interest on class A and class B debt. TWUCF currently benefits from a £200 million DSR facility. In addition, TWUL is required to maintain operating and maintenance (O&M) reserves to cover at least 10% of forecast operating and capital expenditure for the following 12 months. TWUCF currently benefits from a £105 million O&M facility. Drawing under either the DSR or the O&M facilities results in a distribution lock-up.

## Business Description

TWUF and TWUCF are the funding subsidiaries of TWUL, the regulated water and wastewater utility covering Greater London and the Thames Valley. Both funding subsidiaries and TWUL are ring-fenced from the parent Kemble Water, which is a consortium of infrastructure investors and pension funds managed by the Macquarie group (see chart below). This structure effectively isolates the credit quality of the regulated water and wastewater utility from Kemble, which has a less favorable business risk profile--given its unregulated operations--and a weaker financial profile.



TWUL, is the largest regulated water and wastewater utility in the U.K., providing drinking water to just over 8.5 million customers, and managing wastewater services for 13.6 million customers.

## Rating Methodology

Standard & Poor's assessment of the debt ratings of TWUF and TWUCF begins with a review of TWUL's underlying water business, followed by an analysis of the structural features, which add to the certainty and stability of cash flows as well as financial flexibility. Our analysis of financial risk then follows a blended approach looking at forecast financial ratios and prescribed covenanted levels.

## Business Risk Profile: Supportive Regulatory Framework And Strong Competitive Position Underpin Credit Quality

TWUL benefits, like its peers, from a generally supportive regulatory framework. It has moreover significantly

improved its regulatory and operating performance under its new ownership and management. That said, this progress needs to be sustained for the company to meet its revised 2010 regulatory targets. Moreover, the 2010 regulatory reset underway for the 2010-2015 regulatory period adds some uncertainty.

### **Strategy**

New management intends to pursue its "back-to-basics" strategy of improving TWUL's regulatory and operational performance, while cutting costs, which it implemented with success in 2007/2008.

### **Regulation**

TWUL's regulatory environment is generally supportive, providing high cash flow stability and predictability. The five-yearly price control periods, under which all U.K. water and wastewater businesses operate, are designed to provide companies with sufficient funds to finance their operations, provided that specified, pre-agreed operational and financial targets are met. Each regulatory review, such as the one underway for the 2010/2015 period, brings some uncertainties, however.

As part of the 2010-2015 regulatory price review, TWUL has made public its business plan which calls for a large £6.5 billion investment program--including £1.3 billion for the Thames Tideway project--to be funded by a yearly increase in tariffs of 3% above the retail price index (RPI). The Tideway tunnel aims at mitigating storm water discharges in the River Thames and represents a very large investment of £2.5 billion-£3 billion, which will be spread over a number of regulatory periods. Construction work on a new reservoir, the Upper Thames reservoir, to enable TWUL from 2020 to meet forecast growth in demand linked to expected population growth, is also expected to begin in the 2010/2015 regulatory period.

### **Markets**

TWUL's stable and affluent market supports its regulated cash flow. TWUL serves about 13.6 million customers over a catchment area of 13,750 square kilometers (sq km); this area, which includes London and the large urban centers of Reading, Oxford, and Swindon, has a higher-than-average population density of 300-699 inhabitants per sq km and income levels significantly above the U.K. average.

The stability of TWUL's revenues is supported by a high proportion of residential customers (70% of volume of water provided) and low industrial sector concentration.

However, the region has one of the lowest rainfall levels in the U.K.

### **Operations**

TWUL has significantly improved its regulatory performance in 2007/2008. In particular, the company met its leakage target for the second year running, thanks largely to a step-up in its Victorian mains replacement program (527 km replaced in 2007/2008, which is 204 km more than in 2006/2007). In addition, TWUL exceeded its target for security of supply (SoSI, 89 against a target of 58). Major progress was also achieved in sewerage and waste treatment, with reductions in sewer flooding and collapses. The company also reduced the number of its noncompliant sewerage treatment plants to zero from 18 in the previous year. It also recorded substantial improvements in customer service. As a result TWUL's overall performance assessment (OPA), a key synthetic OFWAT yardstick, improved to 397, the highest ever score achieved by the company, from 342, the maximum possible score being 438.

That said, TWUL needs to further improve its performance to meet its revised 2010 regulatory targets.

The Beckton desalinization plant, for which the company has eventually received planning permission, will enable it to meet its 100 SoSI target. With respect to leakage, TWUL intends to continue with its main replacement program. Heavy leakage is concentrated in Northern London and stems from the age of the mains (over 50% are more than 100 years old and 30% are more than 150 years old), and the area's corrosive clay, which moves as it freezes or gets wet, exerting pressure on the pipes and thus causing leaks or burst mains. TWUL aims to have replaced 1,603 km of mains pipes by the end of the current regulatory period.

Moreover, sewer flooding remains a key area of concern for TWUL. In 2007/2008, over 1,347 properties experienced sewer flooding as a result of severe weather conditions, four times more than the previous year.

The improvement in TWUL's regulatory performance has been largely driven by an increase in capital expenditure. Capital expenditures rose to close to £1 billion in 2007/2008 and will remain at that level in 2008/2009. TWUL has approached OFWAT to seek approval to maintain a high level of investment in 2009/2010 above its overall capital expenditure allowance for the current regulatory period.

While improving its regulatory performance, TWUL also reduced by 7% its operating costs excluding depreciation in 2007/2008. Operating costs had exceeded the regulatory allowance in the first two years of the current regulatory period. TWUL intends to continue to maintain operating costs well below the regulatory allowance in the last two years of the current regulatory period to make up for the initial overspend.

#### **Competitive position/Profitability**

TWUL operates a monopoly business with little competitive threat. OFWAT is keen, however, to introduce more competition in the sector.

In the absence of real competition, OFWAT currently employs essentially surrogate competition through regulatory comparison.

## **Financing Risk Profile: Aggressive Financial Policy Mitigated By Stable Cash Flows And Strong Liquidity**

TWUL's high leverage is partially offset by the protective structural features of its corporate securitization. Free operating cash flow will remain negative in the coming years; this is not unusual in the industry, but will be particularly accentuated for TWUL because of the scale of its capital expenditure program.

#### **Accounting**

TWUL prepares its financial statements in accordance with the historical cost convention and, except for the classification of profit on the sale of fixed assets and the treatment of infrastructure renewals expenditure, with applicable accounting standards in the U.K. (U.K. GAAP).

We don't adjust reported debt for postretirement liabilities. In March 2008, TWUL had a combined pension fund surplus of £26.1 million, with the Thames Water Mirror Image Pension Scheme surplus of £27.1 million offsetting the Thames Water Pension Scheme deficit of £1 million.

Table 1

Reconciliation Of Thames Water Utilities Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)*					
--Fiscal year ended March 31, 2008--					
Thames Water Utilities Ltd. reported amounts					
	Debt	Operating income (before D&A)	Interest expense	Cash flow from operations	Capital expenditures
Reported	4,827.9	878.5	251.9	655.6	960.4
Standard & Poor's adjustments					
Operating leases	7.4	0.4	0.4	0.9	3.0
Postretirement benefit obligations	--	(3.0)	--	12.0	--
Surplus cash and near cash investments	(81.4)	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	(44.8)	--
Total adjustments	(74.0)	(2.6)	0.4	(31.9)	3.0
Standard & Poor's adjusted amounts					
	Debt	EBITDA	Interest expense	Funds from operations	Capital expenditures
Adjusted	4,753.9	875.9	252.3	623.7	963.4

\*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.

### Corporate governance/Risk tolerance/Financial policies

TWUL's financial policy is driven by the covenants of its corporate securitization. We have given limited credit to TWUL's inability to issue subordinated class B debt until 2010, as from then on class B issuance will carry few restrictions. Our analysis assumes that TWUL will issue class B debt in 2010 and is therefore based on net debt to RCV gradually increasing to 75% until 2010, and then remaining at 85% following the issuance of class B debt. In March 2008, debt to RCV stood at 68%, while FFO coverage of net debt was 13.1% and debt to EBITDA was 5.5x.

TWUL pays substantial dividends to the Kemble companies (interim dividend of £102 million paid in 2007/08 with a further £131 million interim dividend paid in May 2008). These dividends are, however, subject to a lock-up covenant and thus provide a significant buffer if operational performance is not in line with expectations.

### Capital structure/Asset protection

The Thames Water corporate securitization enjoys the same protective structural features as the other similar U.K. water transactions. These structural features are a key source of support for the ratings and include:

- The ring-fencing of the financing group from the rest of group. This ring-fencing is achieved by complementing the regulatory oversight by having a special purpose intermediate holding company at the head of the ring-fenced group and restrictive financial and business covenants within the finance documents. The structural ring-fence is achieved first by having an intermediate special purpose holding company, TWH (Thames Water Holdings), at the top of the ring-fence, between TWUL and the first of the Kemble Water companies. The sole purpose of TWH is to carry out the business of a holding company and to own the shares of TWUL, and thus provide lenders with

a security over those shares. Second, the legal ring-fence stems from the constitutional documents of the companies involved, and from the covenant and security package in the finance documents. Third, the regulatory ring-fence complements the legal and structural aspects.

- Three independent directors at TWUL who, together with the three executive directors, are the only ones able to vote on matters affecting TWUL and companies above it, such as dividends.
- Subordination of the class B debt (which can only be issued from 2010 with limited restrictions), which cannot, in particular, create an event of default for class A debt.
- A strong covenant package to protect debtholders, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.
- Three levels of financial covenants (distribution lock-up, trigger events, and events of default--see table 2) and an automatic 18-month standstill after an event of default, which provides creditors with significant control over TWUL at the earliest stage of financial and/or operational difficulty, or of material changes in business circumstances, in order to prevent special administration and minimize the borrower probability of default, creating an additional credit cushion.
- Prudent debt management policies with covenanted spread of maturities (maturities in any two-year period and any regulatory five-year period cannot exceed, respectively, 20% and 40% of total debt) and interest rate hedging (at least 85% of liabilities outstanding must be fixed rate or index linked until the end of the current regulatory period, and 75% for the next regulatory period). In addition, foreign-currency exposure is capped at 0.1% of RCV.
- Liquidity support through dedicated facilities (see table 3).

**Table 2**

Thames Water Corporate Securitization Financial Covenants
<b>Main distribution lock-up covenants:</b>
The senior regulated asset ratio (RAR) is greater than 75% (greater than 85% after 2010)
Drawings under the debt service reserve (DSR) or O&M facilities occur
Ratings on class A bonds fall below investment grade
<b>Main event of default covenants:</b>
Class A interest cover ratio falls below 1.6x
Class A adjusted interest cover ratio falls below 1x
Senior RAR is greater than 85% (greater than 95% after 2010)
There is insufficient liquidity to cover forecast capital expenditures and working capital requirements for the next six months from forecast cash flows for the next six months, combined with amounts available to be drawn in the next six months under the expenditure and working capital facilities

**Table 3**

Thames Water Corporate Securitization Liquidity Support
£200 million working capital facility, corresponding to the highest estimated intra-year working capital swing
£550 million capital expenditure facility, corresponding to 12-month forecast capital expenditure
£200 million DSR facility, corresponding to 12 months of forecast debt service*
£105 million O&M facility, corresponding to 10% of forecast 12-month operating expenditures and maintenance capital expenditures*
*Drawing under either the DSR or the O&M facilities results in a distribution lock-up.

Nevertheless, the structure also has the following weaknesses:

- Limited incentive for TWUL under the structure to aim for debt-protection measures that are materially higher than covenant levels, and expectation that cash will be returned to shareholders to the maximum extent possible.
- Limitations on security, as the bulk of TWUL's assets is "protected land".
- The possibility for a super senior tranche within class A debt, capped at 8% of the latter, corresponding to the indexation accrued under RPI-linked swaps.

**Table 4**

<b>Thames Water Utilities -- Peer Comparison*</b>				
	<b>Thames Water Utilities Finance Ltd.¶</b>	<b>Southern Water Services Ltd.</b>	<b>Anglian Water Services Financing PLC</b>	<b>South East Water (Finance) Ltd.</b>
Class A debt ratings§	BBB+	A- (SPUR)	A- (SPUR)	BBB (SPUR)
(Mil. £)	<b>--Fiscal year ended March 31, 2008--</b>			
Revenues	1,494.2	618.7	969.2	169.5
EBITDA	875.9	395.2	638.9	103.1
Net income from cont. oper.	278.0	87.4	311.7	38.7
Funds from operations (FFO)	623.7	277.2	419.5	76.4
Capital expenditures	963.4	415.6	414.1	77.5
Debt	4,753.9	3,307.4	4,882.8	681.0
Equity	1,668.0	811.4	1,457.5	163.1
<b>Adjusted ratios</b>				
Oper. income (bef. D&A)/revenues (%)	58.7	63.9	66.0	61.2
EBITDA interest coverage (x)	3.5	1.8	2.0	1.9
Return on capital (%)	11.1	7.2	7.4	10.0
FFO/debt (%)	13.1	8.4	8.6	11.2
Free operating cash flow/debt (%)	(6.2)	(4.8)	(0.5)	0.2
Debt/EBITDA (x)	5.4	8.4	7.6	6.6

\*Fully adjusted (including postretirement obligations). ¶Excess cash and investments netted against debt. §On Sept. 23, 2008. SPUR--Standard & Poor's underlying rating.

**Table 5**

<b>Thames Water Utilities -- Financial Summary*</b>	
	<b>--Year ended March 31--</b>
<b>(Mil. £)</b>	<b>2008</b>
Revenues	1,494.2
Net income from continuing operations	278.0
Funds from operations (FFO)	623.7
Capital expenditures	963.4
Debt	4,753.9
Equity	1,668.0
Debt and equity	6,421.9
<b>Adjusted ratios</b>	
EBITDA interest coverage (x)	3.5
FFO int. cov. (x)	3.3
FFO/debt (%)	13.1

Table 5

Thames Water Utilities -- Financial Summary*(cont.)	
Debt/debt and equity (%)	74.0

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

Ratings Detail (As Of September 25, 2008)*	
<b>Thames Water Utilities Cayman Finance Ltd.</b>	
Senior Secured (8 Issues)	BBB+
<b>Business Risk Profile</b>	1 2 3 4 5 6 7 8 9 10
<b>Financial Risk Profile</b>	Aggressive
<b>Debt Maturities</b>	
2008/2009 (12 months to March 2009): £366.3 mil.	
2009-2010: £204.4 mil.	
Between 2010-2011 and 2012-2013: £497 mil.	
Beyond: £3,760.3 mil.	
<b>Related Entities</b>	
<b>Thames Water Utilities Finance Ltd.</b>	
Senior Secured (13 Issues)	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.

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