

Thames Water Utilities Cayman Finance Limited/Thames Water Utilities Finance Limited

WBS / United Kingdom

*This pre-sale report addresses the structure and characteristics of the proposed transaction based on the information provided to Moody's as of 8 August 2007. Investors should be aware that certain issues concerning this transaction have yet to be finalised. Upon conclusive review of all documents and legal information as well as any subsequent changes in information, Moody's will endeavour to assign definitive ratings to this transaction. The **definitive** ratings may differ from the **provisional** ratings set forth in this report. Moody's will disseminate the assignment of definitive ratings through its Client Service Desk. This report does not constitute an offer to sell or a solicitation of an offer to buy any securities, and it may not be used or circulated in connection with any such offer or solicitation.*

Estimated Closing Date

[24] August 2007

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PROVISIONAL (P) RATINGS

Thames Water Utilities Cayman Finance Limited:

Class	Rating	Amount (million)	% of Notes	Legal Final Maturity	Coupon
A1 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
A2 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
A3 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
A4 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
A5 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
A6 Unwrapped	(P) A3	GBP[·]	[·]	[·]	[·]% (Indexed)
Total		GBP1,200	100.00		

Thames Water Utilities Finance Limited:

In addition to the new Bonds to be issued by Thames Water Utilities Cayman Finance Limited, the transaction may include up to approximately GBP2.9 billion of rated existing bonds (the "**Existing Bonds**") issued by Thames Water Utilities Finance Limited (formerly Thames Water Utilities Finance Plc), which may accede to the intercreditor arrangements (the "**Secured Existing Bonds**"), and thereby reach the same legal status in relation to covenants, events of default and security package as the new Class A Notes to be issued (GBP2.1 billion of the Existing Bonds will automatically transfer into the transaction and accede to the intercreditor arrangements on the Closing Date). Those Existing Bonds, whose bondholders do not accede to the terms of the transaction (the "**Unsecured Existing Bonds**"), will not benefit from the security that will be provided to the Class A Notes and the Secured Existing Bonds. The ratings of the Existing Bonds are discussed within this Pre-Sale Report.

The ratings address the expected loss posed to investors by the legal final maturity. In Moody's opinion the structure allows for timely payment of interest and ultimate payment of principal at par on or before the rated final legal maturity date. Moody's ratings address only the credit risks associated with the transaction. Other non-credit risks have not been addressed, but may have a significant effect on yield to investors.



OPINION

Thames Water Utilities Limited (“TWUL” or the “Borrower”) is, in terms of customers served, the largest of the ten water and sewerage companies (“WaSCs”) in England and Wales, nine of which are rated by Moody’s. The purpose of the proposed transaction is to (i) refinance part of the acquisition debt of Kemble Water Limited (“Kemble”), a consortium led by Macquarie’s European Infrastructure Fund, which acquired TWUL’s parent Thames Water Plc from German utility RWE AG in December 2006, and (ii) pay the costs of establishing the MTN Programme and issuing the Class A Notes. Future debt issuance under the MTN Programme will be principally for the purpose of funding TWUL’s capital expenditure programme, refinancing maturing debt and funding distributions to shareholders. The fundamental business risk of TWUL and its financial strength under this new funding structure determine the credit quality of the transaction.

The structure of the transaction is similar to precedents, previously rated by Moody’s, with the exception that initially TWUL’s ability to increase leverage before distribution lock-ups are triggered will be restricted at a level of 72% of Senior Net Debt to Regulated Capital Value (“RCV”) (which may increase to 75% once the aggregate indebtedness in respect of the Unsecured Existing Bonds and any unsecured financial indebtedness is equal to or less than 0.8% of RCV (the “**Permitted Unsecured Financial Indebtedness Trigger**”)) for the remainder of the current regulatory period ending March 2010. Thereafter, TWUL will have the option to leverage up to 82% of Senior Net Debt to RCV before distribution lock-ups are triggered (or 85% of Senior Net Debt to RCV if the Permitted Unsecured Financial Indebtedness Trigger has already occurred) by issuing additional debt in the form of Class B Debt, which will be subordinated to the Class A Debt to be issued at the close of the transaction, as defined below. In Moody’s opinion, the additional potential liquidity cushion provided by the initially lower distribution lock-up trigger level should provide sufficient protection to operational risks, in the light of TWUL’s recently poor performance track record. Moody’s rating rationale is outlined further below.

Strengths of the Transaction

- Low business risk profile of TWUL’s regulated business as the monopoly provider of essential water and sewerage services to a population of about 8.5 million and 13.5 million, respectively, in the United Kingdom;
- Cash trapping triggers if the required financial ratios are breached;
- Debt Service Liquidity Facilities at least equal to 12 months of debt service will allow the company to absorb temporary cash shortfalls caused by adverse events;
- Operating and Maintenance Reserve Liquidity Facilities at least equal to 10% of annual projected operating and maintenance expenditure for the next 12 months provide further protection against temporary cash shortfalls;
- Bondholders benefit from a first-ranking fixed charge over the shares of TWUL;
- Financial creditors have also agreed to give up their individual rights to petition for insolvency proceedings against the TWU Financing Group;
- Standstill Period of 18 months improves chances of recovering from financial difficulties and permits an orderly sale of the business (subject to regulatory approval), thus potentially reducing the likelihood of Special Administration; and
- Monthly requirement to deposit 1/12th of the Annual Finance Charge, which equals all interest and advances repayable under inter-company loan agreements, fees, hedge payments, leases, authorised loans and *de minimis* debt that ranks *pari passu* with Class A and Class B Debt.

Weaknesses of the Transaction

- Highly leveraged financial structure with initial total debt equal to 72% (prior to the occurrence of the Permitted Unsecured Financial Indebtedness Trigger, or 75% thereafter) of the RCV but likely step-up to 82% of the RCV by 2010 (or only 85% if the Permitted Unsecured Financial Indebtedness Trigger has already occurred by that time);
- Default under the Unsecured Existing Bonds may trigger the appointment of a Special Administrator in respect of TWUL without the benefit of a Standstill Period being available;
- Poor performance track record in recent years, in relation to customer services, operational cost efficiency and leakage (TWUL agreed additional investments for the replacement of its oldest water mains in London, which resulted in the company meeting a revised leakage target by March 2007 for the first time in four consecutive years);
- Challenging opex targets set by Ofwat;
- Similar to the rest of the industry, TWUL will face large capital requirements in future regulatory periods, with potentially even higher exposure due to large capital projects such as Thames Tideway;
- High sensitivity of TWUL's debt protection measures to the return allowed on the regulated asset base, which will be revised by the industry's Regulator at the time of the next periodic review, resetting price limits from April 2010;
- Dependence upon continued market access to fund ongoing capital expenditure heightens exposure to changing conditions and investors' sentiment in the debt capital markets; and
- Inability to appoint and direct an Administrative Receiver at TWUL in the event of insolvency.

STRUCTURE SUMMARY

Issuer:	Thames Water Utilities Cayman Finance Limited (incorporated in the Cayman Islands) (the “ Issuer ” or “ TWUCF ”)
Existing Bond Issuer:	Thames Water Utilities Finance Limited (“ TWUF ” or “ Existing Bond Issuer ”)
Structure Type:	Senior/subordinated pass-through structure
Interest Payments:	Varies by class: initially annual for fixed rate and for index-linked
Principal Payments:	Bullet maturities subject to concentration limits
Credit Enhancement/Reserves:	Class A Notes (including Existing Bonds) supported by subordination of Class B Notes (and other debt <i>pari passu</i> to Class B Notes)
Working Capital Facility:	GBP200 million revolving credit facility
Working Capital Facility Provider:	Barclays Bank PLC (Aa1/P-1), BNP Paribas (London branch) (Aa1/P-1), Dresdner Bank AG (London branch) (Aa2/P-1), Deutsche Bank AG (London branch) (Aa1/P-1), HSBC Bank plc (Aa2/P-1), Lloyds TSB Bank plc (Aaa/P-1), Morgan Stanley Bank (Aa3/P-1), The Royal Bank of Scotland (Aaa/P-1) and Royal Bank of Canada (Aaa/P-1)
Capital Expenditure Facility:	GBP550 million tranche available up to three years after Closing date to the Borrower to meet capital expenditure and for general corporate purposes
Capital Expenditure Facility Provider:	Barclays Bank PLC, BNP Paribas (London branch), Dresdner Bank AG (London branch), Deutsche Bank AG (London branch), HSBC Bank plc, Lloyds TSB Bank plc, Morgan Stanley Bank, The Royal Bank of Scotland and Royal Bank of Canada
Liquidity Facility:	Class A DSR Liquidity Facility equal to 12 months’ Class A Debt interest payments, and certain Class A Debt payments
Liquidity Facility Provider:	Barclays Bank PLC, BNP Paribas (London branch), Dresdner Bank AG (London branch), Deutsche Bank AG (London branch), HSBC Bank plc, Lloyds TSB Bank plc, Morgan Stanley Bank, The Royal Bank of Scotland and Royal Bank of Canada
O&M Reserve Facility:	A liquidity facility equal to 10% of the Borrower’s projected operating expenditure and capital expenditure for the next 12 months to be made available to the Issuer to be on-lent to the Borrower.
O&M Reserve Facility Provider:	Barclays Bank PLC, Dresdner Kleinwort Limited, HSBC Bank plc and Royal Bank of Canada
Hedging:	In compliance with Hedging Policy (as described fully below)
Existing Hedge Counterparties:	The Royal Bank of Scotland plc, Deutsche Bank AG, JPMorgan Chase Bank N.A. (Aaa/P-1) and Bayerische Landesbank (Aa2/P-1)
Principal Paying Agent:	Deutsche Bank AG (London branch)
Existing Bond Principal Paying Agent:	Citibank N.A. (Aaa/P-1)
Security Trustee:	Deutsche Trustee Company Limited
Bond Trustee:	Deutsche Trustee Company Limited
Existing Bond Trustee:	The Law Debenture Trust Corporation plc
Arranger/Lead Manager:	Barclays Bank PLC, Dresdner Bank AG (London branch), HSBC Bank plc, Royal Bank of Canada Europe Limited and Macquarie Bank Limited (London branch)

COLLATERAL SUMMARY

Receivables:	Principal and interest arising from the Initial Issuer/TWUL Loan Agreement. Further issuances of Notes by the Issuer will be lent to the Borrower under further Issuer/TWUL Loan Agreements
Borrowers:	Thames Water Utilities Limited (“ TWUL ”)
Existing Bond Issuer:	Thames Water Utilities Finance Limited (“ TWUF ” or “ Existing Bond Issuer ”)
Holdco:	Thames Water Utilities Holdco Limited (“ Holdco ”)
Parent:	Thames Water Limited (“ Parent ”)
Guarantors:	Holdco, TWUL, TWUF and the Issuer (the “ Obligors ”)

RATING SUMMARY

Rated Securities

Moody's has assigned provisional (P)**A3** long-term ratings to the following Notes to be issued by Thames Water Utilities Cayman Finance Limited ("TWUCF"):

- GBP[·] Class A1 Index-Linked Notes due [·]
- GBP[·] Class A2 Index-Linked Notes due [·]
- GBP[·] Class A3 Index-Linked Notes due [·]
- GBP[·] Class A4 Index-Linked Notes due [·]
- GBP[·] Class A5 Index-Linked Notes due [·]
- GBP[·] Class A6 Index-Linked Notes due [·]

Moody's has also placed on review for possible upgrade the **Baa1** ratings of approximately GBP2.1 billion of bonds issued by Thames Water Utilities Finance Limited (formerly Thames Water Utilities Finance Plc) ("TWUF") and guaranteed by TWUL.

The approximately GBP2.1 billion placed on review for possible upgrade include clauses that will automatically incorporate the new terms of the MTN Programme upon closing of the structured financing transaction. Moody's believes that there is a reasonably good probability that the proposed financing will be executed. Upon closing of the transaction, the ratings of the bonds that have been placed on review will be upgraded to A3, if the definitive ratings assigned to the Class A Unwrapped Notes are in line with their provisional ratings.

The **Baa1** ratings of the following bonds issued by TWUF were placed on review for possible upgrade:

- GBP250 million 4.75% EMTN, Ser. 38 due 2010
- GBP200 million 4.9% EMTN, Ser. 39 due 2015
- GBP200 million 5.05% EMTN, Ser. 40 due 2020
- GBP225 million 6.59% EMTN, Ser. 41 due 2021
- GBP300 million index-linked EMTN, Ser. 42 due 2055
- GBP300 million index-linked EMTN, Ser. 43 due 2053
- GBP600 million 5,125% EMTN, Ser. 44 due 2037

Moody's has also affirmed the **Baa1** ratings of the remaining approximately GBP0.8 billion of bonds issued by TWUF and guaranteed by TWUL maintaining the developing outlook assigned in October 2006. Moody's maintains the **Baa1** rating with developing outlook on the GBP0.8 billion, for which TWUF has launched a consent solicitation with respect to the Yen-denominated bonds and remains in discussion with the ABI with respect to the remaining three Sterling-denominated bonds. For those bonds, whose holders do not accede to the terms of the structured transaction, Moody's would expect – upon the closing of the structured financing – to affirm the rating at the current level with a stable outlook to reflect the these bonds (the "Unsecured Existing Bonds") will not benefit from the security that will be provided to the Class A Unwrapped Notes and those Existing Bonds that will accede to the structured financing. Whilst Moody's regards the benefit of the security package of the structured financing as being limited, as explained below, under certain scenarios in the event that Special Administration proceedings are commenced in respect of TWUL, Moody's understands that the Unsecured Existing Bonds might be in a subordinated position in respect of the allocation of certain disposal proceeds for TWUL's assets. Although Moody's believes that the likelihood of this particular scenario occurring is relatively low, the resulting loss for the Unsecured Existing Bonds could be very severe. Accordingly, Moody's regards it as appropriate to reflect this additional risk exposure in a notch distinction between the definitive rating of the Class A Unwrapped Notes and the rating of the Unsecured Existing Bonds, which under most scenarios may effectively enjoy a pari-passu position.

The **Baa1** ratings of the following bonds issued by TWUF were affirmed with developing outlook:

- GBP330 million 6.75% EMTN, Ser. 11 due 2028
- GBP200 million 6.5% EMTN, Ser. 22 due 2032
- GBP175 million index-linked EMTN, Ser. 37 due 2021
- JPY4 billion 2.28% EMTN, Ser. 6 due 2008

- JPY2 billion 3.0% EMTN, Ser. 7 due 2011
- JPY5 billion 1.704% EMTN, Ser. 13 due 2009
- JPY5 billion 2.135% EMTN, Ser. 18 due 2009

Corporate Family Rating of (P)Baa1 assigned to TWUL

Furthermore, Moody's has assigned a provisional corporate family rating ("CFR") of (P)**Baa1** to TWUL. A corporate family rating is an opinion on the expected loss associated with a company's financial obligations, assuming that it has a single class of debt and is a single consolidated legal entity. The (P)**Baa1** CFR assigned to TWUL consolidates the legal and financial obligations of TWUL, TWUF, TWUCF and Thames Water Utilities Holdings Limited, TWUL's immediate holding company, which together constitute the ring-fenced TWU Financing Group as defined under the terms and conditions of the MTN Programme and factors in the structural enhancements of the MTN Programme.

Class A Debt includes, among other things, all Existing Bonds and Class A Notes

For the purposes of this pre-sale report, **Class A Debt** is defined as all debt outstanding under (i) any Class A Wrapped Notes and Class A Unwrapped Notes, (ii) the Secured Existing Bonds issued by TWUF, (iii) the Initial Credit Facility, (iv) the Existing Authorised Credit Facilities, (v) the Existing Finance Leases, (vi) the Existing Hedging Agreements, (vii) the DSR Liquidity Facilities, (viii) the O&M Reserve Facility (see below), (ix) any Financial Guarantee Fee Letter and (x) any guarantee and reimbursement deed between the Issuer and a Financial Guarantor, in respect of any Class A Wrapped Notes. Any Unsecured Existing Bonds which become Secured Existing Bonds after the Closing date will also be included in the definition of Class A Debt.

Class B Debt means primarily the Class B Notes to be issued in the future

Class B Debt is defined as all debt outstanding under (i) any Class B Wrapped Notes and Class B Unwrapped Notes to be issued by the Issuer after the Closing Date and (ii) any guarantee and reimbursement deed between the Issuer and a Financial Guarantor in respect of any Class B Wrapped Notes.

Senior Debt is defined as the aggregate of Class A and Class B Debt.

Rating Rationale

The (P)**Baa1** CFR assigned to TWUL is based upon the stable and predictable nature of the company's cash flows from its regulated water and sewerage business under an established and transparent regulatory framework, the highly leveraged financial structure and the structural enhancements of the bond covenant and security package. The CFR is in line with the corporate family ratings assigned to similar transactions in the UK water sector (e.g. Anglian Water and Southern Water).

TWUL's regulated business exhibits a low business risk profile as the monopoly provider of essential water and sewerage services to a population of about 8.5 million and 13.5 million, respectively, in the United Kingdom. Similarly to its peers, TWUL's credit quality is constrained by the high likelihood that the company will maintain a highly leveraged financial structure and by its exposure to refinancing risk, i.e. dependence upon continued market access to fund ongoing capital expenditure and the risk of adverse financial market conditions that may not allow TWUL to fund its capex programme or refinance its debt at reasonable terms.

The (P)**Baa1** CFR takes into account TWUL's option to increase leverage from the initial 75% on a Senior Net Debt to RCV basis up to 85% from April 2010 before distribution lock-ups are triggered, by issuing additional debt in the form of Class B indebtedness, subordinated to Class A indebtedness. The issuance of Class B Debt post April 2010 would align TWUL's funding structure to that of the precedent transactions. Moody's believes that there is a very high probability that TWUL will decide to increase leverage close to 85% in 2010 when this is allowed in order to repay remaining acquisition debt raised above the TWU Financing Group level.

The (P)**Baa1** CFR furthermore takes into account the protection afforded to lenders by the covenant package, in particular the financial covenants that limit indebtedness as a percentage of the RCV and restrict distributions to shareholders if certain key credit metrics weaken beyond specified thresholds and the requirement to maintain debt service liquidity facilities at least equal to 12 months of debt service (including interest payments on the Unsecured Existing Bonds) to absorb temporary cash shortfalls caused by adverse events.

Additional structural features include a first-ranking fixed charge over the shares of TWUL, the agreement by financial creditors to relinquish their individual rights to petition for insolvency proceedings against the TWU Financing Group and to accept a standstill period of 18 months.

Moody's considers that these features may improve the company's chances of recovering from financial difficulties and may permit an orderly sale of the business by reducing the likelihood of Special Administration. However, the CFR also recognises that, notwithstanding the whole business securitisation funding approach, the benefit of the security provided to bondholders is limited because of the regulated and essential nature of the services provided by TWUL, as governed by its licence and the Water Industry Act 1991 ("WIA") and the associated inability to appoint and direct an administrative receiver at TWUL in the event of insolvency.

The (P)**Baa1** CFR also reflects a further limitation of the maximum leverage before distribution lock-ups are triggered to 72% on a Senior Net Debt to RCV basis (or 82% from April 2010), so long as the Permitted Unsecured Financial Indebtedness Trigger has not occurred. Moody's believes that this will modestly reduce the default probability of TWUL and offset the additional expected loss associated with the risk of independent declaration of default and acceleration by the Unsecured Existing Bondholders, which will not have signed up to the intercreditor agreements and in particular the standstill arrangements following an event of default.

Moody's has considered TWUL's poor performance track record in recent years, in relation to customer services, operating cost efficiency and leakage. However, Moody's has noted TWUL's additional investment, as agreed with the industry's Regulator Ofwat, for the replacement of its oldest water mains in London, which resulted in the company meeting a revised leakage target by March 2007 for the first time in four consecutive years. Moody's has also taken into account the additional discipline imposed by the bond covenants in terms of allowed distributions to shareholders, which mitigates the potential impact of underperformance on the company's future credit metrics.

The (P)**A3** rating of the Class A Unwrapped Notes reflects the strength of the debt protection measures for this class of bonds and other indebtedness of TWUL that ranks *pari passu* with them. The ratings also reflect the priority of claim of the Class A Debt in the waterfall established under the MTN Programme, in the likely event that additional leverage is introduced in the structure, as this is only allowed through the issuance of subordinated Class B Debt.

Outlook

The outlook for the provisional ratings is stable. Moody's believes that TWUL's financing structure is reasonably resilient to downside sensitivities that assume that a lower cost of capital for the industry will be allowed at the next periodic review, which will set price limits for the water companies for the period April 2010-March 2015. In Moody's opinion, the company's capital structure also appears sufficiently robust to support large capital programmes over the next and subsequent regulatory periods. Given the proposed structure and Moody's expectation that TWUL would likely maintain leverage close to the maximum level allowed by its financial covenants in shareholders' interest, there will be limited potential for an upgrade of the definitive ratings, assuming these are assigned in line with the provisional ratings. The ratings could come under downward pressure in the event of (i) unexpected and adverse regulatory determinations at future periodic reviews, (ii) serious underperformance in operating or capital expenditure, (iii) lack of improvement in the current performance resulting in regulatory action and fines, (iv) negative funding conditions, or (v) a material adverse change in the regulatory framework.

Rating Methodology

This is the fourth leveraged financing of a water and sewerage company ("WaSC") of England and Wales that uses a whole business securitisation approach rated by Moody's. These transactions are of a hybrid nature, in that they include a set of structural enhancements characteristic of structured or project financings, retaining at the same time direct exposure to the sector's fundamental business risks and a typical corporate debt structure involving bullet maturities and refinancing risk.

Moody's approach to rating highly leveraged structures in the UK water sector draws on both corporate and structured analytical tools and is described in detail in the following two recent rating methodologies:¹

- “The UK Water Sector: Financial Parameters and Structural Enhancements for Leveraged Financings”, July 2002.
- “The UK Water Sector: Moody's Approach to Rating Highly-Leveraged Structures for Asset Ownership”, February 2001.

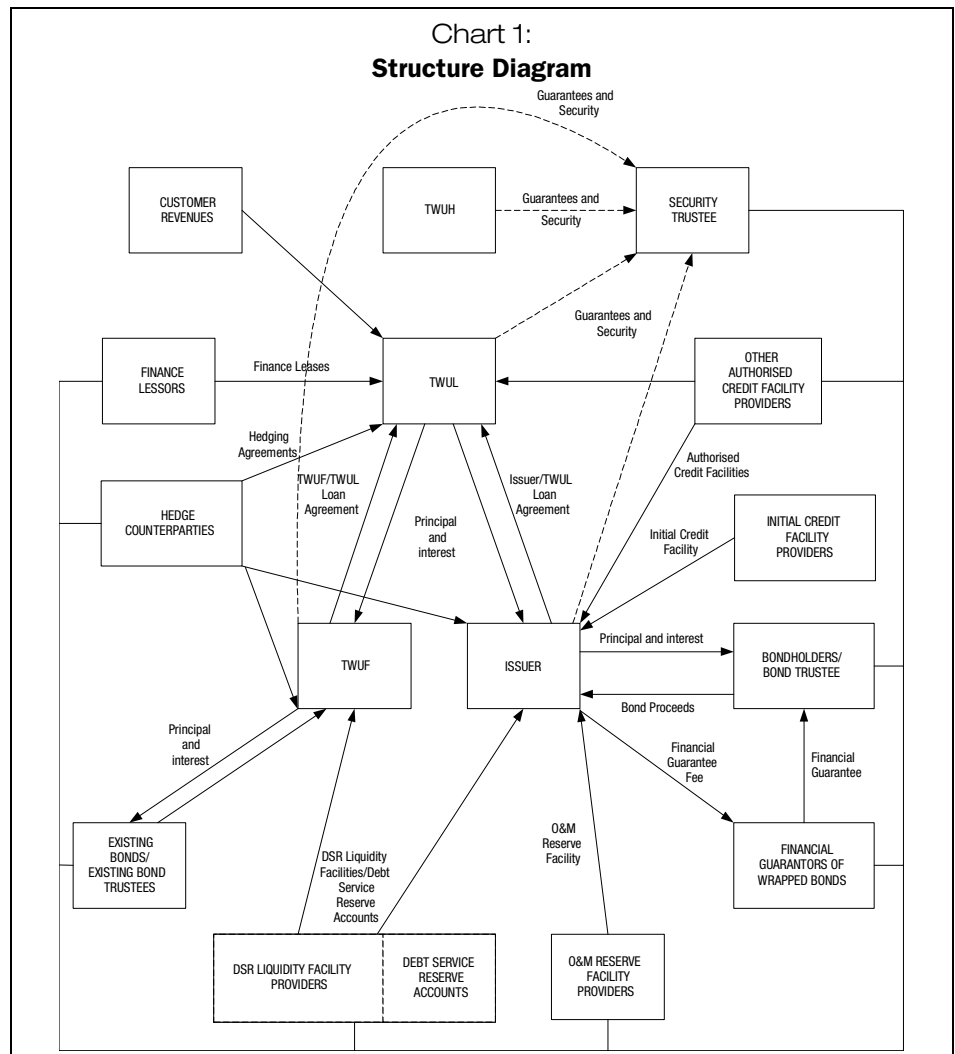
TRANSACTION DESCRIPTION

First issuance of Notes under the TWUCF GBP10 billion MTN programme

The present transaction is the first issuance of Notes under the Thames Water Utilities Cayman Finance Limited GBP10,000,000,000 medium term note programme (the “**Programme**”). Under the Programme, the Issuer may issue Notes in series (each a “**Series**”) and in one or more of four classes (each a “**Class**”): (i) Class A Wrapped Notes, (ii) Class A Unwrapped Notes, (iii) Class B Wrapped Notes and (iv) Class B Unwrapped Notes.

Each Class of Notes may be (i) zero-coupon, (ii) fixed-rate, (iii) floating rate or (iv) index-linked. Furthermore, each Class of Notes may be denominated in (i) Sterling, (ii) Euros or (iii) US Dollars.

STRUCTURAL AND LEGAL ASPECTS



¹ For additional reference, please also refer to Moody's Special Comments: “UK Water Sector – Q&A on Moody's Approach to New Structured Financings”, published in October 2006; and “UK Water Sector – Key Ratios Used by Moody's in Assessing Companies' Credit Strength”, published in March 2006.

Inter-company Loans

The Issuer will on-lend the issuance proceeds to TWUL under the Issuer/TWUL Loan Agreement

The Issuer will apply the proceeds of issuance of the Notes on the Closing Date to provide a loan to the Borrower pursuant to a loan agreement to be entered into between the Issuer and TWUL on the Closing Date (the “**Initial Issuer/TWUL Loan Agreement**”). The Issuer will on-lend to the Borrower the proceeds of each subsequent Series of Notes issued after the Closing date pursuant to a new Issuer/TWUL Agreement (together with the Initial Issuer/TWUL Loan Agreement, the “**Loans**”). Each advance to be made by the Issuer to TWUL under the Loans will reflect the corresponding amount and terms of borrowing by the Issuer of each Class of Notes, each borrowing under any relevant Authorised Credit Facilities and, to the extent such borrowing is hedged under a Hedging Agreement, the terms of such Hedging Agreement.

Therefore, the primary source of funds for the payment of interest and principal on each Series of Notes will be the right of the Issuer to receive payments of interest and payments of principal in respect of the Loans.

The Existing Bond Issuer has on-lent the issuance proceeds of the Existing Bonds to TWUL under a TWUF/TWUL Loan Agreement

In addition, the indebtedness of TWUF (as at the Closing Date being incurred through, amongst other things, the issue of the Existing Bonds) will be backed by an aggregate matching debt obligation owed by TWUL to TWUF under a loan agreement (each a “**TWUF/TWUL Loan Agreement**”). Each advance to be made by TWUF to TWUL under the TWUF/TWUL Loan Agreements will reflect the corresponding amount and terms of borrowing TWUF of each Class of Existing Bonds and any Authorised Credit Facilities entered into by TWUF from time to time.

As of the Closing Date, the aggregate indebtedness of the Issuer and TWUF equals approximately £[4.6] billion (£4.1 billion in relation to the Notes, the Secured Existing Bonds and the Unsecured Existing Bonds).

Borrower Security

There are cross-guarantees and security provided by each of Holdco, TWUL, TWUF and the Issuer

The Notes and the Secured Existing Bonds will be unconditionally and irrevocably guaranteed and secured by each of the Issuer, TWUL, TWUF and Holdco (together with the Issuer, the “**Obligors**”) pursuant to a guarantee and security agreement (the “**Security Agreement**”). Each Obligor has granted a security over its entire property, assets, rights and undertaking in favour of the Security Trustee, except that the security will not include any security over Protected Land (see below). However, in respect of TWUL, the creation, perfection and enforcement of such security will be subject to the Water Industry Act 1991, as amended (the “**WIA**”) and its licence.

The following diagram shows the security provided by the Obligors in favour of the Security Trustee on behalf of the Secured Creditors:

SECURITY		GUARANTEE
Fixed and floating charge Principal secured asset is its holding of shares in TWUL	TWH	Guarantees all obligations of TWUL, TWUF and the Issuer under the Finance Documents
Fixed and floating charge over its property, assets and undertaking, all subject to the WRA and the Instrument of Appointment	TWUL	Guarantees all obligations of TWUF and the Issuer under the Finance Documents
Fixed and floating charge	TWUF	Guarantees all obligations of TWUL and the Issuer under the Finance Documents
Fixed and floating charge	ISSUER	Guarantees all obligations of TWUL and TWUF under the Finance Documents

Security provided by TWUL is limited by UK legislation and does not allow the appointment of an administrative receiver

Security granted by Holdco, TWUF and the Issuer are not limited by UK legislation

A Special Administration period may be imposed upon a default of TWUL

Intercreditor arrangements regulate the secured creditors

TWUL's licence restricts its ability to create a charge or mortgage over Protected Land, which includes the vast majority of TWUL's assets. This affects the ability of TWUL to create a floating charge over the whole or substantially the whole of its business. In any event, there is no right of a floating charge holder under the Water Acts to block the appointment of a special administrator, which the Secretary of State and Ofwat may appoint under the WIA in certain circumstances in respect of TWUL and its business. The appointment of a special administrator effectively places a moratorium upon any holder of security from enforcing that security. Accordingly, the security provided by TWUL in favour of the Security Trustee provides significantly less protection to the Security Trustee than would be the case if TWUL were not a regulated business.

These limitations apply only to TWUL as a regulated business and do not apply to the fixed and floating charges granted by the Issuer, TWUF and Holdco. Enforcing on the shares of any company within the TWU Financing Group, other than the shares of the Issuer and TWUF, which are both owned by TWUL, is not subject to any moratorium and would not be blocked by the appointment of a special administrator for the regulated business. Nonetheless, Moody's understands that any intended enforcement either directly or indirectly of the security granted by Holdco over the shares of TWUL would involve consultation with Ofwat.

The High Court may appoint a special administrator when petitioned by Ofwat or the Secretary of State in order to ensure the continued provision of water and sewerage services to the public. In addition, the High Court may appoint a special administrator in response to a petition by a creditor of TWUL whereby, in the absence of the Special Administration requirement, TWUL would be wound-up.

During the Special Administration period, the administrator may dispose of assets subject to a floating charge, but the proceeds will be applied as if subject to the floating charge. Assets subject to a fixed charge may only be sold with the approval of the secured creditor or the Court. A special administrator may not sell the assets to a purchaser that is unable to carry out the regulated functions.

The special administrator is expected to transfer to other regulated companies – as a going concern – as much of the business as is necessary to ensure continuation of the licensed services. This means that the special administrator is unlikely to be able to accept an offer to purchase the assets on a break-up basis.

TWUL's license may be transferred to another entity during special administration. Ofwat or the Secretary of State has a duty to ensure, to the extent consistent with the WIA, that creditors are not unfairly prejudiced by the transfer of assets from TWUL. A special administrator also has the power to modify the licence, subject to the approval of Ofwat or the Secretary of State.

The WIA and the terms of its licence compel TWUL to comply with a number of restrictions typical of whole business securitisations. For example, the financial "ring-fencing" of the regulated business, including a requirement to insure TWUL has sufficient financial and managerial resources to undertake its licensed activities. TWUL is restricted from granting affiliated companies loans or guarantees and from entering into cross-default obligations. TWUL is prohibited from giving or receiving cross-subsidies and must complete all transactions with related companies on an arm's length basis. The directors of TWUL must act solely in the interests of TWUL. The latter must also maintain three independent non-executive directors. TWUL must also endeavour to maintain an investment grade rating.

Intercreditor Arrangements

The intercreditor arrangements (the "**Intercreditor Arrangements**") in respect of the TWU Financing Group are contained in the Security Trust and Intercreditor Deed ("**STID**") and the Common Terms Agreement ("**CTA**") and bind each of the Secured Creditors, the Secondary Market Guarantors (as described below) and each of the Obligors.

The Intercreditor Arrangements regulate, among other things (i) the claims of the Secured Creditors; (ii) the exercise, acceleration and enforcement of rights by the Secured Creditors and the rights of the Secondary Market Guarantors to participate in any related vote; (iii) the rights of the Secured Creditors and the Secondary Market Guarantors to instruct the Security Trustee; (iv) the rights of the Secured Creditors during a Standstill Period; (v) the Entrenched Rights and the Reserved Matters of the Secured Creditors; and (vi) the giving of consents and waivers and the making of modifications to the Finance Documents.

Unsecured creditors will not become parties to the Intercreditor Arrangements and, although ranking behind the Secured Creditors in an administration or other enforcement, will have unfettered, independent rights of action in respect of their debts. However, the aggregate amount of unsecured Financial Indebtedness will be restricted under the CTA to being no more than 0.8% of TWUL's RCV. This threshold will exclude the Unsecured Existing Bonds until the occurrence of the Permitted Unsecured Financial Indebtedness Trigger.

As of the Closing Date, the Unsecured Existing Bonds will also not accede to the Intercreditor Arrangements. The result is that if an event of default occurs with respect to the Unsecured Existing Bonds, it is likely that a Special Administrator will be appointed in respect of TWUL and the Noteholders and Secured Existing Bondholders will not benefit from the Standstill Period that would have commenced following an Event of Default on the Notes. Moody's has taken this into account in its analysis and is of the view that the lower leverage levels before distribution lock-ups are triggered of TWUL set at 72% of Senior Net Debt to RCV prior to April 2010 and 82% thereafter, in circumstances where the Permitted Unsecured Financial Indebtedness Trigger has not occurred, provides some protection against the described risk. Once the aggregate indebtedness under the Unsecured Existing Bonds and any other unsecured financial indebtedness falls below 0.8% of RCV, the leverage levels may rise to 75% and 85% respectively.

The Intercreditor Arrangements also provide for the ranking in point of payment of the claims of the Secured Creditors, both before and after any enforcement of the Security, and for the subordination of all claims among the TWU Financing Group (other than claims in respect of the Issuer/TWUL Loan Agreements and the TWUF/TWUL Loan Agreement funded through the raising of Senior Debt).

Liquidity

Liquidity is provided to the transaction by cash deposits or liquidity facilities available for the funding of the following accounts:

Adequate liquidity is in place to cover 12 months' projected expenditures

- **Initial Credit Facility** – a revolving credit facility made available to the Issuer which will comprise: (i) a GBP200 million tranche to fund (via the Initial Issuer/TWUL Loan Agreement) the working capital requirements of TWUL (the "**Working Capital Facility**") and (ii) a GBP550 million tranche to meet (via the Initial Issuer/TWUL Loan Agreement) TWUL's capital expenditure requirements (such amount to be repayable three years after drawdown) (the "**Capital Expenditure Facility**").
- **DSR Liquidity Facilities** – a 364 day revolving facility to be made available to each of the Issuer and TWUF in an amount equal to the aggregate of projected interest payments on the Class A Debt, the Unsecured Existing Bonds and Class B Debt for the next 12 months. The Issuer will not be able to make a drawing in respect of a liquidity shortfall relating to Class B Debt unless the sum available to be drawn on the DSR Liquidity Facilities is no less than the aggregate of the next 12 months' interest and other finance charges due on the Class A Debt. TWUF will not be able to make a drawing in respect of a liquidity shortfall relating to Class B Debt, although only TWUF will be able to make a drawing in respect of a liquidity shortfall relating to the Unsecured Existing Bonds.
- **O&M Reserve Facility** – a liquidity facility to be made available to the Issuer in an amount equal to 10% of TWUL's projected operating expenditure and capital maintenance expenditure for the next 12 months (to be on-lent by the Issuer to TWUL via the Initial Issuer/TWUL Loan Agreement).

The funding of the DSR Liquidity Facilities and the O&M Reserve Account are financial covenants of TWUL. In addition, it is a Trigger Event if the aggregate of TWUL's operating cash flows – plus amounts available operating accounts available to meet capital expenditure and working capital requirements for the next 12 months plus available authorised loan facilities (excluding liquidity facilities) available for the next 12 months is less than the sum of forecast working capital needs, capital expenditure and the amount equal to the net amount payable by the Issuer, TWUF or TWUL to a hedge counterparty following the exercise of an option to terminate a Treasury Transaction.

In addition, it is also a Trigger Event if the aggregate amount available for drawing under the DSR Liquidity Facilities and all amounts standing to the credit of the Debt Service Reserve Accounts of the Issuer and TWUF is less than an amount equal to the next 12 months' interest payable on the Class A Debt, the Unsecured Existing Bonds and Class B Debt. Failure to maintain the amounts required in the O&M Reserve Facility or the DSR Liquidity Facility is also a Trigger Event.

As of the Closing Date, Existing Authorised Credit Facilities comprising an aggregate amount of approximately GBP550,000,000 (with maturities between 2008 and 2021) have been made available to TWUL to be applied towards TWUL's capital expenditure requirements. The ability of the Existing Authorised Credit Provider to accelerate sums owing to it is regulated by the STID.

Upon enforcement of the security pursuant to the STID, all debt outstanding under any liquidity facility will rank in priority to the Notes.

Hedging

As at the Closing Date, TWUL will be a party to existing hedging agreements which comprise four currency hedging agreements (in relation to Japanese yen denominated Existing Bonds) and two interest rate hedging agreements relating to existing finance leases.

The TWU Financing Group has covenanted to comply with the Hedging Policy, which, in Moody's opinion, provides sufficient investor protection against market changes in interest rates and currency exchange rates. Moody's believes that a limited amount of variable rate exposure can be adequately managed by a WaSC in the context of the industry's regulatory model and, in particular, the consideration by the Regulator of current interest rate levels, among other factors, when assessing the cost of capital at periodic reviews.

Only the Issuer, TWUF and TWUL may enter into hedging arrangements. The hedging agreements to be entered into pursuant to the Hedging Policy would comply with Moody's swap criteria to allow the structure to achieve delinkage from the risk of the swap counterparty.

The Hedging Policy requires that the TWU Financing Group hedge into sterling all currency exposure. It also requires the TWU Financing Group to hedge into fixed rate at least 85% of its total outstanding debt liabilities for the current period until the next Periodic Review, and at least 75% in the next Periodic Review periods thereafter. The Hedging Policy may be changed only with the approval of the Security Trustee.

The Issuer, TWUF and TWUL may also enter into RPI-linked hedging agreements under which payments to be made by the Issuer, TWUF or TWUL are indexed by reference to RPI. Given that such payments are to be made senior to payments to the Class A Debt in the payment waterfall, it is a Trigger Event if the aggregate amount of all accretions of indexation to the notional amounts of any RPI-linked hedging agreement exceeds 8% of Class A Indebtedness (the definition of which includes, amongst other things, the principal outstanding amount of all Class A Debt and accretions of indexation to the notional amounts under any RPI-linked hedging agreement).

Financial Covenants

TWUL and the Issuer covenant to calculate specified financial ratios that reflect the financial performance of TWUL in two key respects: the cash flows available to make debt service payments and the amount of debt outstanding compared to its RCV.

In line with our published methodologies for the UK water sector, Moody's believes that these particular financial ratios are appropriate measures of financial performance and flexibility as further discussed in the Cash Flow Analysis section of this report. The ratios are used to define both Trigger Events and Events of Default, discussed below. The following table shows the level at which the various financial ratios will create restrictions on TWUL and the Issuer:

Hedging Policy reinforces prudent management of financial indebtedness

Hedging agreements will comply with Moody's swap criteria

RPI-linked hedging agreements are subject to a financial covenant

Financial covenants are consistent with Moody's rating methodology for the water sector

The ratios are in line with comparable transactions

Table 1:

Financial Ratios	Distribution lock-up tests	Trigger Events (also distribution lock-ups)	Additional Indebtedness	Events of Default
Class A ICR				<1.60x
Class A Average Adjusted ICR		<1.40x		
Class A Adjusted ICR		<1.30x	<1.30x	<1.00x
Senior Average Adjusted ICR		<1.20x		
Senior Adjusted ICR		<1.10x		
Class A RAR		>75%	>75%	
Senior RAR	>75%* and >85% **	>75%* and >90%	>75%* and >90%	>85%* and >95%

* Before 31 March 2010

** Prior to the occurrence of the Permitted Unsecured Financial Indebtedness Trigger, lock up will occur if the Senior RAR exceeds 72% before 31 March 2010 and 82% thereafter.

Definitions:

Class A ICR: in respect of a Test Period, the ratio of Net Cash Flow for such Test Period to Class A Debt Interest for such Test Period.

Class A Average Adjusted ICR: the sum of the ratios of Net Cash Flow less the aggregate of current cost depreciation (“**CCD**”) and infrastructure renewals charge (“**IRC**”) to Class A Debt Interest for each of the Test Periods comprised in a Rolling Average Period divided by three.

Class A Adjusted ICR: in respect of a Test Period, the ratio of Net Cash Flow less the aggregate of CCD and IRC during such Test Period to Class A Debt Interest during such Test Period.

Senior Average Adjusted ICR: the sum of the ratios of Net Cash Flow less the aggregate of CCD and IRC to Senior Debt Interest for each of the Test Periods comprised in a Rolling Average Period divided by three.

Senior Adjusted ICR: in respect of a Test Period, the ratio of Net Cash Flow less the aggregate of CCD and IRC during such Test Period to Senior Debt Interest during such Test Period.

Class A RAR: on any Calculation Date in respect of any Test Period, the ratio of Class A Net Indebtedness to RCV as at such Calculation Date and, in the case of forward looking ratios for Test Periods ending after such Calculation Date, as at the 31 March falling in such Test Period.

Senior RAR: on any Calculation Date in respect of any Test Period, the ratio of Senior Net Indebtedness to RCV as at such Calculation Date and, in the case of forward looking ratios for Test Periods ending after such Calculation Date, as at the 31 March falling in such Test Period.

Net Cash Flow: (a) in respect of any historical element of a Test Period, the aggregate of net cash flow from operating activities as shown in the TWUL financial statements (after adding back, without double counting, and to the extent that such items are included in net cash flow from operating activities, any exceptional items (including the initial transaction fees payable on or about the Initial Issue Date) to the extent such items represent expenditure of TWUL and/or are included in the net cash flow from operating activities as shown in TWUL's financial statements, any recoverable VAT, any Capital Expenditure, any movement in debtors and/or creditors relating to Capital Expenditure and any Deferrals of K) minus any exceptional items to the extent such items represent receipts of TWUL and/or are included in the net cash flow from operating activities as shown in TWUL's financial statements and corporation tax paid (other than in respect of interest received on the Intra-Group Loan between TWUL and TWH) which shall exclude payments in respect of a Permitted Tax Loss Transaction as part of any Intra-Group Debt Service Distribution, during such Test Period; and

(b) in respect of any forward-looking element of a Test Period, the aggregate of anticipated net cash flow from operating activities (after adding back, without double counting and to the extent that such items are included in the anticipated net cash flow from operating activities, any exceptional items to the extent such items represent expenditure of TWUL and/or are included in the net cash flow from operating activities as shown in TWUL's financial statements, any recoverable VAT, any Capital Expenditure any movement in debtors and/or creditors relating to Capital Expenditure and any Deferrals of K in each case anticipated to occur during such Test Period) minus any exceptional items to the extent such items represent receipts of TWUL and/or are included in the net cash flow from operating activities as shown in TWUL's financial statements and corporation tax which shall exclude payments in respect of a Permitted Tax Loss Transaction as part of any Intra-Group Debt Service Distributions anticipated to be paid during such Test Period less any anticipated net cash flow from operating activities of its business other than its Appointed Business and after adding back corporation tax anticipated to be paid (other than in respect of interest received on the Intra-Group Loan between TWUL and TWH) as a result of such businesses during such Test Period.

Class A Debt Interest: adjusted lease reserve amount, lease reserve amount and cash interest paid, due but unpaid or, payable on Class A Debt and any Permitted Financial Indebtedness which is unsecured plus any premia paid to financial guarantors in respect of Class A Debt less all interest received from a third party (excluding any interest received by TWUL under any Intra Group Loan).

Senior Debt Interest: adjusted lease reserve amount, lease reserve amount and cash interest paid, due but unpaid or, payable on Class A Debt, Class B Debt, any other financial indebtedness ranking in priority to subordinated debt and any Permitted Financial Indebtedness which is unsecured plus any premia paid to financial guarantors in respect of wrapped Class A and Class B Notes less all interest received from a third party (excluding any interest received by TWUL under any Intra Group Loan).

Class A Net Indebtedness: Class A Debt (including accretions by indexation to the notional amount on any RPI-linked instrument and hedging agreements) and the nominal amount of any financial indebtedness in respect of the Unsecured Existing Bonds and any unsecured financial indebtedness which is outstanding plus permitted *de-minimis* indebtedness, less value of cash and permitted investments, but excluding customer rebates of distributions declared but not paid.

Senior Net Indebtedness: Class A Debt plus Class B Debt (including accretions by indexation to the notional amount on any RPI-linked instrument and hedging agreements) and the nominal amount of any financial indebtedness in respect of the Unsecured Existing Bonds and any unsecured financial indebtedness which is outstanding plus permitted *de-minimis* indebtedness, less value of cash and permitted investments, but excluding customer rebates of distributions declared but not paid.

CCD: expenditure designated under the heading "current cost depreciation" in the financial projections contained in the supplementary report issued by Ofwat detailing the numbers and assumptions specific to TWUL in Ofwat's most recent Final Determination adjusted as appropriate for any subsequent Interim Determination of 'K' ("**IDOK**") and for Out-turn Inflation.

IRC: the amounts set out under the heading "infrastructure renewals charge" in the financial projections contained in the supplementary report issued by Ofwat detailing the numbers and assumptions specific to TWUL in Ofwat's most recent Final Determination adjusted as appropriate for any subsequent IDOK and for Out-turn Inflation.

Test Period: (a) the period of 12 months ending on 31 March in the then current year; (b) the period of 12 months starting on 1 April in the same year; (c) each subsequent 12 month period up to the Date Prior (the date which is one day before the next Periodic Review Effective Date, which is the date when new price limits come into effect); and (d) if the Calculation Date falls within the 13 month period immediately prior to the Date Prior, the Test Period would be effective from the 12-month period from the Date Prior, provided that for the Calculation Dates on 30 September 2007 and 31 March 2008, the first Test Period shall be from 1 April 2007 to 31 March 2008, in the case of the Calculation Date on 30 September 2007 the second Test Period shall be the period of 12 months starting on 1 April in the following year, and interest shall be annualised on the basis of the interest charge from the Closing Date to 31 March 2008.

Rolling Average Period: means on each Calculation Date the Test Period ending on 31 March that falls in the same calendar year as that Calculation Date and the next subsequent two consecutive Test Periods.

Calculation Date: 31 March and 30 September in each year starting on 30 September 2007.

As per the definitions above, each financial ratio is measured as at the 31 March and 30 September of each financial year both on a historical and forward-looking basis, either up to the end of the current regulatory period or for the subsequent two years, in the case of the Average Adjusted ICRs. Forward-looking tests will also capture the first year of the subsequent regulatory period during the last year of the current regulatory period. Projections would be based on management's assumptions, but Moody's understands that they would need to reflect final price determinations, as soon as these have been published by Ofwat.² Given the overall predictability of a WaSC's cash flows during the course of a regulatory period, Moody's believes that forward looking tests, which also look into the next regulatory period, are important tools with which to monitor the evolution of a company's financial performance and to activate restrictions on distributions or additional indebtedness in time to support credit quality.

Restricted Payment Conditions

Restricted payment conditions ensure that all subordinated debt can be treated as equity

Restricted payments include distributions, payments on subordinated debt and TWUL preference shares and customer rebates.

TWUL, TWUF and the Issuer have covenanted not to pay any distributions, make payments on any subordinated debt or TWUL preference shares unless (i) authorised by their Board of Directors, (ii) there are no drawings under the liquidity facilities, (iii) the Senior RAR is less than or equal to 72% (prior to the occurrence of the Permitted Unsecured Financial Indebtedness Trigger, or 75% thereafter) for each Test Period prior to 31 March 2010, or less than and equal to 82% (prior to the occurrence of the Permitted Unsecured Financial Indebtedness Trigger, or 85% thereafter) for each Test Period thereafter, and will remain so after the proposed payment, (iv) no Trigger Event exists or will result from the payment, (v) no Event of Default exists or will result from the payment, and (vi) the repeated representations are correct.

In addition, TWUL, TWUF and the Issuer covenant to pay customer rebates only if there is no Trigger Event or Event of Default, effectively permitting customer rebates at a higher leverage (Senior RAR > 75% before 31 March 2010 and 90% thereafter) than other forms of distributions (Senior RAR > 75% before 31 March 2010 and 85% thereafter).

There is an additional restricted payment test requiring that if the underlying ratings of the Class A Wrapped Notes and any rating in respect of Class A Unwrapped Notes are downgraded below **Baa3**, then no payments can be made until the ratings have been restored.

² TWUL has undertaken to permit the Security Trustee to investigate and request substantiating evidence for calculations contained in any Compliance Certificate that it believes to be incorrect or misleading, or in the event that there is a deterioration in the historical ratios.

Trigger Events provide some protection against financial deterioration

Trigger Events

The occurrence of a Trigger Event has, amongst others, the following consequences: (i) no Obligor may make any restricted payments and TWUL may not provide customer rebates, (ii) TWUL is required to provide information on its plan of action to the Security Trustee and (iii) the Security Trustee may commission an Independent Review and consult with Ofwat.

The Trigger Events include, amongst others, the following:

- Breach of certain financial covenants (see table above);
- Failure by TWUL to make the monthly debt service amounts (i.e. 1/12th of annual senior debt service, including scheduled interest on Class B Debt although non-payment of Class B is not an Event of Default);
- Material deviation in capex projections over the whole of a regulatory period of more than 10% compared to Ofwat's capex allowances for such period;
- Insufficient financial resources, defined as projected operating cash flows plus amounts available under the DSR Liquidity Facility and in the Debt Service Reserve Account of the Issuer and TWUF, to meet forecast interest due on Class A Debt, the Unsecured Existing Bonds and Class B Debt for the next 12 months;
- TWUL's operating cash flows plus amounts available under Authorised Credit Facilities (excluding liquidity facilities) and in the Operating Accounts, is less than the forecast operating expenses, working capital requirements, capital expenditure for the next 12 months and termination amounts (if any) payable by the Issuer, TWUF or TWUL under any hedging agreements;
- A drawdown on the O&M Reserve Facility;
- Expected appointment of a special administrator or termination or material modification of licence or adverse determination of 'K' by Ofwat (the adjustment factor set for each year by the Regulator to the charges that water companies can make to their customers);
- Breach of limitation on Non-Appointed Business, defined as cash operating and capital expenditure on non-appointed businesses exceeding 5% of total cash expenses (opex and capex) in aggregate over the current financial year and the two preceding ones;
- Adverse governmental legislation; and
- An Event of Default, as defined below.

Events of Default

Events of Default trigger a Standstill Period, though also allowing limited enforcement of certain security

Immediately upon notification to the Security Trustee of an Event of Default, a Standstill Period commences for a period of 18 months, unless terminated earlier or extended. During the Standstill Period, none of the secured creditors may direct the Security Trustee to take enforcement action in relation to security granted by the Issuer, TWUF or TWUL, or to accelerate any secured liabilities (although the security granted by Holdco may be enforced at any time by the Security Trustee). In addition, the Standstill Cash Manager assumes control of any available monies received by TWUL, TWUF and the Issuer and amounts credited to the Debt Service Payment Account during this period and applies these funds in accordance with the payment priority. The Standstill Period ends upon certain events, such as two-thirds of the most senior class of Notes electing to terminate. The percentage of bondholders required to terminate is reduced after 18 months, and thereafter reduced further at regular intervals.

The Events of Defaults include, amongst others, the following:

- Non-payment of any amount payable under the Finance Documents;
- Breach of other obligations under the Finance Documents (including the covenants);
- Non-payment of any amount payable in excess of 0.1% of RCV in nominal amount in respect of indebtedness other than in respect of the Finance Documents;
- Insolvency of any Obligor;
- Transfer or revocation or termination of TWUL's licence;
- Insufficient liquidity to meet TWUL's forecast capital expenditure and working capital requirements for the next six months;
- A TWUL change of control;

- The security or other undertakings of any Obligor ceasing to be in full force and effect;
- Class A ICR is less than 1.60x;
- Senior RAR exceeds 85% prior to 31 March 2010 and exceeds 95% thereafter; and
- Class A Adjusted ICR is less than 1.00x.

Negative Covenants

Negative covenants reflect typical provisions in comparable transactions

Each Obligor will give various negative covenants in relation to the running of its future operations, which include, *inter alia*,:

- Not acquiring or incorporating a company or acquiring any shares or securities of a business other than Permitted Acquisitions, Authorised Investments and Permitted Joint Ventures;
- Not disposing of any asset other than a Permitted Disposal, a Permitted Joint Venture or a Permitted Security Interest;
- Not incurring or allowing to remain outstanding any indebtedness, other than Permitted Financial Indebtedness or, in the case of TWUL, Permitted Volume Trading Arrangements.

Permitted Financial Indebtedness includes (i) Class A Debt or Class B Debt provided that the Senior RAR is less than or equal to 75% prior to 31 March 2010 or 90% thereafter, (ii) Class A Debt if the Class A RAR is less than or equal to 75% and the Class A Adjusted ICR is greater than or equal to 1.30x and (iii) any unsecured financial indebtedness provided the aggregate amount of such debt does not exceed 0.80% of RCV.

Positive Covenants

Positive covenants reflect typical provisions in comparable transactions

Each Obligor will also give various positive covenants in relation to the running of its future operations and business, which include, *inter alia*,:

- To undertake to ensure the secured claims of the Secured Creditors will rank prior to the claims of all its other unsecured and unsubordinated creditors;
- To provide certain information to the Security Trustee expected to be relevant to any party providing credit to the TWU Financing Group (including audited financial statements, notice of litigation and notification of any Default or Potential Trigger Event);
- The maintenance of suitable insurance cover for the business;
- To comply with the Hedging Policy;
- To maintain an underlying rating in respect of the Wrapped Notes and a rating in respect of the Unwrapped Notes;
- The maintenance of authorisations, consents, licences and intellectual property rights; and
- The payment of taxes.

CASHFLOW ANALYSIS

Ratings reflect high leverage and structural mitigants

The assigned ratings reflect TWUL's limited financial flexibility as a result of the highly leveraged capital structure adopted with this transaction. The ratings also factor in the probability that TWUL's debt protection measures may weaken in future regulatory periods at the level of leverage envisaged by the transaction. Moody's believes that TWUL's funding structure is sufficiently resilient for the assigned rating levels notwithstanding the operational challenges the company faces as discussed in the relevant sections below. Our view takes into account the company's prospective credit metrics on the basis of the assumed cost of debt, which show significant headroom in comparison to its peers. We have also considered the positive effect of the financial covenants, which, in Moody's view, should be helpful – in many downside scenarios – to maintain or restore an adequate balance of debt and equity in the event of weaker financial performance or large capital requirements in the future.

Moody's notes that all projections and scenarios, as discussed in the sensitivities section of this report, are based on a distribution lock-up trigger level of 75% (or 85% post-2010 assuming issuance of Class B Debt) in order to stress test the most conservative case. Obviously, the resulting financial metrics of the sensitivity analysis would be modestly stronger, if distribution lock-ups were triggered already at a 72% level (or 82% post-2010) prior to the occurrence of the Permitted Unsecured Financial Indebtedness Trigger.

Financial Projections

Financial projections consistent with Moody's benchmarks for structured financings of WaSCs at the assigned rating levels

The table below shows the results for key financial ratios under the management base case for the remainder of the current regulatory period ("AMP4").

Table 2:

Management Base Case	Trigger Level	2007/2008	2008/2009	2009/2010
Net Debt to RCV – Class A	75%	71.8%	72.8%	72.1%
Adjusted ICR – Class A	1.30x	2.20x	2.16x	2.24x
Average Adjusted ICR – Class A	1.40x	2.20x	2.24x	2.33x

The projections underlying the above results are based on TWUL's current business plan, including the following main assumptions:

- Figures for the regulatory variables, the RCV, IRC and CCD are based on those published by Ofwat as final determinations for AMP4 in December 2004.
- Regulatory variables and revenue, opex and capex projections from TWUL's budget are inflated using an RPI of 2.5%. Revenues are also adjusted in line with the 'K' factor in TWUL's price limits, which was set by Ofwat at 1.2% for 2007/2008, 1.3% for 2008/2009 and 1.5% for 2009/2010.
- All new debt at securitisation as well as any future debt post-securitisation is expected to be funded 100% through index-linked debt. This will result in about 31% of the RCV at securitisation to be funded by index-linked debt (about 44% of total Class A Debt, which will represent approximately the total of debt outstanding at least until after April 2010). Moody's understands that management may decide to issue straight index-linked debt or use inflation-linked swap arrangement to swap fixed-rate debt into index-linked debt (subjects to the covenant restrictions mentioned above).
- Interest expenses are based on the projected cost of debt upon execution of the refinancing and for future issuance. The weighted-average cost of total debt (including fees) at closing of the transaction is assumed at about 3.7% on a cash basis and 5.2% on an accrual basis (i.e. including the indexation element of index-linked debt). Future senior debt issuance is projected at a base rate, i.e. excluding margins and fees, of 4.617% for conventional debt and 1.518% for index-linked debt based on 20-year gilt-rates for fixed-rate issuance, reflecting current market conditions. The correspondent all-in rates are 5.52% for conventional Class A Debt and 2.57% for index-linked Class A Debt, and 5.77% for conventional Class B Debt and 2.82% for index-linked Class B Debt. Moody's notes that Ofwat assumed a real cost of debt of 4.3% (equivalent to 6.8% nominal assuming 2.5% RPI) for a water company leveraged in accordance with the Regulator's notional capital structure in the range 55%-65%. Assuming the Class A Notes are issued in line with assumptions, TWUL will clearly enjoy an overall cost of debt materially lower than assumed by Ofwat at close to 75% leverage. Moody's also notes that TWUL's cost of debt will compare well with that of its peers. For example, Anglian Water reported a nominal weighted average cost of debt of approximately 6.9% at March 2007 with leverage at approximately 81.6% (both Class A and Class B combined).

- The calculation of debt and RCV is based on the figures published by Ofwat reflecting the assumptions made by the Regulator at the 2004 price review, with minor adjustments.³

To analyse TWUL's capital structure and associated risks, Moody's concentrates on two financial ratios:

- The RAR or Senior Net Debt to RCV ratio. This is the ratio of senior net indebtedness to RCV for a given class of debt. The RCV represents the regulatory capital base of the business of a WaSC in the Regulator's model.
- The Adjusted Interest Cover Ratio ("Adjusted ICR"). This second ratio is calculated by Moody's to measure the cash interest cover of a WaSC after deducting from available cash flows the portion of the capital expenditure that is required to maintain the RCV at a constant value (in real terms) over the regulatory period.

In addition to the above-mentioned financial indicators, Moody's also believes that it is important to monitor the execution of the company's capital programme against the capex allowances and output requirements set by Ofwat.

Financial covenants should align the interests of shareholders with those of creditors

TWUL's financial covenants as described above are largely consistent with Moody's analytical approach. Limitations on distributions to shareholders or payments to subordinated debt providers and restrictions on additional indebtedness are based on the above-mentioned ratios. Moody's believes that the financial covenants should be helpful in preserving TWUL's financial flexibility and maintaining the stability of its debt structure. In downside scenarios, the covenants should align the interests of the shareholders with those of the creditors.

As characteristic of the industry, TWUL's financial performance for the current regulatory period has a reasonably high degree of predictability and management's projections take into account the additional expenditure required under the Section 19 Undertaking given by the company to Ofwat. We show below how TWUL's projected credit metrics react to a number of downside sensitivities. We highlight here, however, that the projected levels of the Adjusted ICR are clearly dependent on the cost of debt issued at the closing of the transaction, which for the purpose of the provisional ratings Moody's has assumed that it will be in line with the assumptions mentioned above, the cost of future debt and the degree of index-linked funding available to TWUL.

Given the development of the index-linked market, since the precedent transactions were executed, and given the degree of index-linked funding already available to TWUL, Moody's considers the company's plan to achieve a higher proportion of index-linked issuance at closing to be reasonable. The following table shows the impact on the Adjusted ICRs of reducing the level of index-linked debt available for future debt post-securitisation to 50% of new debt. It can be seen that this would have only a marginal impact over the remainder of AMP4. The effect would become more material looking forward to AMP5, as discussed below.

Table 3:

Management Base Case (50% of future debt index-linked)	Trigger Level	2007/2008	2008/2009	2009/2010
Net Debt to RCV – Class A	75%	71.8%	72.8%	72.1%
Adjusted ICR – Class A	1.30x	2.20x	2.16x	2.19x
Average Adjusted ICR – Class A	1.40x	2.18x	2.19x	2.19x

³ The RAR calculations include adjustments for the pension deficit based on a figure of GBP76.7 million as per an actuarial valuation conducted in October 2006 (TWUL's financial statements for FYE March 2007 show a surplus of GBP15.9 million) and operating leases (GBP63.5 million as per interim results; GBP51.5 million for the 12 months ended 31 March 2007) in line with Moody's methodology. However, we note that these adjustments are excluded from the definition of the financial covenant calculation. Moody's adjusts for operating leases in order to achieve consistency across different industry sectors. The adjustment does not materially affect leverage ratios, as we add the capitalised leases (in the range of GBP50-60 million) to both the debt and the RCV. Given the small size of the pension deficit compared to the overall debt, we do not consider the risk in relation to these liabilities to be material, also taking into account the pass-through to customers of the increased service costs and approximately 50% of deficit allowed by Ofwat at the 2004 periodic review.

Availability of Index-linked debt will be critical for the covenant tests

Moody's notes that as water companies adopt a highly leveraged structure, they tend to replace equity funding with index-linked debt, as in both cases the providers of capital require a cash flow stream that matches the company's future cash flow profile under Ofwat's regulatory model, which allows a real rate of return on an inflation-linked capital value. If a company that has executed a structured financing similar to that proposed by TWUL, were unable to exhibit Adjusted ICRs above the trigger levels due to the unavailability of index-linked debt, it would be forced to deleverage by the dividend lock-up mechanism.

The tables above show that TWUL should show significant headroom in its Adjusted ICRs compared with Moody's ratio guidelines as published in our 2002 Rating Methodology for structured water companies, and reproduced in the table below.

Table 4:

Debt Tranche	Base Case Adjusted ICR
Class A Debt (A3)	1.45-1.55x
Total Senior Debt (Class A & subordinated Class B Tranche)	1.25-1.36x
	Maximum RAR (Senior Net Debt to RCV)
Class A Debt (A3)	75%
Total Senior Debt (Class A & subordinated Class B Tranche)	85%

TWUL's most relevant peers, Anglian Water and Southern Water that executed a similar structured financing to what is now proposed by TWUL in 2002 and 2003, respectively, showed projected metrics at the time of the execution of the financings and have exhibited actual metrics to date largely in line with the above-mentioned guidance (for example, Anglian Water's latest reported Class A PMICR at 31 March 2007 was about 1.6x with Class A RAR at about 71.5%; and Southern Water's latest reported Class A PMICR at 31 March 2007 was about 1.6x with Class A RAR at about 69.5%).

Moody's has taken into account the substantial headroom in TWUL's projected credit metrics to assess the company's overall credit quality in the light of the operational problems and poor cost efficiency experienced by the company during the current regulatory period, when comparing the company against its peers.

With a ratio of Senior Net Debt to RCV at about 72-73% following the refinancing, TWUL will be marginally below the allowed maximum leverage, which provides some, albeit limited, financial flexibility for unforeseen additional capex requirements in order to meet Ofwat's leakage requirement or other regulatory targets during AMP4. The fact that until March 2010 the distribution lock-ups are set at the Class A levels – 75% for the RAR, instead of the typical 85% of similar water structured financings, and 1.4/1.3x for the Adjusted ICR, instead of 1.2/1.1x – would also result in stronger cash retention in the event of that the lock-ups are triggered due to serious underperformance (note that Class B Debt in the water industry structured financings needs to be serviced as long as there is cash available).

Clearly, the benefit of this cash retention may no longer apply post April 2010, as thereafter TWUL is allowed to increase indebtedness up to 85% of the RCV, based on a two-tranche debt structure similar to that adopted by Anglian Water and Southern Water. However, Moody's expects that TWUL's board would decide to increase leverage and receive the necessary regulatory clearances to upstream the corresponding cash balances only if such decision did not prejudice the company's credit quality, which, in Moody's view, would require that the company showed a risk profile broadly in line with the rest of the sector.

In summary, we believe that TWUL should show a better degree of financial flexibility than its peers, given the advantageous cost of funding assumed and the limit on indebtedness to 75% of RCV until April 2010, and that this positive factor provides sufficient mitigation to a somewhat higher degree of operational risk associated with TWUL's current operational underperformance in comparison with its peers.

Stronger cash retention than peers – at least for initial period ending April 2010 – supports credit profile and provides some mitigation against performance problems

Moody's notes that during the current regulatory period, index-linked funding has not only been generally available, but also available at very favourable rates, so that we have seen most of the water companies tapping the index-linked debt market for substantial fund raising. For example, United Utilities Plc, the parent company of United Utilities Water Plc and of a regulated electricity distribution company, reported recently that it has raised index-linked debt equivalent to about 18% of group regulated asset value. Moody's notes that these favourable funding conditions have generally resulted in comfortable levels of interest coverages across the sector, although not necessarily to the extent projected for TWUL. Moody's believes that this could be one of the factors leading to a reduction in the weighted average cost of capital ("WACC") by Ofwat at the next price review and, as we have discussed below, we have tested the resilience of TWUL's credit metrics to lower WACC scenarios.

As commonly seen in previous transactions, WaSCs funded under the structured finance model tend to maintain a highly leveraged financial profile. Unless regulatory constraints apply in the future, Moody's believes that the evolution of TWUL's financial structure will be driven principally by the interaction of its shareholders' interest in receiving cash distributions and TWUL's financial covenants.

The provisional ratings therefore factor in a high likelihood that TWUL may increase leverage to close to 85%, when allowed under the covenants, which would allow an extraordinary distribution payment at the start of AMP5 (this could be used by shareholders to refinance debt raised above the TWU Financing Group).

Moody's has thus assumed that TWUL will manage its capital structure close to the RAR levels that trigger restrictions on distributions, and therefore with Class A and total senior net indebtedness in the range close to 75% and 85%, respectively (obviously, provided that the Adjusted ICR tests are met). Moody's notes that TWUL will be able to raise additional debt against any growth in its RCV due to inflation which is not offset by an increase in the outstanding principal of index-linked debt or does not need to be retained to support the equity-funded portion of the capital programme. These funds can be upstreamed to the shareholders, subject to financial covenants being met.

Sensitivity and Areas of Potential Stress

To reflect the risk that TWUL's financial performance may weaken over the next regulatory period, Moody's has applied stress analysis to TWUL's financial projections. Principal factors that may affect TWUL's metrics in the future include:

- The outcome of the regulatory settlement at future periodic reviews. In particular, the allowed return on capital and the size of the capital programme are key variables, which can significantly impact the financial performance.
- Performance against regulatory target, both with respect to operational performance and the delivery of the capital investment programme.
- The impact of large projects, such as Thames Tideway on TWUL's performance. This is discussed in a separate sensitivity analysis section below.
- Exposure to changing conditions and investor sentiment in the debt capital markets, in particular in relation to index-linked debt. TWUL will need to continue to raise new debt to fund its capital expenditure programme and refinance maturing debt. As is the case for similar structured financings executed by other WaSCs, the liquidity arrangements should allow TWUL some flexibility in accessing the debt markets. However, they essentially address timing issues and cannot resolve the problem of a higher underlying cost of debt if the market no longer supports the structure.
- General event risk. This refers to unforeseen events which may determine a shortfall in revenues or an upsurge in costs (such as accidents and weather conditions). Moody's notes that TWUL's licence (as common for all the WaSCs) contains the "substantial adverse determination" clause (previously known as the "shipwreck" clause), which establishes the principle that the company is entitled to seek protection from the Regulator for events outside its control whose adverse consequences could not be avoided by prudent management action.

Ratings reflect assumption of continued high leverage

Financial structure reasonably resilient to downside stresses, but ratings could come under pressure in low-WACC scenarios if index-linked debt is unavailable

**Reduction of WACC during AMP5
is prudent assumption**

The ability (which is also a duty) of the Regulator to reset the allowed return on capital for the WaSCs at the time of a periodic review is a feature of the regulatory model for the water sector (and other UK regulated utility sectors) that is often associated by investors with the concept of regulatory risk, although it can potentially provide essential protection to changing market conditions.

TWUL's debt protection measures, particularly its Adjusted ICRs, could reduce in AMP5 as a result of a reduction in the WACC assessed by Ofwat for the industry at the next periodic review. For AMP4, Ofwat calculated and published a basic post-tax WACC of 5.1% for the industry (equivalent to 5.8% based on the pre-tax cost of debt and the post-tax cost of equity). However, since the date of the Final Determinations in December 2004, funding conditions for the sector have been more favourable than assumed by the Regulator. For example, the risk-free rate, as represented by reference gilts, has been considerably lower than assumed by the Regulator at the time of the review. Therefore, a number of water companies have been able to raise new debt or refinance existing debt at a cost materially lower than that assumed by Ofwat, thereby building a larger degree of headroom in their ICRs than anticipated at the beginning of AMP4. As discussed above, water companies have also been able to raise significant amounts of index-linked debt that helps mitigate financeability constraints.

At the last price review, no index-linked debt was factored in by Ofwat when modelling the water companies' future financial profiles for the purpose of the financeability test⁴ and allowed a financeability uplift to the WACC. Based on these market developments as well as on recent decisions of other Regulators (Ofgem, the economic Regulator for the electricity and gas sectors, used 4.4% real, post-tax WACC for electricity and gas transmission companies for the period 2007-2012 in its Transmission Price Control Review concluded in December 2006, and 4.2% real, post-tax WACC in its initial proposals for the Gas Distribution Price Control Review for the period 2008-2013 published in May 2007), we consider it prudent to factor in our ratings a high likelihood that Ofwat's WACC assumptions for AMP5 will be lower than those for the current period.

Based on the transactions financial model, Moody's has analysed the sensitivity of TWUL's financial profile to a number of different WACC scenarios, and in combination with assumptions regarding the availability of index-linked debt, given that the any change in the WACC will have a more marked impact on the company's Adjusted ICR, if no or only limited index-linked funding is available.

The table below summarises the impact of different WACC assumptions for AMP5 on the RAR, and the Class A and Senior ICRs. The table shows the results for (i) the real, post-tax WACC set at the current level of 5.1%, (ii) a reduction of 80bp to 4.3%, and (iii) a further reduction by 80bp to 3.5%, which we regard as an extreme scenario. The results should not be considered for their absolute values, but as an indication of sensitivity, as they are a function of certain major assumptions made in the model, in particular:

- TWUL's performance from AMP5 onwards is in line with Ofwat's assumptions, i.e. the model does not assume any out-performance- or underperformance.
- The size of TWUL's capital programme (excluding large projects) is assumed similar in real terms to the allowances set by Ofwat for AMP4, i.e. around GBP2.5 billion at 2002/2003 prices.
- All external funding requirements to finance the capital programme will be 50% index-linked and 50% nominal fixed-rate debt. The cost of debt is projected to remain constant at the same level as for the initial financing, which is a major simplification, since the assumption not only implies constant market conditions, but also constant credit quality for TWUL under the different WACC scenarios.
- Interest calculations are based on the opening debt number in each financial year, i.e. the relevant ICRs for the first year of AMP5 do not reflect the step-up in Class B Debt due to the time-lag.

⁴ Please refer to our 2004 Industry Outlook for more details on the approach used by Ofwat in this area at the 2004 price review (see Related Research section).

Table 5:

AMP5 post-tax WACC	WACC Scenarios based (50% Index-Linked of future debt)	Trigger Level	2010/2011	2011/2012	2012/2013	2013/2014	2014/2015
5.1%	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	2.22x	2.17x	2.10x	2.02x	2.04x
	Adjusted ICR – Senior	1.10x	2.18x	1.88x	1.83x	1.76x	1.78x
4.3%	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.90x	1.82x	1.75x	1.68x	1.69x
	Adjusted ICR – Senior	1.10x	1.86x	1.58x	1.52x	1.46x	1.47x
3.5%	RAR – Class A	75%	71.6%	69.2%	68.4%	67.3%	67.0%
	RAR – Senior	85%	81.6%	79.2%	78.4%	77.2%	77.0%
	Adjusted ICR – Class A	1.30x	1.58x	1.49x	1.46x	1.38x	1.39x
	Adjusted ICR – Senior	1.10x	1.55x	1.29x	1.26x	1.19x	1.20x

Moody's notes that in the very low WACC scenario, i.e. assuming 3.5% post-tax WACC for AMP5, TWUL would be in breach of its covenants, particularly the Adjusted ICR. Therefore excess cash is retained and not paid to shareholders, which appears as a reduction in leverage, given that the RAR is calculated on a Net Debt basis. This cash would be available to actually reduce indebtedness, if used to fund capex, or to cover for a funding shortfall in the case of operational difficulties.

In addition to the above WACC sensitivities, we have considered a downside index-linked scenario for the two lower of the WACC sensitivities assuming that all future debt issuance (excluding that raised at closing of the transaction) would be funded through conventional fixed-rate debt, with the following results:

Table 6:

AMP5 post-tax WACC	Downside Index-Linked WACC Scenarios (0% Index-Linked of future debt)	Trigger Level	2010/2011	2011/2012	2012/2013	2013/2014	2014/2015
4.3%	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.78x	1.67x	1.59x	1.49x	1.49x
	Adjusted ICR – Senior	1.10x	1.75x	1.41x	1.34x	1.27x	1.26x
3.5%	RAR – Class A	75%	70.3%	67.6%	66.7%	65.0%	64.1%
	RAR – Senior	85%	80.2%	77.6%	76.7%	75.0%	74.1%
	Adjusted ICR – Class A	1.30x	1.49x	1.39x	1.36x	1.29x	1.30x
	Adjusted ICR – Senior	1.10x	1.46x	1.17x	1.14x	1.08x	1.09x

The results in the above tables show that, through the activation of the distribution lock-ups, TWUL would be able to sustain lower WACC levels, even if only limited index-linked funding was available. However, very low WACC levels combined with unavailability of index-linked debt would be likely to exert downward pressure on the ratings, a scenario that we do not regard as likely.

From the two above-mentioned WACC sensitivities, we have used the 4.3% case, as a more likely outcome compared to the other two WACC scenarios, to consider certain **performance downside scenarios** assuming the following:

1. Opex overrun of 10% p.a. during the remainder of AMP4 and continuing throughout AMP5.
2. Capex overrun of 10% p.a. (no logging up into RCV) during the remainder of AMP4 and continuing throughout AMP5.
3. Combined sensitivity of 1 and 2.

These three sensitivities assume 50% of future funding is on an index-linked basis. Sensitivity 4 shows the same stresses as under sensitivity 3 in a downside index-linked scenario (100% of new debt funding post closing of the transaction as conventional fixed rated debt).

The projected key credit metrics under this scenario is presented below.

Table 7:

Sensitivity	Performance Scenarios (50% Index-Linked of future debt)	Trigger Level	AMP4 (post-tax WACC 5.1%)			AMP5 (post-tax WACC 4.3%)				
			2007/ 2008	2008/ 2009	2009/ 2010	2010/ 2011	2011/ 2012	2012/ 2013	2013/ 2014	2014/ 2015
1.	RAR – Class A	75%	71.8%	72.8%	72.1%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	n/a	n/a	n/a	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.93x	1.93x	2.01x	1.52x	1.46x	1.49x	1.50x	1.52x
	Adjusted ICR – Senior	1.10x	n/a	n/a	n/a	1.50x	1.27x	1.30x	1.30x	1.33x
2.	RAR – Class A	75%	71.8%	72.8%	72.1%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	n/a	n/a	n/a	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	2.20x	2.17x	2.20x	1.89x	1.80x	1.74x	1.66x	1.68x
	Adjusted ICR – Senior	1.10x	n/a	n/a	n/a	1.85x	1.57x	1.51x	1.45x	1.46x
3.	RAR – Class A	75%	71.8%	73.1%	72.1%	73.4%	73.4%	73.5%	74.0%	74.4%
	RAR – Senior	85%	n/a	n/a	n/a	83.3%	83.4%	83.5%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.93x	1.94x	2.01x	1.50x	1.41x	1.40x	1.39x	1.42x
	Adjusted ICR – Senior	1.10x	n/a	n/a	n/a	1.48x	1.23x	1.22x	1.21x	1.24x
Performance Index-linked Downside										
4.	RAR – Class A	75%	71.8%	73.1%	70.4%	69.7%	67.9%	67.4%	68.1%	74.4%
	RAR – Senior	85%	n/a	n/a	n/a	79.7%	77.9%	77.4%	78.1%	84.4%
	Adjusted ICR – Class A	1.30x	1.93x	1.94x	1.97x	1.44x	1.39x	1.43x	1.42x	1.43x
	Adjusted ICR – Senior	1.10x	n/a	n/a	n/a	1.41x	1.16x	1.20x	1.20x	1.20x

TWUL’s financial performance would be particularly impacted in the event of severe opex overruns compared to the allowed level of operating expenditure or a combination of underperformance for opex and capex. Underperformance for capital expenditure on its own is likely to have only a marginal impact on credit metrics, subject to the level of index-linked funding available to cover any additional expenditure, as it would be funded by a reduction in the funds available for distributions to shareholders.

The above-mentioned results show a marked deterioration in the Class A and Senior Adjusted ICRs in the next regulatory period, when the performance issues are combined with a lower WACC assumption. However, depending on the level of index-linked funding available, TWUL would appear able to sustain even a very prolonged period of underperformance under a lower WACC scenario. Under the index-linked downside scenario, which assumes that all future debt after the securitisation date will be funded with conventional debt, TWUL’s distribution lock-ups would be activated in the first years of AMP5 and cash would be retained. This cash would then be available to cover for additional operational and capital expenditure. Even under this severe downside, TWUL’s credit metrics are projected to recover close to Moody’s guidelines towards the end of the AMP5 regulatory period.

Moody’s believes that the above-mentioned capex sensitivities represent a severe and unlikely downside case. Notwithstanding the additional capital expenditure to meet its leakage targets agreed with Ofwat, as discussed below, which represents one of the most serious instances of non-loggable additional capex in the sector since privatisation, TWUL still expects to meet its overall capex targets for AMP4. This sensitivity nonetheless shows that the company’s financial structure is relatively resilient to downside scenarios, even in a more challenging WACC environment.⁵

⁵ At the last price review, Ofwat introduced to the theoretical framework for setting price limits relating to the amount of capital expenditure that can be logged up to a company’s regulated capital value (“RCV”) at the price review (i.e. expenditure outside the scope of the regulatory assumptions). Ofwat normally applies a ceiling on investment by service unless strict tests are met. Expenditure in excess of this ceiling is not added to the RCV and therefore the company cannot recover the associated financing costs. However, Ofwat decided to introduce a refinement to this general rule to deal with what are expected to be “rare” situations in which a company invests significantly in excess of the regulatory allowances, but the expenditure does not meet Ofwat’s tests. In such cases, Ofwat will apply a limit to the investment ceiling rule of 10% of the water service turnover for the five-year regulatory period, whereby all additional capital expenditure above this limit will be included in the RCV and thus remunerated from the start of the next regulatory period (per Ofwat paper MD191).

If TWUL's Adjusted ICR dropped below the covenanted average trigger levels for only a limited number of periods but were realistically projected to move back above those levels (as shown above in the downside scenario), the stability of Moody's ratings would not be compromised. Similarly, if TWUL exceeded the maximum RAR levels (based on the financial covenants but also on any liability not factored in the ratios for covenant purposes), but it were reasonably expected to deleverage in the intermediate term, it would be likely that TWUL could maintain its ratings. However, any permanent deterioration of TWUL's expected key credit metrics materially away from our ratio guidance would likely lead to rating downgrades.

Large capital projects in addition to extensive capital programme appear to be financeable, subject to the availability of index-linked debt

Under TWUL's current plans, the company is likely to be engaged beyond the current regulatory period in the execution of a number of capital projects that will require significant and, in certain cases, concentrated investment and may present complex technical and logistical aspects, not typical of the capital programmes across the water sector in the current and previous regulatory periods. These capital projects include (i) a continuation of mains replacement programme into AMP5, (ii) the potential impact of the EU Water Framework Directive on the need for sewage treatment works upgrade, especially for the major London works, (iii) the Upper Thames Reservoir Development, a large reservoir in the Essex area, which is part of TWUL water resource planning scheme, or (iv) the Thames Tideway tunnel, a sewage interceptor under the Thames (both projects mentioned in (iii) and (iv) above, are explained in more detail in the company and business description below).

For the Upper Thames Reservoir, a programme of study has been included within the current regulatory period with technical and environmental studies in progress and public consultation planned before a formal planning application will be submitted. Regarding the Thames Tideway tunnel project, TWUL is in the process of agreeing principles of funding the scheme with Ofwat. The timetable for the main works, divided into two parts covering the upgrade of Beckton treatment works and the construction of the Tideway tunnel, from the submission of planning application to final completion is currently expected to stretch over two regulatory periods (AMP5 and AMP6) with the Beckton upgrade projected to complete during 2014 and the Thames Tideway tunnel by 2020.

The transactions financial model already includes some expenditure for the Upper Thames Reservoir Development of about GBP1.0 billion at 2002/2003 prices over AMP5 and AMP6. However, as indicated above there is additional potential for large capital projects, *inter alia* the Thames Tideway tunnel, for which no specific projections are currently available.

To stress TWUL's risk exposure to material capital projects, Moody's has considered three different scenarios assuming a large project with the following capital requirements within AMP5:

1. Approximately 25% of the base AMP5 capex (including Upper Thames Reservoir)
2. Approximately 50% of the base AMP5 capex (including Upper Thames Reservoir)
3. Approximately 100% of the base AMP5 capex (including Upper Thames Reservoir)

In running the above-mentioned sensitivities, we assumed that the additional capex would be added to TWUL's RCV, i.e. the funding of such capex would have been agreed with the Regulator. These sensitivities are based on the assumption of 4.3% post-tax WACC for AMP5 in order to test the resilience of TWUL's funding structure in a lower WACC scenario. In a further downside scenario (no. 4), we again assumed no index-linked funding for any future capex after closing of the transaction for the Large Capital Project Sensitivity 1. The following table summarises the results:

Table 8:

			AMP5 (post-tax WACC 4.3%)				
Sensitivity	Large Capital Project Scenarios (50% Index-Linked of future debt)	Trigger Level	2010/	2011/	2012/	2013/	2014/
			2011	2012	2013	2014	2015
1.	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.90x	1.80x	1.73x	1.66x	1.67x
	Adjusted ICR – Senior	1.10x	1.86x	1.57x	1.51x	1.44x	1.46x
2.	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.90x	1.79x	1.71x	1.64x	1.65x
	Adjusted ICR – Senior	1.10x	1.86x	1.56x	1.49x	1.43x	1.44x
3.	RAR – Class A	75%	74.0%	74.0%	74.1%	74.1%	74.3%
	RAR – Senior	85%	84.0%	84.0%	84.0%	84.1%	84.3%
	Adjusted ICR – Class A	1.30x	1.90x	1.77x	1.67x	1.61x	1.62x
	Adjusted ICR – Senior	1.10x	1.86x	1.55x	1.46x	1.41x	1.42x
Large Capital Project Index-Linked Downside							
4.	RAR – Class A	75%	74.0%	74.0%	74.0%	74.0%	74.4%
	RAR – Senior	85%	83.9%	84.0%	84.0%	84.0%	84.4%
	Adjusted ICR – Class A	1.30x	1.78x	1.67x	1.57x	1.47x	1.46x
	Adjusted ICR – Senior	1.10x	1.75x	1.41x	1.33x	1.25x	1.25x

The above-mentioned sensitivities test the ability of TWUL's funding structure to support very large capital programmes. The critical factor is the amount of equity funding that would be available to the company through the retention of funds that could otherwise be distributed to shareholders. The financial covenants that limit the amount of debt that the company can raise in proportion of its RCV require that distributions to shareholders be adjusted to maintain the required debt/equity balance. In all the above-mentioned sensitivities, the transaction financial model shows that there is sufficient internally generated equity funding to support the capital programme and supplement the additional debt raised within the covenants.

Clearly, these types of sensitivities do not address the risk that, depending on the size of each single project compared to the overall capital programme and the technical complexity of the project, a single large project could materially increase the risk that TWUL may have to absorb substantial capex overruns (i.e. expenditure that becomes necessary for the completion of the project that exceeds the amount allowed by Ofwat for the project and that is not eligible for logging up to the RCV at the next regulatory review). Moody's notes that of the large capital projects mentioned above, only the Thames Tideway tunnel intrinsically exhibits a materially different and significantly higher risk profile compared with activities and projects carried out by TWUL and the other water companies in the past. We also observe that the actual exposure of TWUL in respect of Thames Tideway will depend under which conditions the company may be asked to execute the project as part of its responsibilities in future regulatory periods. We believe that exposure to a higher degree of risk in respect of its capital programme compared to its peers would need to be reflected in Ofwat's price determinations for TWUL at future price reviews. It is possible that TWUL may be required to carry out Thames Tideway in a "de-risked" fashion (e.g. through risk allowances and risk sharing mechanisms); it is also possible that a higher risk exposure is compensated through a higher allowed return on capital. Whilst we do not regard the latter as the most probable scenario – we believe that TWUL's new shareholder and financial structure make it unlikely that the company will pursue higher risk projects at the potential expense of future distributions to shareholders – we note that this scenario would require a re-assessment of the ability of the company to support a highly leveraged capital structure at the assigned rating levels.

However, we also note that if TWUL were to agree to a significantly riskier profile for AMP5 and subsequent regulatory periods, it may also decide not to increase leverage from 75% to 85% of the RCV. We believe that a positive feature of the transaction is the fact that TWUL will only be able to step up leverage at a time when the regulatory settlement for AMP5 will be known. This will include requirements in relation to any large capital project. In deciding whether to step up leverage, TWUL's board will need to be satisfied that this would not prejudice the company's ability to carry out its statutory functions (e.g. by being able to raise debt funding at a suitable cost) and would need to obtain regulatory clearance for the upstream of funds to its holding company. We believe that this process should support rating stability.

BUSINESS RISK PROFILE

Business profile reflects low risk characteristics of the regulated UK water industry

TWUL's business risk profile reflects the very low risk characteristics of the UK regulated water sector as a whole, which is lower than for most other industries, given a well-established and transparent regulatory framework with prices currently set until 2010, and a regional natural monopoly position for each provider of water and sewerage services in England and Wales. The very low level of business risk underpins TWUL's credit quality and makes the assigned investment grade ratings consistent with comparatively weak debt protection measures resulting from high leverage. We briefly discuss below the main features of TWUL's regulated business, but also refer to our key rating methodologies published for the sector.

Overview

Past record of poor performance provides challenges for current regulatory period

TWUL is, in terms of customers served, the largest of the WaSCs in England and Wales, nine of which are rated by Moody's. The regulated and monopolistic nature of TWUL's assets and activities results in stable and predictable cash flows typical of the sector.

Recently, TWUL's operational performance has been one of the worst amongst the WaSCs. The company has experienced operational problems particularly in relation to leakage and security of supply. Customer services and asset serviceability conditions have been ranked poorly in Ofwat's overall performance assessment. TWUL's poor performance has led to additional investment undertakings that oblige the company to spend extra funds, at the expense of shareholders, for the replacement of major water and sewerage mains on top of the existing capital expenditure programme agreed with the Regulator for the current regulatory period. Apart from this expenditure, which will not be added to the company's RCV, Moody's considers that TWUL may face further challenges in relation to its capital investment programme over future regulatory periods due to the possibility that it will have to undertake major projects in order to comply with environmental obligations as well as to ensure security of supply over the medium-to-long term. We discuss in the following paragraphs – in relation to key areas of business risk – how we view the challenges that TWUL faces and why we believe that TWUL funding structure is sufficiently resilient to support these challenges at the assigned rating levels.

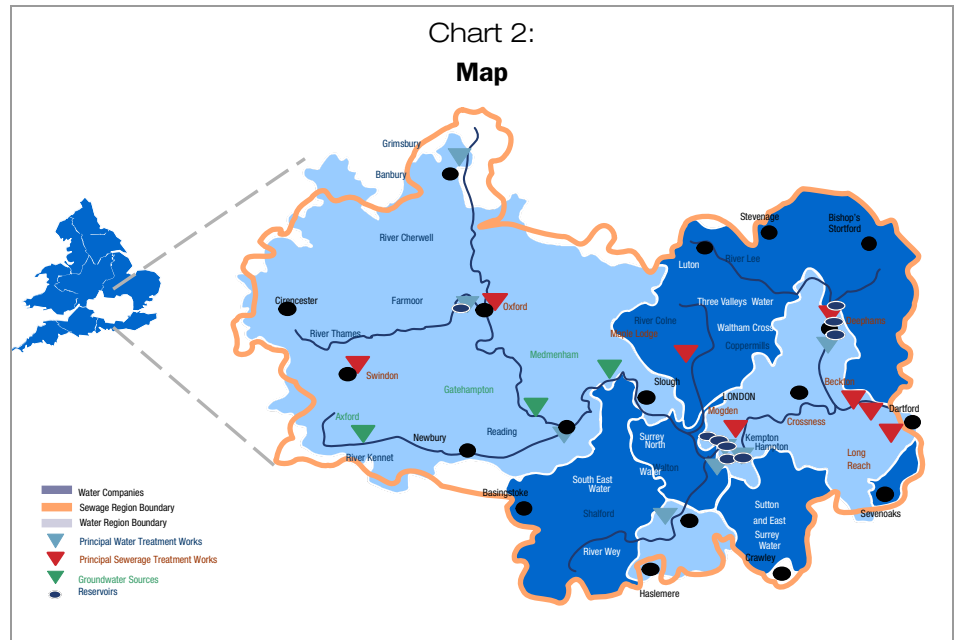
Franchise Area and Revenue Risk

TWUL is the largest of the WaSCs within England and Wales in terms of customers served

TWUL provides water services to a population of 8.5 million within an area of 8,000 sq km and sewerage services to 13.5 million customers in an area of 13,300 square km in London and the Thames Valley. The difference in customer base for water and sewerage is due to the presence of a number of small independent water only companies ("WoCs") covering part of the territory over which TWUL is responsible for the sewerage services, as can be seen from the map below.

The company supplies 3.1 million domestic and 0.2 million commercial or industrial properties. By number of premises supplied TWUL's customer base is similar to that of United Utilities Water (2.9 million) and Severn Trent Water (3.2 million). However, the absolute number of people served is higher for TWUL due to the densely populated urban areas in particular in the capital London.⁶ For the year ended 31 March 2007, TWUL had a RCV of about GBP6.501 billion, reported revenues of GBP1.431.0 billion and operating profit of GBP439.1 million. TWUL's RCV is currently smaller than that of United Utilities Water, which reported a RCV of GBP6.915 billion as at 31 March 2007, but by the end of the regulatory period TWUL's RCV is expected to be marginally larger than that of United Utilities Water, due to the extensive capital programme planned until 2010.⁷ About 50% of TWUL's water asset stock relates to potable water mains, and more than 80% of its sewerage asset stock consists of sewers, both of which are the main areas for capital expenditure during AMP4.

The graph below shows TWUL's franchise area and its location within the UK.



Franchise area also includes London, the largest and most densely populated city in the UK, with a steady population growth trend

The south-east region of England, in which TWUL operates, is one of the most prosperous parts of the UK. The franchise area also includes the nation's capital London, the largest and most densely populated city in the UK, with a steady population growth trend. There is no high concentration of heavy industries and the vast majority of TWUL's customers (about 94%) are households.

TWUL supplies water through 31,000 km of mains and operates 101 water treatment works and 213 water pumping stations. The company is also responsible for the operation and maintenance of nine impounding reservoirs, with storage capacity of 216,470 MI, 25 dams and 338 service reservoirs. In relation to the provision of sewerage services, TWUL manages 349 sewerage treatment works and 40 sludge treatment facilities, which treat sewage from a network of 68,000 km of sewers and 2,542 pumping stations.

⁶ United Utilities Water serves a population about 7 million with water and sewerage services, and Severn Trent Water supplies a population of approx. 7.4 million for water and 8.3 million for sewerage service.

⁷ Severn Trent Water's RCV as at 31 March 2007 was GBP5.659 billion.

Of the total number of properties serviced by TWUL about 25% are metered for each water and sewerage services. This translates into about 40% of TWUL's revenues from the water and waste water activities being derived from metered customers (excluding large users, which are generally metered). Revenues from metered customers may be subject to a degree of volatility in the demand pattern, principally due to weather conditions, but also to water conservation measures. Under current legislation, it is mandatory for new developments to install a water meter, but for existing properties the installation is not required, unless there is a change in ownership. In order to manage the future supply and demand balance, TWUL is actively promoting the installation of meters. However, Moody's understand that management does currently not envisage that the proportion of metered customers will increase materially over the medium term. In any case, Moody's does not believe that substantial increases in the percentage of metered customers would affect TWUL's risk profile materially, in consideration of the protections available under the regulatory framework for persistent changes in demand levels.

TWUL currently supplies 335 large users (with an annual consumption above 50 million litres ("ML"), which are entitled to choose their water supplier. TWUL's prices for the consumption of water are currently higher than the prices of the surrounding water companies (apart from Wessex Water), which makes it possible that some customers may switch supplier. The revenues generated from large users contribute just about 4% to TWUL's total revenues of the appointed business (or 5% of total water revenues and 6% of total water supplied). There is no concentration of these revenues in respect of one particular large customer. Given the limited amount of revenue exposed to potential competition risk, Moody's considers the theoretical impact of large customers opting for an alternative supplier as small. According to the current framework, in simplistic terms, if a water undertaker loses customers to competition, then this is its risk during a review period. At the next review, to the extent that assets are required to service other customers of the undertaker, the cost of those assets is likely to be recovered from the generality of customers. In a longer term perspective, although the regulatory framework for competition among the providers of water and sewerage services may evolve as a result of legislative or regulatory changes – Ofwat has just published a consultation paper on options to introduce effective market competition in the sector⁸ – Moody's believes that the related risks should remain low for at least several years, as currently it is unclear as to whether competition in water and sewerage could ever develop to the extent seen in other sectors, such as electricity and gas, and there is no agreed agenda to implement structural reforms of the sector that would be necessary to widen the scope for competitive activities and would require primary legislation.

Non-regulated activities remain outside the TWU Financing Group, and non-appointed businesses are limited to levels unlikely to affect credit profile

The TWU Financing Group will comprise only the regulated activities of TWUL. Non-regulated businesses of the Thames Water group, such as property management services, utility services, and certain investments in PFI transactions, *inter alia*, Metronet, remain outside of the ring-fenced structure and have been transferred to another holding company within the Kemble group. The regulated activities consist primarily of the appointed business as an undertaker of water and sewerage services, but also comprise certain non-appointed and commercial activities, such as developer services (support for property developers regarding water and sewerage infrastructure services, e.g. asset location maps), rental income, income from power generation, gravel sales, and research and development income. The non-appointed business accounts for about 3% of TWUL's total revenues, of which 20% is generated from developer services and rental income.

⁸ "Consultation on market competition in the water and sewerage industries in England and Wales" published by Ofwat in July 2007.

Water Quality and Resources

Balance of water supply and demand may prove to be an area of high risk given population growth and potential for drought in TWUL's franchise area

Given the characteristics of TWUL's franchise area, in particular around the capital, Moody's believes the balance of supply and demand may prove an area of relatively high risk for the company. The Thames Water region not only supplies the largest number of customers of all other franchises in England and Wales, it also has one of the highest demand rates in the UK and exhibits the fastest rate of increase in demand due to constant population growth.

The water supply is not usually prone to seasonal fluctuation. The average daily water supply is 2,800 MI, with peak supply up to 4,100 MI per day. TWUL's supply is provided by a reasonably diverse resource base, comprising primarily surface sources, such as rivers (75%), and groundwater (25%).

TWUL's franchise area, along with many other regions, particularly in the South East of England, has recently been exposed to one of the most severe droughts resulting from below average rainfall for two consecutive winter periods (2004/2005 and 2005/2006). Due to the subsequent low water levels in groundwater aquifers, reservoirs and river beds, TWUL had to introduce a hose pipe and sprinkler ban from April 2006 (the first one in the region for 15 years). Although the ban has been lifted in early 2007, it is generally acknowledged by the industry that the water resources in the South East of England will remain under increasing pressure due to droughts, climate change, new housing developments and changing land use. It will therefore be of paramount importance that TWUL can manage its water resources effectively.

The drought also materially affected Ofwat's evaluation of TWUL in relation to security of supply, whereby the company achieved the lowest score among the water companies. For 2005/2006 the score was 22 (i.e. signalling a very large deficit of water supply available compared to a required target headroom for a dry year) and TWUL agreed an action plan with the regulator to increase the security of supply index to 100 (the maximum score achievable) by 2009/2010.⁹

Addressing of leakage problem and construction of new desalination plant are key components of TWUL's security of supply strategy

The main element of TWUL's resource management strategy is to address the existing leakage problem, which is acute for the London area (for the Thames Valley area TWUL has been able to meet the leakage target). Due to the leakage problem within the Greater London region, at overall company level TWUL has been unable to meet Ofwat's annual leakage target for three consecutive years and, although other WaSCs had similar leakage problems, Ofwat considers TWUL to be the company with the worst record on leakage control for its continuing failure to hit its target. In this context, the Regulator took stronger action against TWUL in 2006. Under the so-called "Section 19 Undertaking" agreed with the Regulator, TWUL will be obliged to spend about GBP157 million in excess of its capital investment allowance for the current regulatory period on the replacement of at least 368 km of London's oldest water mains by 2009/2010. This investment will not be added to the company's RCV. TWUL also agreed to accelerate the pace and level of its planned Victorian Mains Renewal programme (about 1,235 km) bringing completion forward from March 2010 to March 2009 in order to meet the revised leakage targets set for 2009/2010. If a reduction in leakage can be achieved to a level as envisaged by the company, TWUL would expect this to improve security of supply by providing about 175 MI of water per day that would have otherwise been lost through leakage. Increased expenditure during 2006/2007 already resulted in some improvement of the water infrastructure network as TWUL has been able to meet Ofwat's revised leakage target for the FYE March 2007 for the first time in four years.

⁹ Ofwat's Security of Supply index ("SoSI") measures the water companies' ability to maintain sufficient supply headroom to maintain water supply without restrictions even in a dry year. The maximum SoSI score achievable is 100, which is awarded to companies whose water available for use equals or exceeds the required capacity. A score below 50 signals a large deficit against the target headroom requirement. The SoSI score calculation is based on the actual deficit/surplus of the water available for use versus the target capacity requirement, and the proportion of the population affected within the franchise area.

Furthermore, TWUL proposed the construction of a water desalination plant at its Beckton sewage treatment works in Newham, East London, which would supply additional water of approximately 140 MI per day. After an initial application for planning permission was rejected by London's mayor, TWUL appealed and made changes to the plant design to ensure that only renewable energy sources will be used to run the plant. The desalination plant was granted planning consent by the government on 18 July 2007 and TWUL now expects the plant to become operational by 2009, which should enable the company to achieve their security of supply target set by Ofwat.

In terms of compliance with water quality and environmental standards, TWUL has a generally good track record, in line with the majority of water companies in England and Wales. Under the operational performance index of the Drinking Water Inspectorate ("DWI") that is based on key parameters reflecting the quality of the operation and maintenance of treatment works and distribution systems with respect to e.g. water clarity or contamination with bacteria or metallic residues from the pipes, it was ranked above average for the year 2005/2006.

TWUL treats all water derived from its river and groundwater sources in its treatment works, although the degree of treatment varies depending on the source, with groundwater generally needing less treatment than river abstractions that follow a more complex process, including clarification, filtration and disinfection.

Similar to the rest of the industry, TWUL has to manage a number of environmental risks, such as contamination of water supplies by third parties, flooding from sewers, pollution discharges from their facilities, management of sludges and effluents, legislative requirements to improve sustainability of the water environment. In addition, the new EU regulations in relation to carbon emissions apply to a number of TWUL's sewage treatment and sludge disposal sites. For the calendar year 2005, verified emissions for most of these plants were well below their allocated allowances as a result of investments made into biogas and combined heat and power ("CHP") plant technologies on site. Moody's understands that this positions TWUL well to meet its obligation for phase 1 under the EU Emissions Trading Scheme. Overall, in Moody's opinion, TWUL's risk profile in these areas is not materially different from the rest of the sector, with risks generally assessed at low levels as a result of operational track record, regulatory oversight, and the protection available under the regulatory framework in relation to additional cost and investment resulting from changes in legal requirements or business circumstances affecting the whole industry.

Performance and Operational Risk

Previous poor service performance likely to result in additional penalty imposed by the Regulator, but management appears to be on track in tackling the problems

At the last annual assessment for the performance in the financial year 2005/2006, one year into the current regulatory period, TWUL was assessed as below average in its overall service performance, with generally poor results in comparison to regulatory targets. TWUL ranked eighth out of the ten WaSCs for overall service performance, resulting from performance failures in dealing with billing contacts and written complaints, for which the company was put under investigation in early 2006.¹⁰ Following the conclusion of the investigation, the Regulator is entitled to impose a penalty on TWUL, which could amount up to 10% of the company's total appointed revenues.

In addition to poor service performance, TWUL has also been assessed the least efficient water company in terms of operating efficiency for the financial year 2005/2006 (it ranked last among all 22 water companies, also taking into account the smaller WoCs). However, in terms of capital maintenance efficiency for water services, TWUL ranks among the top performers, which likely results from its size giving it the advantage of scale for its investment programme. Contrary to the water services, the scale and density of the population in the London area also appears to benefit TWUL's performance in relation to its sewerage service, which Ofwat assessed to be at the top end for operating efficiency and average for capital maintenance efficiency.

¹⁰ Similar performance failures have been investigated for Southern Water and Severn Trent.

In the first two years of the current five-year regulatory period (2005-2010), TWUL's operating efficiency ranking for water services deteriorated compared to the Regulator's assessment at the last review in 2004, which set the targets for efficiency improvements over the current five-year period. Under Ofwat's Final Determinations for the current regulatory period, TWUL will have to reduce its annual operating costs on average by 2.5% for water and by 0.5% for sewerage services. This will be particularly challenging with regard to the water services, as the target is significantly larger than the industry average (see table below).

Table 9:

	Average Annual Opex Efficiency	
	Water	Sewerage
Thames Water	2.5%	0.5%
Industry Average	1.4%	1.4%

For the first two years into AMP4, TWUL is underperforming the Regulator's assumptions; however, the new management is confident about its ability to reverse this trend over the remainder of the current period

Given the deterioration of operating efficiency for water services, TWUL is currently underperforming against the Regulator's targets. Moody's understands that the new management put in place by Kemble is refocusing on the regulatory activities and pursuing a new organisational structure, with tighter controls on spending in order to improve cost efficiencies. Staff redundancies in administrative positions are expected to further reduce operating costs. The company's business plan assumes that from 2007/2008 onwards TWUL will be able to outperform the annual opex target set by the Regulator for the relevant year. However, even though certain measures such as the reduction in staff cost will have an immediate effect, the overall potential and size for such outperformance remains uncertain. In particular, there remains the risk that another drought or a potential failure to meet the revised leakage target going forward may result in unexpected cost increases.

Moody's notes that it will be particularly challenging for TWUL to be able to meet the efficiency target for operating costs set by the Regulator for the current five-year period, given material underperformance in the initial two years and the fact that structural changes may take longer than anticipated to deliver improvements. However, we also acknowledge that the new management has the relevant expertise to tackle the company's problems and we expect that the refocus of the company's managerial resources on the performance of the regulated business will lead to an improvement over the medium-term, although a clear impact may not be visible until the next regulatory period.

Areas of potential cost pressures are energy costs and sludge disposal. TWUL procures the majority of its electricity from RWE nPower under a contract that runs until December 2009. Prices under the contract are not fixed, rather forward prices apply, with hedging arrangements in place for sites with larger (>100KW) energy demand. Around 10% of the company's own energy needs are generated by sewage gas combined heat and power generation and sewage sludge incineration. According to management, this method of sustainable waste management helps to reduce TWUL's use of landfill, which become more expensive as their availability reduces or gets restricted for environmental reasons. During 2005 nearly 50% of waste generated by TWUL's operations and just under 60% of waste generated by its capital investment activities were reused or recycled, with 100% of sewage sludge being put to beneficial use within agriculture (70%) or to generate energy through incineration (30%). TWUL's management believes that future restrictions on the available land bank for sludge disposal may lead to the requirement for further incinerator development. Although Moody's would expect such investment to be covered within the price control mechanism at the price review, the additional capital requirement would further increase TWUL's risk exposure to an already material investment programme.

Additional potential risks with regard to operating expenditure relate to drought costs that the company may incur in future. TWUL had to sustain significant operational expenditure of the order of GBP23 million in relation to the hose pipe ban and the application for a drought order during 2006 as the period from November 2004 to April 2006 was the driest on record (records began in 1897). Moody's notes that these drought costs were not reported as "exceptional" in the company's financial statements and that accordingly similar expenditure in the future should be included in the calculation of the financial covenants.

Asset Condition marginal or deteriorating for key asset categories provides evidence of high maintenance requirements going forward

Asset Condition, Capital Expenditure and Cost Overrun Risk

An assessment of asset condition is performed regularly by the WaSCs and independently by their reporters: the technical auditors that validate water companies' submissions to Ofwat. In 2005/2006 TWUL's asset serviceability was deemed to be marginal or deteriorating for water and sewerage infrastructure as well as sewerage non-infrastructure assets (above ground sewage works). Above ground water servicing assets were the only category assessed as being stable. As a result of the assessment that three of TWUL's asset categories are in marginal or deteriorating state, Ofwat has implemented a second level of regulatory control, which requires TWUL to set out detailed action plans and report quarterly to the Regulator on progress as to how stable serviceability is to be restored and maintained for all asset classes.

The poor infrastructure asset condition results largely from the fact that the London area has some of the oldest pipes in the overall UK water and sewerage network. 50% of the London mains operated by Thames are more than 100 years old, and 30% are over 150 years old (the latter are those referred to as Victorian mains). Furthermore, about 80% of London's mains are cast iron and installed in areas of heavy traffic, which increases the risk of mains bursting.¹¹ TWUL's management also considers London's clay soil as one factor adding to the risk of leakage because it moves when it freezes or gets wet, thus exerting additional pressure on pipes. With the accelerated mains replacement programme that TWUL agreed with Ofwat, Moody's expects the serviceability of the infrastructure assets to improve over the medium term. The June 2007 Return submitted by TWUL to Ofwat already projects a slight improvement in the water and sewerage infrastructure asset serviceability.

In relation to sewerage non-infrastructure assets, TWUL's franchise area has been affected by the failure of a number of sewage treatment works, causing flooding in properties and environmental pollution in rivers, albeit largely triggered by exceptional weather conditions. Additional expenditure required to address the problem of sewer flooding has been acknowledged by Ofwat at the last periodic review, when TWUL secured funding of up to GBP525 million (at 2003/2004 prices) as part of the capital maintenance allowance for the upgrade of the above ground sewer network and sewage treatment works. With the increased investment programme, TWUL is required to deliver stable serviceability for sewers by 2009 and for sewage treatment plants by 2008. At the end of March 2007 TWUL had seven failing sewage treatment works, some of them requiring significant capital expenditure to resolve the existing issues. Moody's believes that this is an area which will require careful management as the company may be unable to meet Ofwat's target to achieve stable serviceability by 2008, which may result in more stringent regulatory action to ensure that stable serviceability is achieved by 2009.

To reduce future incidents of river pollution, TWUL is also proposing the construction of a 34 km tunnel underneath the Thames (known as the "Thames Tideway" project) to provide storm water storage, as the sewage inflow and pollution risk is particularly high during severe storms. The construction of the Thames Tideway tunnel would be a complex project which is likely to involve a construction period of 5 to 10 years. In March 2007, the UK government approved the project, which is estimated to cost more than GBP2 billion. Ofwat has undertaken some preliminary work to explore a range of financing and delivery option for this project, but appears generally concerned about the value for money achievable to water customers in terms of health and environmental benefits given the very high costs of this scheme.

¹¹ The new replacement pipes will largely be plastic, which is expected to be more resilient against soil corrosion.

Substantial capital expenditure programme remains key challenge for AMP4 and beyond

The Regulator stated publicly that the substantial investment programme carried out by TWUL to upgrade its sewerage infrastructure assets and treatment works has and will continue to deliver improvements to the quality of sewerage services.

Moody's believes that the existing capital investment programme is the main challenge for TWUL during AMP4, and is likely to remain so in future. The overall regulatory allowance for capital expenditure is GBP3.1 billion (at 2003/2004 prices) over the five-year period from 2005-2010, of which GBP1.7 billion relates to water services and GBP1.4 billion is allocated to sewerage services. TWUL's investment programme is substantially bigger in size than that of its closest peers, e.g. it is about 23% larger than the capital programme of United Utilities Water Plc (GBP2.5 billion, at 2003/2004 prices) and about 40% larger than that of Severn Trent Water Plc (GBP2.2 billion, at 2003/2004 prices). A project such as Thames Tideway would further increase the current level of capital expenditure, although it is expected that the investment would be spread over two or more regulatory periods. Given the existing substantial investment plan (other than the large projects), the incremental increase of the company's risk exposure to cost overrun may be modest for a single regulatory period. However, the Thames Tideway scheme may pose additional risk in relation to construction cost overruns, particularly as no precedents exist of a comparable project.

Another concern in relation to the size of the capital programme is whether TWUL will be able to deliver the programme efficiently, in line with Ofwat's targets. In relation to capital maintenance efficiency, TWUL has a good track record being considered one of the frontier companies for capital maintenance efficiency with respect to water services and above average as regards sewerage services. The capital maintenance efficiency improvement targets for AMP4 (2.7% p.a for water; 5.4% p.a. for sewerage) are therefore less challenging than for most of its peers. However, in relation to capital enhancement expenditure TWUL is obliged to reduce its costs by 10.5% p.a. or 14.9% p.a. with respect to water and sewerage services, respectively. It will be more difficult for TWUL to meet those targets, which, particularly for the sewerage services, are above the industry average (see table below).

Table 10:

	Capital Maintenance Efficiency		Capital Enhancement Efficiency	
	Water	Sewerage	Water	Sewerage
Thames Water	2.7%	5.4%	10.5%	14.9%
Industry Average	5.3%	5.6%	11.3%	11.4%

For the two financial years 2005/2006 and 2006/2007, TWUL's capital expenditure was significantly below the Regulator's allowance, which, according to management, was partly due to delays on the planned desalination plant but also a different timing of expenditure applied by the company to deliver the required outputs. The latter largely results from the fact that the necessary funding for the investment programme was secured during the first year of AMP4 with investments expected to step-up in later years. TWUL's current business plan assumes that the accelerated mains replacement programme and the planned sewerage works upgrade investments will compensate for the previous under-spend.

To reduce the overall costs of its capital programme in order to meet the challenging objectives of the Final Determination, TWUL is reviewing its delivery structure by restructuring its procurement, design and construction processes.

Nevertheless, Moody's believes that TWUL faces specific risks in relation to the delivery of its capital programme, particularly as the AMP4 capital programme provides significantly less flexibility than in previous regulatory periods given that the programme output is more clearly defined after a number of action plans have been agreed with the Regulator to enable TWUL to improve its performance.

At the same time, the limited flexibility increases the risk of a cost overrun, which may impact the extent to which investments are included in TWUL's future RCV (generally no log-up for inefficient expenditure). Given the poor condition of TWUL's infrastructure and sewerage non-infrastructure assets, higher than expected investments may be needed to achieve the regulator's output target.

Expenditure in excess of the capital investment allowance due to additional work necessary may not be logged up into the RCV, if the excess spending equals up to 10% of the water service turnover for the five-year regulatory period. Also, Ofwat already specifically stated that the additional investment of GBP157 million to reduce leakage will not be logged-up. As mentioned above, the transaction's covenant package includes a specific Trigger Event associated to capex overruns (10% in excess of Ofwat's allowances for the regulatory period), which would not be immediately captured by the Adjusted ICR and RAR tests.

Moreover, a challenge in relation to TWUL's extensive capital programme may be the availability of procurement and delivery resources towards the end of AMP4, in particular with the projected step-up in the programme due to the earlier under-spend. The additional potential for the inclusion of development work for the Tideway Tunnel into AMP4 may put even more pressure on engineering resources, given that construction works for the 2012 Olympics will be in full progress toward the later years of AMP4.

Insurance

TWUL's maintains insurance cover that its management believes is consistent with the generally accepted practices for the industry, including insurance policies against property damage and business interruption, employer's liability, public liability and directors' and officers' liability. Moody's understands that TWUL's insurance programme is provided by a captive insurance company, currently owned by Thames Water Plc, and reinsured above net risk retentions of GBP5 million for each and every loss and GBP10 million in aggregate during the period of insurance. The reinsurance is placed in the global insurance and reinsurance market.

Under the Finance Documents, TWUL has undertaken to maintain insurance cover in accordance with an agreed programme and to notify the Security Trustee of any event that could reasonably be expected to give rise to an insurance claim in excess of 0.25% of the RCV (i.e. currently about GBP16 million). There are clearly business risks, principally relating to exceptional or catastrophic events, for example, involving flooding, contamination, customer compensation or complete loss of assets, where insurance cover may not be available or may not be sufficient to cover TWUL's losses. However, this would apply to all water companies. Moody's believes that in situations where such loss were to be severe and could not be avoided by prudent management, a water company may seek to mitigate the financial impact by invoking the "shipwreck" clause in its licence. Specific conditions would need to be satisfied in order for the Regulator to consider such an application.

Management

Moody's believes that the presence and commitment of a capable and experienced management team is an important factor for the long-term success of the transaction, as would be the case for all WaSCs.

With the sale of the Thames Water group from RWE to Kemble a new management team was introduced. The consortium appointed Sir Peter Mason as successor to the previous chairman Jim Forbes. David Owens replaced the incumbent CEO, Jeremy Pelczer. David Owens has extensive experience in the UK utilities sector with over 30 years experience in the delivery of essential services to customers and is familiar with the UK regulatory framework. He was previously the CEO of a joint venture between Eastern Electricity and London Electricity. Furthermore, Steve Shine, who previously worked as managing director under David Owens, has been appointed the new COO of the Thames Water group.

Moody's views the change in management positively, given that TWUL's recent problems revealed a lack of management focus and inability to control costs and tackle operating inefficiency. Management's renewed focus on the regulated activities, further strengthened by the contractual ring-fencing around the TWU Financing Group, is considered to be a credit positive as it should ensure that the existing performance failures will be addressed. Moody's takes additional comfort from the fact that the new management is experienced in the running of UK regulated utility operations and intends to improve and optimise the company's relationship with the Regulator, which should support the credit profile over the medium-to-long term.

New management team appears to be committed and focused on efficient operational performance, which should support long-term success of the transaction

MONITORING

Moody's assessment is based on the prevailing regulatory framework of the water and sewerage industry (specifically in relation to the business and operations of TWUL). Continued success, however will depend on the fundamentals of the water and sewerage industry, as well as the risk profile, strategy and management of Thames Water's operating business. All of these are characteristics of traditional corporate debt issuance. Investors should be aware that the ratings on the Notes are sensitive to any such changes, despite the benefit of some structural features particular to asset-backed securitisation.

The transaction relies on the prevailing legal framework in the UK. Therefore, any changes to the insolvency regime in any of the countries could potentially have credit implications for this transaction. Moody's will carefully monitor any amendment in the UK legislation.

Moody's will monitor the transaction on an ongoing basis to ensure that its transaction continues to perform in the manner expected, including checking all supporting ratings and reviewing periodic servicing reports. Any subsequent changes in the rating will be publicly announced and disseminated through Moody's Client Service Desk.

RELATED RESEARCH

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions please refer to the following reports:

Industry Outlook:

- UK Water Sector: Stable Rating Outlook Factors Broadly Neutral Credit Impact of Draft Determinations for 2005-10: A Pragmatic Price Review from a Pragmatic Regulator, November 2004 (89557)

Rating Methodologies:

- Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations – Part II (IFRS), February 2006 (96729)
- The UK Water Sector: Financial Parameters and Structural Enhancements for Leveraged Financings, August 2002 (75507)
- The UK Water Sector: Moody's Approach to Rating Highly Leveraged Structures for Asset Ownership, February 2001 (64166)

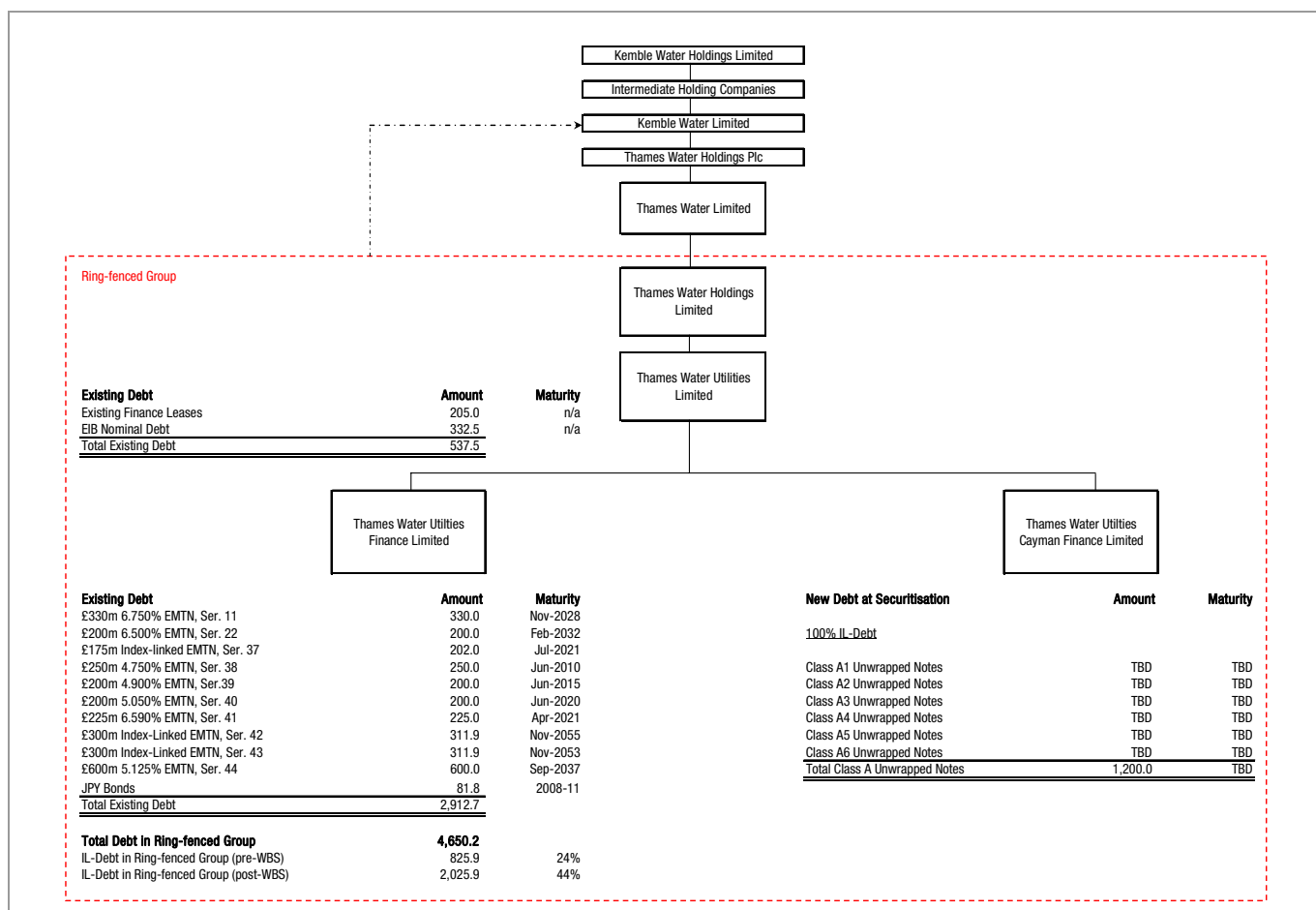
Special Comments:

- UK Water Sector: Q&A on Moody's Approach to New Structured Financings, October 2006 (100343)
- UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength, March 2006 (97010)

New Issue Reports:

- Anglian Water Services Financing plc, September 2002 (SF15418)
- Southern Water Services (Finance) Limited, September 2003 (SF23751)
- South East Water (Finance) Limited, August 2004 (88280)

Thames Water - Group & Debt Structure at Securitisation 2007/08



all amounts in £ millions

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