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Thames Water Utilities Cayman Finance Ltd.

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Thames Water Utilities Cayman Finance Ltd.

Major Rating Factors

None

Strengths:

- Supportive U.K. water regulatory framework.
- Improved regulatory and operational performance.
- Positive structural features designed to protect debtholders and enhance cash flow certainty.
- Strong liquidity, as mandated by the borrowing documents.

Weaknesses:

- Aggressive capital structure and dividend distribution.
- Negative free operating cash flow generation for the foreseeable future.
- Regulatory reset risk.

Rationale

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

These strengths are partially offset by TWUL's aggressive capital structure; negative free cash flow generation resulting from a large capital expenditure (capex) program and significant dividend payouts; and the uncertainties associated with the regulatory reviews undertaken every five years.

Our analysis of business and financial risk focuses on the regulated operating company, TWUL, in addition to the structural enhancements in the corporate securitization that increase cash flow certainty and stability. TWUL's financial statements are unconsolidated, but the debt issued by the subsidiaries TWUCF and TWUF is reflected in TWUL's balance sheet in the form of intercompany loans.

Key business and profitability developments

In the six months to Sept. 30, 2010, TWUL reported a slight drop in EBITDA to £505.1 million (£506.6 million in the same period of 2009), as a modest increase in revenues of 1.0% was more than offset by an increase in operating costs that the company views outside of its direct control, such as pension costs. Controllable costs continued to show an improving trend, however. The limited growth in revenues partly reflects the start of the new regulatory period for 2010-2015 (AMP5) on April 1, 2010, whereby TWUL is allowed a tariff increase of only 0.2% for the financial year ended March 31, 2011, compared with an allowed increase of 1.5% in the financial year ending March 31, 2010 (the final year of AMP4).

Capex in the six months to Sept. 30, 2010, was £328.1 million, which is lower than in the same period of 2009 (£379.2 million) because of minor delays resulting from the negotiation of significant new capital delivery contracts associated with AMP5. TWUL anticipates that the rate of delivery will recover by financial year-end March 31, 2011, and that capex will be approximately £1 billion by the same time.

TWUL's Overall Performance Assessment (OPA) score, which is the regulator's most comprehensive measure of a water company's performance, rose to 416.8 out of a possible 438.0 in financial 2009-2010, from 405.6 in financial 2008-2009, and 397 in financial 2007-2008. This was TWUL's best-ever performance, ranking the company third out of ten water and sewerage companies in England and Wales. In addition, TWUL met all its regulatory targets for AMP4 (2005-2010).

The steady improvement in TWUL's operational performance reflects substantial progress on key measures such as leakage, security of supply, and operating expenditure efficiency. These improvements, in turn, have been driven by TWUL's substantial capex program.

The regulator's final determination for AMP5 (2010-2015) allows TWUL an average annual price increase of 1.4%, which compares positively with an industry average of 0.5%. The assumed cost of capital is 4.5% (on a post-tax, real basis) and TWUL's capex allowance is the largest in the industry, at £4.9 billion. Although we view the determination as demanding in a number of areas, particularly operating expenditures and return on capital, we see a number of positive elements. For example, the introduction of the Capital Incentive Scheme (CIS) means that all actual capex is reflected in the Regulatory Capital Value (RCV). We also note that certain macroeconomic indicators, specifically inflation and the cost of debt, are currently more favorable than the regulator assumed when setting price limits. If these trends were to continue, we would see reasonable potential for outperformance for the regulated water companies during AMP5.

Key cash flow and capital-structure developments

In our view, TWUL's financial ratios are likely to weaken moderately during AMP5 due to the company's substantial investment program and dividend payments, which together will result in negative free operating cash flows. However, we believe that TWUL's debt measures are likely to remain commensurate with the ratings, especially when factoring in the protective structural features of the corporate securitization.

TWUL has an aggressive financial structure. On March 31, 2010, the ratio of unadjusted debt (all Class A) to RCV was 68.3%, while funds from operations (FFO) coverage of net debt was 10.7%. We project that the ratio of debt to RCV will increase to about 80% in the current financial year, due to the issuance of £850 million of Class B subordinated debt since July 2010, aimed at funding future capital investments. This issuance is already factored into the ratings, and is within the company's debt covenants, which specify that the ratio of total senior debt (Class A and Class B) to RCV cannot exceed 85%. Class A debt is limited to 75% of RCV.

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

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

These features provide creditors with significant control over TWUL at the earliest stage of financial and/or operational difficulty. Conversely, there are limitations on security, since the essential nature of water and waste-water services means that the company is by law not permitted to grant the related assets as security.

Liquidity

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

Liquidity support is provided through dedicated facilities comprising:

- A £200 million working capital facility, corresponding to the highest estimated intrayear working capital swing (maturity in August 2012).
- A £550 million capex facility, corresponding to 12 months of forecast capex (maturing in August 2012).
- A £320 million, 364-day debt service reserve (DSR) facility, corresponding to 12 months of forecast debt service (of which £70 million matures in July 2011, and £250 million matures in Aug 2011).
- A £105 million, 364-day operating and maintenance (O&M) facility, corresponding to 10% of forecast 12-month operating expenditures and maintenance capital expenditures (maturing in August 2011).

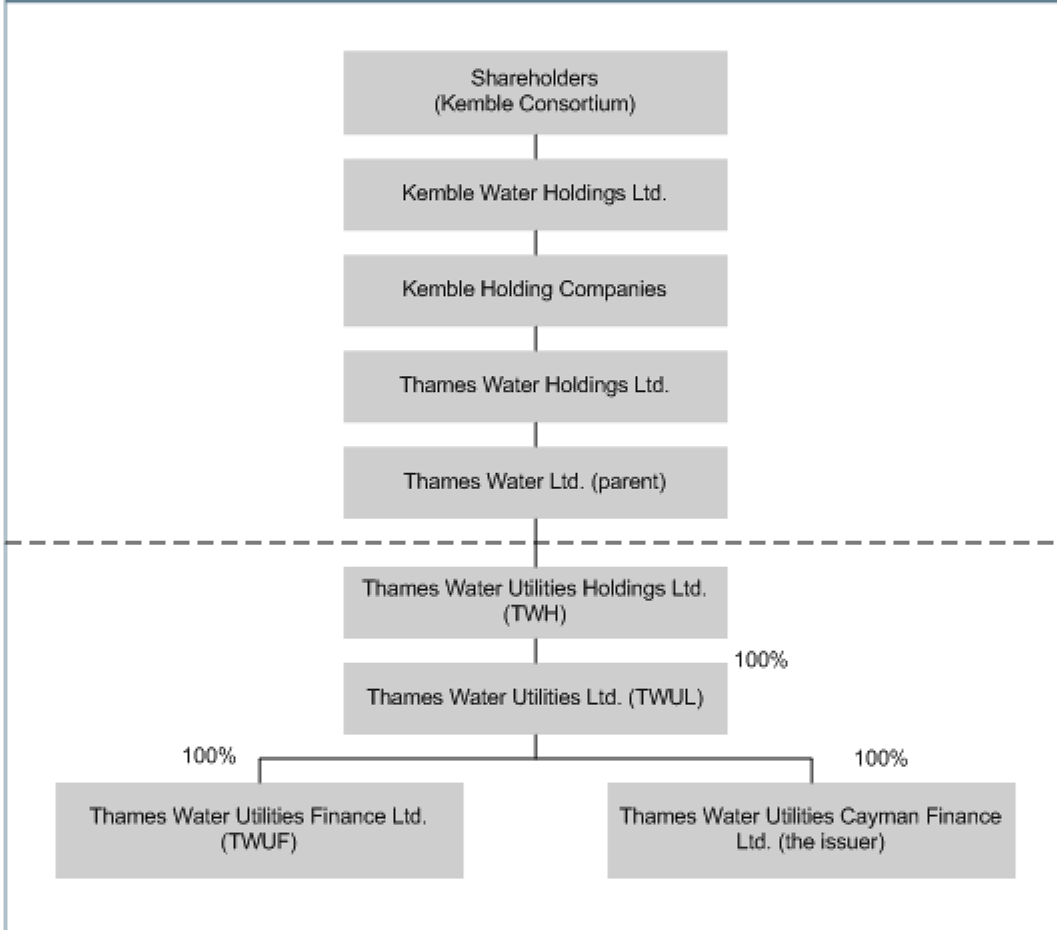
Any drawings under the DSR or O&M facilities result in a lock-up of distributions from TWUL. According to management, there were no drawings under any of the above-mentioned bank facilities on Sept. 30, 2010, and the ring-fenced group had cash and short-term deposits of £216 million.

The steady, predictable cash flow stream produced by TWUL and manageable near-term debt maturities provide further support. As of Sept. 30, 2010, total reported debt was £6.4 billion, of which only £106 million matures in less than 12 months.

Business Description

TWUF and TWUCF are the funding subsidiaries of TWUL, the regulated water and wastewater utility covering Greater London and the Thames Valley. Both funding subsidiaries and TWUL are ringfenced from the ultimate parent Kemble Water Holdings Ltd., which is owned by a consortium of infrastructure investors and pension funds that have appointed Macquarie Group Ltd. (A-/Stable/A-2) as asset manager (see chart). This structure effectively isolates the credit quality of TWUL from Kemble Water Holdings, which in our view has a less favorable business risk profile--given its unregulated operations--and a weaker financial profile.

Thames Water Utilities Group Corporate Structure



TWUL is the largest regulated water and wastewater utility in the U.K., providing drinking water to just over 8.5 million customers, and managing wastewater services for 13.6 million customers. It had an RCV on March 31, 2010 of £7.96 billion.

Rating Methodology

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

Business Risk Profile: Excellent, With Focus On Low-Risk Regulated Water Activities, But Significant Regulatory Reset Risk

The major supports for TWUL's excellent business risk profile are:

- An exclusive focus on low-risk water activities in an affluent region. We view the water sector in England and Wales as having one of the lowest business risks of any corporate and utility segment that we rate. We base our view on the fact that water is an essential commodity with no substitutes. We also take into account the natural monopoly position of water utilities, the lack of effective competition, and low technological risks. TWUL is the natural monopoly water and wastewater company for Greater London and the Thames Valley, which we consider to be one of the most affluent and economically stable regions of the U.K.
- A broadly credit-supportive regulatory framework. The regulatory framework for the water sector in England and Wales is, in our opinion, one of the most established and credit-supportive water regimes globally. Introduced following sector privatization in the late 1980s, the framework is performance-based, providing incentives for the utilities to continuously increase their efficiency. Revenues are set prospectively for periods of five years, ensuring that earnings and cash flows are stable over these periods.
- Strongly improved operating and regulatory performance. Under a new management team, and as a result of its substantial capex program, TWUL has materially improved its operational performance over the last four years. This improvement was the primary factor in our upgrade of TWUL in April 2010. In financial 2009-2010, TWUL achieved its best ever OPA score--416 out of a maximum score of 438. This placed TWUL third out of ten water and wastewater companies in England and Wales. Leakage, which was a significant concern for TWUL a few years ago, continued to improve in financial 2009-2010 and is currently at its lowest ever recorded level.

These supports are partly offset by:

- Regulatory reset risk every five years. We view the current regulatory period, which began on April 1, 2010, as relatively challenging for all the water companies. The regulator has required the water utilities to keep real prices broadly flat, and maintain quite tight operating expenditure allowances, despite the large capital programs required to upgrade the ageing infrastructure. For TWUL, the outcome of the latest regulatory reset was slightly more beneficial than for the average water company, in our view, because the regulator allowed TWUL an average real price increase of 1.4%, compared to a sector average of 0.5%.
- Risks associated with the delivery of a large capex program. TWUL's capex allowance for AMP5 (2010-2015) is the largest in the industry, at £4.9 billion. The scale of the program, which partly reflects TWUL's highly urbanized service area, gives rise to a range of execution risks--including potential project delays and cost overruns-–although we believe that the financial fallout from such events would be ultimately recoverable through the regulatory framework. One risk that we will monitor is the Thames Tideway scheme, a very large project to improve the capacity of London's sewerage system that TWUL estimates will cost about £3.6 billion over a number of regulatory periods. The regulator has confirmed that capex in the current regulatory period will be covered by the CIS, whereby any capex spent is added to the RCV of TWUL, on which TWUL earns a return. However, we understand that, if TWUL were to maintain ownership and funding responsibility for the project, capex in future periods might be funded outside the CIS framework, which could potentially create additional risks. Having said this, we also note that there is still a large degree of uncertainty around the project, which may ultimately be funded and delivered by a party other than TWUL.

Financial Risk: High Leverage, Mitigated By Stable Cash Flows And Protective Structural Features

The main strengths of TWUL's financial risk are:

- The stable and predictable cash flows of the water business. The regulatory framework ensures that TWUL's operating cash flows are both stable and predictable over five-year periods, allowing for significantly higher debt levels than we would otherwise tolerate in companies in nonregulated segments at a given rating level.
- Structural enhancements. The Thames corporate securitization enjoys the same protective structural features as other similar U.K. water transactions. The added protection for bondholders allows for a moderately higher degree of financial leverage compared with conventionally structured U.K. water utilities at the same rating level.
- Strong liquidity, as mandated under the corporate securitization borrowing documents.

These strengths are moderated by:

- An aggressive capital structure. Following the recent issuance of Class B debt, the ratio of unadjusted total debt to RCV is about 80%, which is high, although not unusually so for the capital-intensive water sector. The covenanted maximum ratio, of 85% (Class A and B), allows for some flexibility and remains, in our view, commensurate with the current ratings.
- Negative free operating cash flows. We anticipate that free operating cash flows (after capex and before dividends) will remain negative over the 2010-2015 regulatory period, as TWUL implements the largest capex program in the sector. In addition, the company pays sizeable dividends to its shareholders, the Kemble group of companies. These dividends increased again in 2010, to £308 million. Consequently, we anticipate that debt levels will continue to increase, albeit offset to a large extent by tariff increases.
- Limitations on security. While the structural enhancements in the corporate securitization overall are beneficial to TWUL and the ratings, we note certain weaknesses as well. For example, we see limited incentives for TWUL to aim for debt-protection measures that are materially higher than covenanted levels, and we anticipate that as much cash as possible will be returned to shareholders. Another weakness is the restriction on TWUL's ability to pledge assets as security, given that under the regulations, the bulk of its assets are "protected land".

Financial Statistics/Adjustments

TWUL prepares its financial statements in accordance with U.K. generally accepted accounting principles (GAAP).

We make a number of adjustments to TWUL's reported figures in March 2010. The most important of these are as follows:

- We add operating leases of £7.4 million, comprising the present value of minimum lease payments, to debt.
- We add pension debt obligations £107.4 million, net of tax, to debt.
- We net off debt cash of £579.1 million, which we consider to be surplus.
- We net off debt an intercompany secured loan of £150 million owed to Thames Water Ltd., which is included in TWUL's accounts.
- We treat as operating expense infrastructure renewals expenditure of £71.3 million, which is capitalized under U.K. GAAP, to make figures more comparable with water companies that report under International Financial Reporting Standards (IFRS; See "Revised Methodology For Adjusting Amounts Reported By U.K. GAAP Water

Companies For Infrastructure Renewals Accounting").

- We subtract indexation on inflation-linked debt of £39.8 million from FFO, to arrive at a figure that we view as representative of sustainable cash generation. (See "New Methodology For Inflation-Linked Debt Has No Immediate Effect On Ratings On U.K. Regulated Utilities").

Related Criteria And Research

- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Revised Methodology For Adjusting Amounts Reported By U.K. GAAP Water Companies For Infrastructure Renewals Accounting, Jan. 27, 2010
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Principles-Based Rating Methodology For Global Structured Finance Securities, May 29, 2007
- New Methodology For Inflation-Linked Debt Has No Immediate Effect On Ratings On U.K. Regulated Utilities, April 8, 2009
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 4, 2006

Table 1

Reconciliation Of Thames Water Utilities Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts*

	--Fiscal year ended March 31, 2010--							
Thames Water Utilities Ltd. reported amounts								
(Mil. £)	**Debt**	**Operating income (before D&A)**	**Operating income (before D&A)**	**Operating income (after D&A)**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Capital expenditures**
Reported	6,128.5	1,014.6	1,014.6	671.1	304.5	710.8	710.8	796.0
Standard & Poor's adjustments								
Operating leases	7.4	1.7	0.4	0.4	0.4	1.3	1.3	4.1
Postretirement benefit obligations	107.4	--	--	--	14.8	12.9	12.9	--
Surplus cash and near cash investments	(579.1)	--	--	--	--	--	--	--
Intercompany loan	(150.0)	--	--	--	--	--	--	--
Reclassification of nonoperating income (expenses)	--	--	--	63.9	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	(53.3)	--
Infrastructure renewals expenditure	--	(71.3)	(71.3)	42.7	--	(71.3)	(71.3)	(71.3)
Indexation of inflation-linked debt	--	--	--	--	--	--	(39.8)	--
Total adjustments	(614.3)	(69.7)	(70.9)	107.0	15.2	(57.1)	(150.2)	(67.2)
Standard & Poor's adjusted amounts								
	Debt	**Operating income (before D&A)**	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Capital expenditures**
Adjusted	5,514.2	945.0	943.7	778.1	319.7	653.7	560.6	728.8

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Table 1

Reconciliation Of Thames Water Utilities Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts* (cont.)

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 2

Thames Water Utilities Ltd. Peer Comparison*

	Thames Water Utilities Ltd.	Anglian Water Services Financing PLC	Southern Water Services Ltd.	South East Water (Finance) Ltd.¶
(Mil. £)	--Fiscal year ended March 31, 2010--			
Revenues	1,623.8	1,099.8	679.1	181.0
Net income from continuing operations	331.0	345.1	129.3	52.3
Funds from operations (FFO)	560.6	321.2	285.7	83.9
Capital expenditures	728.8	269.6	183.4	50.6
Cash and short-term investments	0.0	0.0	0.0	93.9
Debt	5,514.2	4,514.0	3,249.2	808.5
Preferred stock	0.0	0.0	0.0	0.0
Equity	1,556.4	1,456.0	810.3	228.5
Debt and equity	7,070.6	5,970.0	4,059.5	1,037.0
Adjusted ratios				
EBIT interest coverage (x)	2.4	1.8	2.2	3.1
FFO interest coverage (x)	2.8	2.1	2.5	3.8
FFO/debt (%)	10.2	7.1	8.8	10.4
Discretionary cash flow/debt (%)	(6.9)	(0.9)	1.7	(0.3)
Net cash flow/capex (%)	34.7	86.6	133.5	115.9
Total debt/debt plus equity (%)	78.0	75.6	80.0	78.0
Return on common equity (%)	20.9	23.6	16.5	23.1
Common dividend payout ratio (unadjusted) (%)	141.5	81.4	58.7	48.4

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. ¶Excess cash and investments not netted against debt.

Table 3

Thames Water Utilities Ltd. Financial Summary*

	--Fiscal year ended March 31--		
(Mil. £)	**2010**	**2009**	**2008**
Rating history	-/-/-	-/-/-	BBB/Stable/--
Revenues	1,623.8	1,558.2	1,487.6
Net income from continuing operations	331.0	314.8	380.0
Funds from operations (FFO)	560.6	523.6	406.6
Capital expenditures	728.8	915.5	803.0
Cash and short-term investments	0.0	0.0	0.0
Debt	5,514.2	5,367.9	4,764.0
Preferred stock	0.0	0.0	0.0
Equity	1,556.4	1,609.2	1,612.2
Debt and equity	7,070.6	6,977.1	6,428.0

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Table 3

Thames Water Utilities Ltd. Financial Summary* (cont.)			
Adjusted ratios			
EBIT interest coverage (x)	2.4	2.5	2.2
FFO interest coverage (x)	2.8	2.7	2.6
FFO/debt (%)	10.2	9.8	8.5
Discretionary cash flow/debt (%)	(6.9)	(9.9)	(8.3)
Net cash flow/capex (%)	34.7	32.9	37.9
Debt/debt and equity (%)	78.0	76.9	74.1
Return on common equity (%)	20.9	19.5	25.8
Common dividend payout ratio (unadjusted) (%)	141.5	126.7	61.3

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

Ratings Detail (As Of January 26, 2011)*	
Thames Water Utilities Cayman Finance Ltd.	
Senior Secured (9 Issues)	A-
Business Risk Profile	Excellent
Financial Risk Profile	Not applicable, as this transaction is assessed under our corporate securitization criteria.
Debt Maturities On March 31, 2010: To March 31, 2011: £250 mil. March 31, 2011–March 31, 2012: £10.3 mil. March 31, 2012–March 31, 2015: £553.5 mil. After March 31, 2015: £4,228 mil. mil. Note: Debt maturities constitute bonds issued.	
Related Entities	
Thames Water Utilities Finance Ltd.	
Senior Secured (14 Issues)	A-
Thames Water Utilities Ltd.	
Senior Secured (5 Issues)	A-

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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