

Global Credit Research - 08 Feb 2011

United Kingdom

## Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating -Dom Curr	Baa1
<b>Thames Water Utilities Cayman Finance Limited</b>	
Outlook	Stable
Bkd Senior Secured -Fgn Curr	A3
Bkd Senior Secured -Dom Curr	Baa3
Senior Unsecured -Fgn Curr	A3
Senior Unsecured -Dom Curr	Baa3

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## Key Indicators

### [1]Thames Water Utilities Ltd.

	3/31/2010	3/31/2009	3/31/2008
Adjusted Interest Coverage	2.0x	2.0x	1.9x
FFO Interest Coverage	4.0x	4.2x	4.6x
Net Debt / Regulated Assets Value	70.1%	72.7%	68.2%
FFO / Net Debt	12.9%	12.9%	13.0%
RCF / Net Debt	9.5%	8.7%	10.9%
RCF / Capex	0.7x	0.5x	0.6x

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

## Opinion

### Corporate Profile

Thames Water Utilities Limited ("TWUL" or "Thames Water") is the largest of the ten water and sewerage companies ("WaSCs") in England and Wales by both Regulatory Capital Value ("RCV") and number of customers served. TWUL provides drinking water to around 8.7 million customers and sewage treatment for a residential population of around 13.8 million in London and the Thames Valley.

TWUL is the major subsidiary of Thames Water Limited which was acquired by Kemble Water Limited, a consortium led by Macquarie's European Infrastructure Funds, in 2006.

### Recent Events

Ofwat, the economic regulator for the water sector in England and Wales, is currently reviewing the regulation and structure of the industry to ensure that it is best able to address current and future challenges. The UK Government has also commissioned a review of Ofwat. This work may lead to significant changes, most likely from the start of the next regulatory review period in 2015. However, Moody's believes that both government and the regulator are mindful of the need to preserve investor confidence in the regulatory framework and, more generally, the creditworthiness of the sector.

In July 2010, Moody's assigned a Baa3 rating with stable outlook to the GBP550 million of 5.375% Class B Notes due 2025 issued under

TWUL's MTN programme. This was the first issue of Class B debt under the programme, the terms of which restricted gearing to a maximum of 75% of Regulatory Capital Value until March 2010. Issuance of Class B debt was always anticipated and reflected in the corporate family rating assigned to TWUL and the rating of the senior Class A debt.

### **Rating Rationale**

Moody's maintains a corporate family rating ("CFR") of Baa1 with stable outlook on TWUL reflecting (i) the company's low business risk profile as the monopoly provider of essential water and sewerage services; (ii) the level of gearing; and (iii) the creditor protections incorporated within the company's financing structure.

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 Baa1 CFR is in line with the corporate family ratings assigned in similar transactions in the UK water sector (Anglian Water, Southern Water and Yorkshire Water). Like 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 prevent TWUL from funding its extensive capex programme or refinancing its debt at reasonable terms.

The rating consolidates the legal and financial obligations of TWUL, Thames Water Utilities Finance Limited, Thames Water Utilities Cayman Finance Limited and Thames Water Utilities Holdings Limited, TWUL's immediate holding company, which together constitute the ring-fenced Thames Water Utilities Financing Group ("TWU Financing Group") as defined under the terms and conditions of TWUL's GBP10.0 billion MTN Programme (the "MTN Programme") and factors in the associated structural enhancements.

### **DETAILED RATING CONSIDERATIONS**

The assessment of TWUL is based on Moody's global Rating Methodology for Regulated Water Utilities, published in December 2009. The methodology grid results in an indicated rating of Baa1 in line with the assigned Baa1 CFR. The following factors are considered under the rating methodology:

#### **FACTOR 1: REGULATORY ENVIRONMENT & ASSET OWNERSHIP MODEL**

TWUL's factor scoring is representative of that of the UK water sector as a whole, which benefits from a very transparent, stable and predictable regulatory regime. We therefore assign a Aaa score to the UK regulatory framework based on the clearly defined risk allocation principles and their consistent application, which underpin the stability and predictability of the UK regulatory environment.

In relation to the asset ownership model, we score the UK water companies at Aa reflecting direct ownership of the water and sewerage assets under a licence. However, this licence can be terminated for failure to comply with the terms and conditions set out in the relevant instrument of appointment. As a consequence, the UK water companies can also be subject to a special administration regime, which can be invoked by the regulator or the UK government in case of severe underperformance or financial distress of a water company. The special administration order is meant to ensure the orderly transfer of the water and sewerage operations and assets to a new provider.

The tariff formula applied under the UK regulatory framework allows for the recovery of operating expenditure and depreciation, which broadly reflects capital maintenance requirements, as well as a return on the regulated asset base set to cover the cost of funding through a combination of debt and equity. The return on capital also reflects the funding cost of capital investments that grow the asset base. There is a moderate degree of risk allocation to the water utilities as cost recovery (both operational and financial) is based on ex-ante allowances set by the regulator at five-yearly price reviews. We score the tariff regime in England and Wales at single-A, reflecting the fact that there is strict regulatory oversight of tariff increases and that operators can be subject to challenging efficiency targets.

Ofwat, the UK water industry's economic regulator, published its Final Determination in November 2009 setting price limits for the period from April 2010 to March 2015 ("AMP5") and TWUL has been allowed to increase its tariffs by an average of 1.4% p.a. in real terms. This compares to an average annual real price increase of 0.5% p.a. for the industry as a whole and a 3.9% increase proposed in the final business plan submitted by TWUL. The final determination also allows a weighted average cost of capital of 4.5% (real, post-tax) for the industry, which is below the company's final business plan assumption of 5.25%.

In terms of revenue volatility, TWUL has some exposure to potential volume risk in relation to its industrial and commercial customer base. However, the overall proportion of non-household revenues is slightly below the industry's average. Furthermore, revenue risk for the UK water companies is mitigated to some extent through the revenue-adjusted price cap mechanism introduced in the 2009 price review, which will allow an ex-post adjustment at the following price review for any under- or over-recoveries in revenues during the preceding price review period. For AMP5, the regulator also allowed a notified item for increases in household bad debt resulting from worsening economic conditions, which would allow companies to ask for an interim price determination if the increase in such costs beaches certain thresholds.

We assign a score of single-A for revenue risk.

#### **FACTOR 2: OPERATIONAL CHARACTERISTICS & ASSET RISK**

Operational performance for TWUL has been assessed as broadly in line with that of other WaSCs. For 2009-10, Ofwat awarded TWUL a score of 416 (2008-09: 406) out of a maximum of 438 in the regulators' overall performance assessment ("OPA") for water supply, sewerage service and customer service. This was TWUL's best ever score and placed it third out of the ten WaSCs.

For the year ended 31 March 2010 Thames Water outperformed its leakage target despite a severe winter which caused a major increase in burst pipes. Thames Water has reduced leakage by 27% in the last four years.

We score the company at Baa for Operational Performance, in line with the sector average.

A significant risk for TWUL is the execution of its extensive capital programme and the associated financing and refinancing requirements. The company's capital expenditure programme is set to continue at a high level over the regulatory period, with planned spending for AMP5 of around GBP4.9 billion (according to Ofwat's final determination and in 2007/08 prices). This is some way below the GBP5.5 billion proposed in TWUL's final business plan but it is still the largest programme amongst the WaSCs, equivalent to 22% of total planned capital expenditure for the sector in AMP5.

The programme includes around GBP850 million of spending on the Tideway tunnels - the Lee Tunnel and the Thames Tunnel - which are intended to reduce the level of untreated sewage overflowing into the River Thames and its tributary, the River Lee. More than GBP600 million of this amount relates to the 7 km Lee Tunnel, exposing the company to potentially significant risks during AMP5 in relation to a single large and complex engineering project. However, Moody's notes that, following discussions between the company and Ofwat, the scheme has been included within the overall capital programme and Thames Water will benefit from the protection provided by the CIS scheme. (Under CIS, water companies suffer penalties for overspend in their capital programmes in the following regulatory period; however, the amount of any overspend is added to the RCV such that the company receives a return in the same way as it would for other capital investment expenditure.) The contracting arrangements for the tunnel are expected to result in further risk mitigation.

Planned capex includes a large amount of capital maintenance (GBP2.1 billion) but it is nevertheless expected to result in Thames' regulatory asset base increasing by around 29% in real terms over the five-year period. Broken down into five equal instalments, the annual investment over the AMP5 period compared to the average RCV equals approximately 12%, resulting in a Ba score for capital requirements.

#### FACTOR 3: STABILITY OF BUSINESS MODEL AND FINANCIAL STRUCTURE

TWUL's scores in this category reflect the additional event risk protection provided by the bond covenant and security package which are designed to enhance the existing licence condition to ensure primary focus on the regulated activities.

We assign a score of Aa for ability and willingness to pursue corporate activity as, subject only to defined exceptions, companies within the financing group are not permitted to make any acquisition or investment. We further assign a score of A for ability and willingness to increase leverage as the financial covenants limit management's ability to increase leverage, with a dividend lock-up coming into effect if gearing increases above 85%. These scores are in line with those assigned to other companies with a similar highly-levered financing structure but one-notch above those assigned to WaSCs such as United Utilities and Severn Trent which have more traditional funding arrangements.

TWUL scores Aa for the targeted proportion of operating profit outside the core water and wastewater activities, in line with the other WaSCs.

#### FACTOR 4: KEY CREDIT METRICS

To assess the financial risk profile of a regulated water utility, Moody's uses four key credit metrics. However, the key focus remains on two particular ratios that have been applied to the credit analysis of UK Water companies in the past, namely Net Debt to RCV and the Adjusted Interest Cover (Moody's FFO Interest Cover adjusted for regulatory capital charges).

TWUL's Baa1 CFR is constrained by the relatively highly leveraged financial structure adopted by the company. The terms and conditions of the MTN Programme allow TWUL to increase its indebtedness (on the basis of Net Debt to RCV) up to 85% before distribution lock-ups come into effect. Failure to maintain a level of Adjusted Interest Cover of at least 1.2x would also trigger the dividend lock-up mechanism. We note, however, that Moody's calculation of both ratios may differ slightly from the definition of the financial covenants in the financing documents due to Moody's specific adjustments.

The very large capital programme during AMP5 will require the company to maintain a prudent approach to its financial structure and careful management of distributions to shareholders - in particular considering the lower WACC allowed by the regulator for AMP5 and initial revenue adjustment due to a relatively high CIS ratio of 125 for water and 108 for sewerage - to ensure its ability to finance these investments. In that respect, the cash trapping features embedded in the MTN Programme provide some protection against excessive shareholder demands.

The current rating assumes Net Debt to RCV gearing below the dividend lock-up levels and Adjusted Interest Cover around 1.3x or more. Historic performance has been in line with or better than this guidance (Net Debt to RCV was 70.1% as at March 2010 and Adjusted Interest Cover for 2010 was 2.0x). Moody's expects gearing to increase over the course of AMP5 as TWUL raises debt to refinance holding company borrowing and to fund its large capital programme. Interest cover is expected to decline due to increasing debt and the lower return on capital allowed by the regulator.

Moody's ratings do not assume any equity raising to support Thames Water's capital investment programme during AMP5.

#### Structural Considerations

TWUL's CFR also takes into account the covenant and security package agreed by the company, which is designed to insulate the company's creditworthiness from that of its ultimate shareholders and improve creditors' protection in a default scenario. The overall covenant and security package is similar to those seen for comparable highly-leveraged financing transactions (Anglian Water, Southern Water and Yorkshire Water).

#### Liquidity Profile

TWUL's liquidity profile is considered sufficient to support the company's operating and capital expenditure over the next 12 months. It is underpinned by the stable and predictable cash flows generated by its regulated activity, cash balances (GBP 216 million, including short-term deposits, as at 30 September 2010) and GBP1,175 million of committed revolving facilities which are currently undrawn. The next significant debt repayment occurs in February 2013 when a EUR500 million bond matures.

Thames has raised more than GBP1.8 billion through five bond issues since April 2010, including GBP850 million of Class B debt. Proceeds of the Class B issuance have been used to refinance holding company debt (outside of the TWU Financing Group), incurred in connection with the acquisition of Thames by the current shareholders.

#### Rating Outlook

The stable outlook on the ratings reflects Moody's expectation that TWUL's financing structure should be relatively resilient to downside scenarios due to the cash trapping triggers designed to ensure that cash is retained in the company if certain ratio thresholds are breached. Such cash could then be used to absorb the effect of possible downsides.

#### What Could Change the Rating - Up

Given the company's funding structure and Moody's expectation that TWUL will likely increase leverage over time to levels close to the maximum level permitted by its financial covenants, there will be limited potential for an upgrade of its ratings. Upward rating pressure would

require a material and permanent improvement in debt protection measures.

**What Could Change the Rating - Down**

Negative pressure on the ratings could derive from:

- Unexpected, severe deterioration in operating performance that results in the company remaining persistently in breach of the distribution lock-up triggers.
- A material, unexpected change in the regulatory framework for the UK water sector leading to a significant increase in TWUL's business risk.
- Unforeseen funding difficulties.

**Rating Factors**

**Thames Water Utilities Ltd.**

<b>Regulated Water Utilities [1][2]</b>	<b>Aaa</b>	<b>Aa</b>	<b>A</b>	<b>Baa</b>	<b>Ba</b>	<b>B</b>	<b>Caa</b>
<b>Factor 1: Regulatory Environment &amp; Asset Ownership Model (40%)</b>							
a) Stability and Predictability of Regulatory Regime	X						
b) Asset Ownership Model		X					
c) Cost and Investment Recovery (Ability & Timeliness)			X				
d) Revenue Risk			X				
<b>Factor 2: Operational Characteristics &amp; Asset Risk (10%)</b>							
a) Operational Efficiency				X			
b) Scale & Complexity of Capital Programme & Asset Condition Risk					X		
<b>Factor 3: Stability of Business Model &amp; Financial Structure (10%)</b>							
a) Ability & Willingness to Pursue Opportunistic Corporate Activity		X					
b) Ability & Willingness to Increase Leverage			X				
c) Targeted Proportion of Revenues Outside Core Water and Wastewater Activities		X					
<b>Factor 4: Key Credit Metrics (40%)</b>							
a) Adjusted Interest Coverage (3 year Avg)					X		
b) Net Debt/ Regulated Asset Value (3 Year Avg)					X		
c) FFO / Net Debt (3 Year Avg)				X			
d) RCF / Capex (3 Year Avg)					X		
<b>Rating:</b>							
a) Indicated Factor-Rating from Grid				Baa2			
+ Rating Uplift for Additional Creditor Protection				+1			
= Final Indicated Rating from Grid				Baa1			
b) Actual Rating Assigned				Baa1			

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 3/31/2010. Source: Moody's Financial Metrics



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