



Moody's Investors Service

Credit Opinion: Thames Water Utilities Ltd.

Global Credit Research - 06 Mar 2009

United Kingdom

Ratings

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

Contacts

Analyst	Phone
Neil Griffiths-Lambeth/London	44.20.7772.5454
Stefanie Voelz/London	
Monica Merli/London	

Key Indicators

Thames Water Utilities Ltd.

	Mar-2008	[1]Mar-2007	Dec-2005
FFO Net Interest Cover	6.0x	4.8x	4.8x
FFO / Net Debt	13.7%	21.2%	22.0%
RCF / Net Debt	11.6%	1.3%	15.8%
RCF / Capex	60.9%	5.4%	82.8%
Adjusted Net Interest Cover	2.4x	2.3x	1.9x
Net Debt / RAV	68.2%	50.3%	42.6%

[1] 15 months

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") is the largest, in terms of customers served, of the water and sewerage companies ("WaSCs") in England and Wales. The company provides drinking water to around 8.5 million customers and sewage treatment for a residential population of about 13.6 million.

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

Rating Rationale

Moody's maintains a corporate family rating ("CFR") of Baa1 with stable outlook on 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 Baa1 CFR assigned to TWUL consolidates the legal and financial obligations of TWUL, Thames Water Utilities Finance Limited ("TWUF"), Thames Water Utilities Cayman Finance Limited ("TWUCF") and Thames Water Utilities Holdings Limited ("TWUH"), 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 the MTN programme ("MTN Programme") and factors in the associated structural enhancements.

The 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 operations exhibit a low business risk profile as the monopoly provider of essential water and sewerage services. One of the principal risks that TWUL has to manage relates to the extensive investment programme.

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 prevent TWUL from funding its capex programme or refinancing its debt at reasonable terms.

In analysing the financial metrics of the WaSCs, Moody's focuses primarily on two key financial ratios: Net Debt to Regulatory Capital Value ("RCV"), and the Adjusted Interest Cover Ratio, calculated to measure the interest cover of a water company, after deducting from post-tax cash flows available to cover interest expenses the portion of the capital expenditure that is required to maintain the RCV at a constant value (in real terms) over the regulatory period.

The Baa1 CFR takes into account TWUL's ability to increase leverage from the initial 75% on a 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 which will be subordinated to the existing Class A debt. 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 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 although we note that the company has not yet announced plans to do so.

Moody's has considered TWUL's previously poor performance in relation to customer services, operating cost efficiency and leakage. However, we further note improvements in many areas as reflected in the company's highest ever score under the industry regulator Ofwat's 'Overall Performance Assessment' which placed TWUL fourth out of the ten WaSCs for 2007/08. Additional investment in replacing some of the oldest water mains in London (more than 40% of which were laid more than 100 years ago) has resulted in the company meeting the leakage targets set by the regulator for both 2006/07 and 2007/08. Management remains focused on the continued improvement in services.

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 future underperformance on the company's future credit metrics.

The bonds issued by TWUF and TWUCF are guaranteed by TWUL and their ratings are based on the business and financial risk profile of TWUL together with the structural protections incorporated in the MTN Programme, from which they also benefit.

Structural Considerations

The Baa1 CFR also 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. Additional structural features include (i) a first-ranking fixed charge over the shares of TWUL; (ii) an agreement by secured creditors to give up their individual rights to petition for insolvency proceedings against the TWU Financing Group and to accept a standstill period of 18 months; and (iii) the requirement to maintain debt service liquidity facilities equal to 12 months of debt service to absorb temporary cash shortfalls caused by adverse events. 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 structured 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 and the inability to appoint and direct an administrative receiver at TWUL in the event of insolvency.

Recent Developments

In August 2008, TWUL submitted its draft business plan to Ofwat as part of the review process being conducted by the regulator to set price limits for the period from April 2010 to March 2015. The plan anticipates investment over the period totalling some £6.5 billion to maintain existing assets (GBP 2.2 billion), accommodate expected customer growth (GBP2.2 billion), comply with new requirements (GBP2.1 billion) and improve service levels (GBP0.6 billion). (The GBP6.5 billion total is calculated after deducting GBP0.6 billion of anticipated cost savings.) The first stage of the proposed Thames Tideway Tunnel is expected to cost GBP1.3 billion and is included within the total for complying with new requirements. Moody's notes that in its draft business plan TWUL said that it expects to raise around GBP5 billion of new debt to deliver its planned investment programme for 2010-15 however this amount is likely to change in the final business plan.

Final business plans will be submitted by water companies in April 2009 and Ofwat has said that it will set the price limits in November 2009.

Ofwat is seeking to expand the role of competition in the water sector and Moody's notes recent proposals by the regulator together with the review commissioned by the UK government (the Cave Review). Detailed proposals have yet to be announced and any changes are likely to be introduced over an extended period. Adverse changes in credit quality in the short to medium term are therefore considered unlikely.

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 42 million at 30 September 2008) and GBP750 million of committed revolving facilities. Moody's notes that the company has pre-funded its capital programme until the end of the current regulatory period in March 2010 and the next significant debt repayments occurs in June

2010 when a GBP250 million bond matures.

In January 2009, TWUF issued a EUR500 million bond. This, together with other recent issuance, demonstrates that utility companies continue to be able to access the capital markets although Moody's notes the relatively high spreads (compared to past issuance) paid by TWUF and other issuers. We recognise however that higher spreads have been mitigated by lower benchmark yields but also believe that Ofwat will set or adjust allowed returns as necessary to preserve the credit quality of the industry.

Rating Outlook

The outlook for the ratings of the bonds issued by TWUF and TWUCF is stable, reflecting the stable outlook on TWUL's Baa1 CFR. 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 for the period from 2010 to 2015. In Moody's opinion, the company's capital structure also appears robust to support the large capital programmes over the next and future regulatory periods.

What Could Change the Rating - Up

Given the 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 ratings.

What Could Change the Rating - Down

- Unexpected and adverse regulatory determinations following the current or future periodic reviews.
- Performance failures leading to regulatory action and fines, or serious underperformance in operating or capital expenditure.
- Negative funding conditions including a significant increase in funding costs and/or restricted market access unless mitigated by appropriate regulatory action
- A material adverse change in the regulatory framework.
- Fundamental changes to the industry structure to bring about competition



Moody's Investors Service

CREDIT RATINGS ARE MIS'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

© Copyright 2009, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and

financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moodys.com under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."