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Research Update: Thames Water 'BBB+' Ratings Still On Watch Neg; 3 Bonds May Move To Securitization Structure

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Rationale

On Jan. 25, 2008, Standard & Poor's Ratings Services said that its 'BBB+' long-term corporate credit rating on Thames Water Utilities Ltd. (TWUL) remains on CreditWatch with negative implications, where it was placed on Aug. 8, 2007. The 'BBB+' ratings on the three sterling bonds (£200 million maturing in 2032, £175 million maturing in 2021, and £330 million maturing in 2028) issued by Thames Water Utilities Finance Ltd. (TWUF), which are still outside the corporate securitization structure, also remain on CreditWatch negative.

This update follows the consent solicitation TWUF recently launched to move the three sterling bonds to within the corporate securitization structure. If this consent solicitation is successful, we will remove from CreditWatch and affirm the ratings on the three bonds, as the three sterling bonds would then rank pari passu with the 'BBB+' rated bonds issued under or already transferred to the structure.

If the consent solicitation is successful we will withdraw from CreditWatch and lower to 'BBB' the corporate credit rating on TWUL, in line with the rating on the only bond to remain outside the structure, the ¥4 billion bond maturing on March 25, 2008. We will withdraw the corporate credit rating on TWUL once this bond has matured, as such a rating will not be meaningful for TWUL, TWUF, or Thames Water Utilities Cayman Finance Ltd. (TWUCF) once all the debt is within the corporate securitization. This is because the corporate securitization's financial structure has been established so that the different tranches of debt have different default characteristics. So far, only class A debt has been issued under this corporate securitization, but the group has the possibility to issue class B debt from 2010 with limited restrictions.

The 'BBB+' long-term debt ratings on the bonds issued under or transferred to the TWUL corporate securitization reflect the credit quality of the TWUL regulated water and wastewater business in London and the Thames Valley region, and the company's improving regulatory and operational performance. Substantial further progress is required for TWUL to meet its regulatory targets by the end of the current regulatory period in 2010, however. The ratings also reflect the corporate securitization's substantial leverage, offset to a degree by various structural features designed to add to cash flow certainty for bondholders.

As the largest U.K. regulated water and wastewater utility, TWUL benefits from the industry's stable and transparent regulatory framework and limited exposure to competition, offset to a degree by uncertainties stemming from the five-yearly price reviews. TWUL faces challenging regulatory and operational issues, but improved its performance in the six months to end-September 2007. In this period, TWUL reduced operating costs by £50 million, increased capital expenditures substantially--which over the full year are likely to reach about £1 billion--and improved regulatory performance. In particular, TWUL is ahead of its leakage target for the year and has significantly improved the environmental performance of its wastewater works. Further substantial improvements are nevertheless required for the company to hit its targets for the end of the regulatory period (2010) with the possibility of intervention by the regulator OFWAT if TWUL is not compliant.

The ratings take into account the following risks of the structure:

- TWUL's aggressive capital structure, with class A plus class B net debt to RCV (regulated capital value) likely to average 82% (85% once the aggregate of unsecured bond debt falls below 0.8% of RCV) over most of the life of the transaction.
- Limited incentive for TWUL under the structure to aim for debt-protection measures that are materially higher than covenant levels, and expectation that cash will be returned to shareholders to the maximum extent possible.
- TWUL's negative free cash flow generation--as is the case for its water sector peers--for the foreseeable future, and consequent need to access the debt markets for additional financing.
- Limitations on security, as the bulk of TWUL's assets is "protected land".
- Possibility, which is however remote, for unsecured debt to create an event of default for class A debt.
- The possibility for a super senior tranche within class A debt, capped at 8% of the latter, however, corresponding to the indexation payable at maturity under retail price index (RPI)-linked swaps.

The ratings also take into account the following structure strengths:

- Ring-fencing of the financing group--Thames Water Holdings Ltd. (TWH), TWUL, and debt issuers TWUCF and TWUF all within the ring fence--from the rest of group.
- Subordination of the class B debt, which cannot, in particular, create an event of default for class A debt.
- Prudent debt management policies with covenanted spread of maturities and interest rate hedging.
- Liquidity support through dedicated facilities.
- A strong covenant package to protect debt holders, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.
- Three independent directors at TWUL who, together with the three executive directors, are the only ones able to vote on matters affecting TWUL and companies above it, such as dividends.
- 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, which provides creditors with significant control over TWUL at the earliest stage of financial and/or operational difficulty, or of material changes in business circumstances, in order to prevent special administration and minimize the borrower probability of default creating an additional credit cushion.
- Robust financial forecasts that significantly sustain stress-test scenarios.

Liquidity

Significant liquidity available, as required by the borrowing documents, is a key feature of the financial structure and supports the ratings. The liquidity buffer is designed to provide a way of overcoming short- to medium-term cash flow shortages until other mechanisms take effect.

Liquidity is available within the structure in the following ways:

- The issuers must maintain debt service reserve (DSR) facilities which, combined with the amounts available on the debt service reserve accounts, must cover forecast next 12 months cash interest on class A and class B debt, and unsecured bonds remaining outside the corporate securitization. The DSR facilities are irrevocable and can be drawn at any time.
- TWUCF must also maintain an operating and maintenance (O&M) reserve. Combined with the amounts available on the O&M reserve account, the reserve must cover at least 10% of forecast operating and capital expenditure for the following 12 months.

The current DSR and the O&M facilities of respectively £200 million and £105 million are 364-day facilities. They are likely to be renewed or will be fully drawn, with the proceeds deposited in, respectively, the DSR account and the O&M reserve account. These amounts would then only be repaid when the facilities have been refinanced.

TWUL also benefits from an additional three-year facility for working capital requirements of £200 million and for capital expenditure of £550 million.

Ratings List

Thames Water Utilities Ltd.
Corporate credit rating BBB+/Watch Neg/--
Thames Water Utilities Finance Ltd.
Senior unsecured debt* BBB+/Watch Neg

*Guaranteed by Thames Water Utilities Ltd.

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