

Thames Water Utilities Whole Business Securitisation – Ofwat Position Note

In our position note of 30 May 2007¹ we discussed Kemble Water Holdings Limited's (Kemble) proposal to transfer all of the existing debt of Thames Water Utilities Limited into a securitisation structure (whole business securitisation) and to refinance some acquisition debt within this structure. This will involve the issuance of new long term bonds which would be ring fenced within the cash flows and obligations of Thames Water Utilities Limited. The proposal would also include, subject to the agreement with the relevant counterparties, the incorporation of certain existing financing arrangements (such as finance lease facilities and existing bond issuance) within the securitised structure. Thames Water Utilities Limited intend to incorporate a covenant package in line with other securitisations undertaken by the water companies, including financial and operational covenants, committed liquidity and facilities for capital expenditure, and provisions that restrict or regulate the exercise, together with acceleration and enforcement rights of secured creditors. Kemble proposed to implement the whole business securitisation to achieve a strong investment grade credit rating for Thames Water Utilities Limited.

At the time we published our position note, the credit rating agencies were in the process of considering this whole business securitisation proposal but had not announced the outcome of their credit rating assessments. We therefore reserved our final position on the financial structure pending the outcome of the credit rating agencies' reviews.

Thames Water Utilities Limited yesterday announced the launch of its whole business securitisation. Subsequently, Standard & Poor's Ratings Services (S&P) and Moody's Investors Service (Moody's) have published their preliminary ratings.

Moody's has assigned provisional (P)A3 ratings to approximately £1.2 billion of Class A Unwrapped Notes to be issued by Thames Water Utilities Cayman Finance Limited.

Moody's has also assigned a provisional corporate family rating of (P)Baa1 to Thames Water Utilities Limited. 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 corporate family rating assigned to Thames Water Utilities Limited consolidates the legal and financial obligations of Thames Water Utilities Limited, Thames Water Utilities Finance Limited, Thames Water Utilities Cayman Finance Limited and Thames Water Utilities Holdings Limited (Thames Water Utilities Limited's immediate holding company), which together constitute the ring-fenced Thames Water Utilities Financing Group.

¹ The completed acquisition of Thames Water Holdings Plc by Kemble Water Limited - A position paper by Ofwat, May 2007

S&P has assigned a 'BBB+' preliminary long-term debt rating to the £1.2 billion Class A Unwrapped Notes to be issued by Thames Water Utilities Cayman Finance Ltd. S&P do not assign corporate family or equivalent ratings to whole business securitisations.

We note the impact on the rating assigned by S&P (a downgrade of one notch from BBB+ to BBB) to some of Thames Water Utilities Limited's existing debt issues (namely the £175 million Guaranteed RPI-linked bonds due 2021; £330 million Guaranteed Bonds due 2028; and £200 million Guaranteed Bonds due 2032 - termed the legacy bonds) should they remain outside the securitised structure.

Within an appointee's debt portfolio, debt issues might have a range of credit ratings (although we would expect senior debt to have a credit rating that is comfortably within the investment grade range). However we are concerned that appointed water companies maintain an overall corporate credit quality that is comfortably investment grade. If the legacy bonds remain outside of the securitised structure, the downgrade of the legacy bonds does not appear to jeopardise Thames Water Utilities Limited's ability to achieve this. We would also be concerned if the ratings outcome of the legacy bonds were to have a significant unfavourable outcome for sentiment in the capital markets for water companies as a whole. On the basis of the information so far, it appears unlikely that the ratings outcome for these particular legacy bonds would have material implications for the water companies' future access to capital.

The rating outcomes provide some headroom above the floor for investment grade credit quality. Ofwat considers headroom above this floor important as a safeguard against future uncertainties.

We propose no regulatory action other than to modify Thames Water Utilities Limited's licence in the way prescribed in our original position note on Kemble's acquisition of Thames Water Utilities Limited.