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CREDIT OPINION
30 May 2018

Update

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RATINGS

Thames Water (Kemble) Finance PLC

Domicile	United Kingdom
Long Term Rating	B1
Type	Senior Secured - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Thames Water (Kemble) Finance PLC

Update following rating affirmation with negative outlook

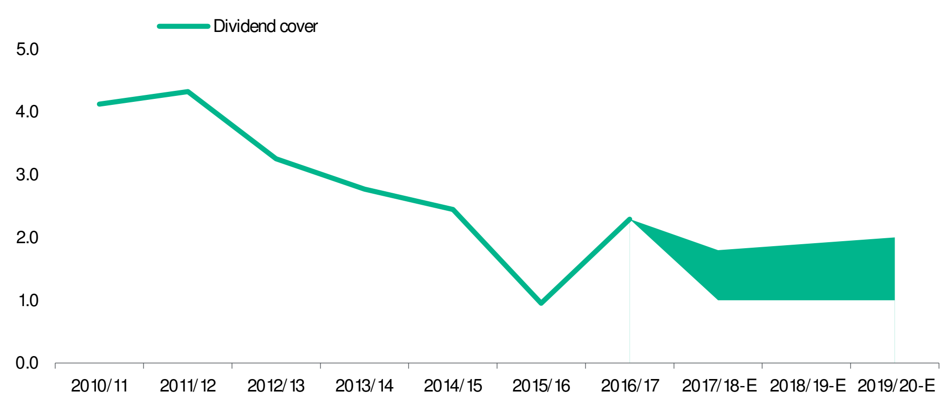
Summary

The credit quality of Thames Water (Kemble) Finance PLC (Kemble), the finance subsidiary of Kemble Water Finance Limited, is supported by the low business risk profile of the group's main operating subsidiary, Thames Water Utilities Limited (Thames Water, CFR Baa1 negative), as the monopoly provider of water and wastewater services in its area, and the stable and transparent regulatory framework for the water sector in England and Wales. It is constrained by (1) the high level of gearing at Thames Water and other debt in the group including the Kemble notes; (2) the terms of the financing structure of Thames Water (the Thames Water Programme) which include various cash-trapping provisions; and (3) the likelihood that Thames Water's ability to pay dividends to Kemble will be constrained by significantly lower baseline returns from April 2020.

We consider the expected loss for the Kemble notes to be very high given their subordinated position towards cash flows as well as security granted to lenders of Thames Water.

While dividend cover has been reducing in the current regulatory period, we expect liquidity at the holding company to provide back-stop cover for debt service over a period of at least 12-18 months. Moody's expects that dividend distributions from Thames Water will largely be limited to amounts needed to cover the debt service of the Kemble notes and other external debt as well as administrative costs over the current regulatory period to March 2020 (AMP6).

Exhibit 1
Kemble's dividend cover has declined with lower returns in current regulatory period 2015-20



Note: 2010/11-2013/14 based on UK GAAP financials, from 2014/15 on IFRS accounts
Source: Thames Water and Kemble Water Finance Limited annual reports, Moody's forecast

Credit Strengths

» Key operating subsidiary Thames Water generates stable cash flows from the provision of monopoly water and wastewater services under a well-established, transparent and predictable regulatory regime.

Credit Challenges

» Very high financial leverage, up to around 90% of Thames Water's regulatory capital value (RCV).

» Cut in allowed returns from 2020 will likely negatively affect operating company's ability to upstream dividends, on which Kemble relies for its debt service.

» Cash flows are subject to distribution lock-up covenants at the operating company level, which increases the probability of default for Kemble.

» Deeply subordinated nature of Kemble's creditors' claims against operating cash flows reduces recovery prospects.

Rating Outlook

As Kemble is wholly reliant on dividend distributions from Thames Water to Kemble Water Finance Limited to service its debts, the negative outlook reflects the negative outlook assigned to Thames Water.

It further takes into account Ofwat's proposal that the regulator should in future assess operating companies' dividend policies and its indication that dividend yields above the level it regards as “reasonable” would not be acceptable in the absence of outperformance or explicit customer support. New measures that restrict the group's flexibility to move cash between operating and holding companies would deepen Kemble's subordinated position.

Factors that Could Lead to an Upgrade

Given the negative outlook, we do not currently envisage a rating upgrade. Kemble's outlook could be stabilised if we conclude that Thames Water's exposure to the lower return environment is adequately mitigated by a combination of a favourable price determination outcome, strong outperformance ability and/or balance sheet strengthening measures, and if regulatory changes do not materially increase Kemble's subordination relative to the operating company.

Factors that Could Lead to a Downgrade

There would be negative ratings pressure if there were a material deterioration in the Kemble group's financial metrics, or this appeared probable, such that dividend lock-ups at the Thames Water level were more likely to be breached. Under the terms of the Thames Water Programme, there is a distribution lock-up at the operating company if (1) Class A RCV gearing or Senior (Class A and Class B) RCV gearing exceeds 75% or 85% respectively; or (2) Class A Adjusted Interest Cover Ratio or Senior Adjusted Interest Cover Ratio falls below 1.30x or 1.10x, respectively. Negative funding conditions, which could increase refinancing risk, adverse changes in the regulatory framework or structure of the water sector in England and Wales, or the implementation of regulatory measures which further restrict Kemble's access to Thames Water's cash flows may also cause downward rating pressure at Kemble.

Key Indicators

Exhibit 2

Highly leveraged capital structure with limited financial flexibility

Financial metrics based on consolidated accounts of Kemble Water Finance Limited

	Mar-15	Mar-16	Mar-17
Adjusted Interest Coverage Ratio	1.9x	1.7x	1.7x
Net Debt / Regulated Asset Base	88.6%	88.0%	89.2%
FFO / Net Debt	8.9%	8.1%	7.2%
RCF / Net Debt	5.1%	4.2%	3.2%

Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Source: Moody's Financial Metrics™

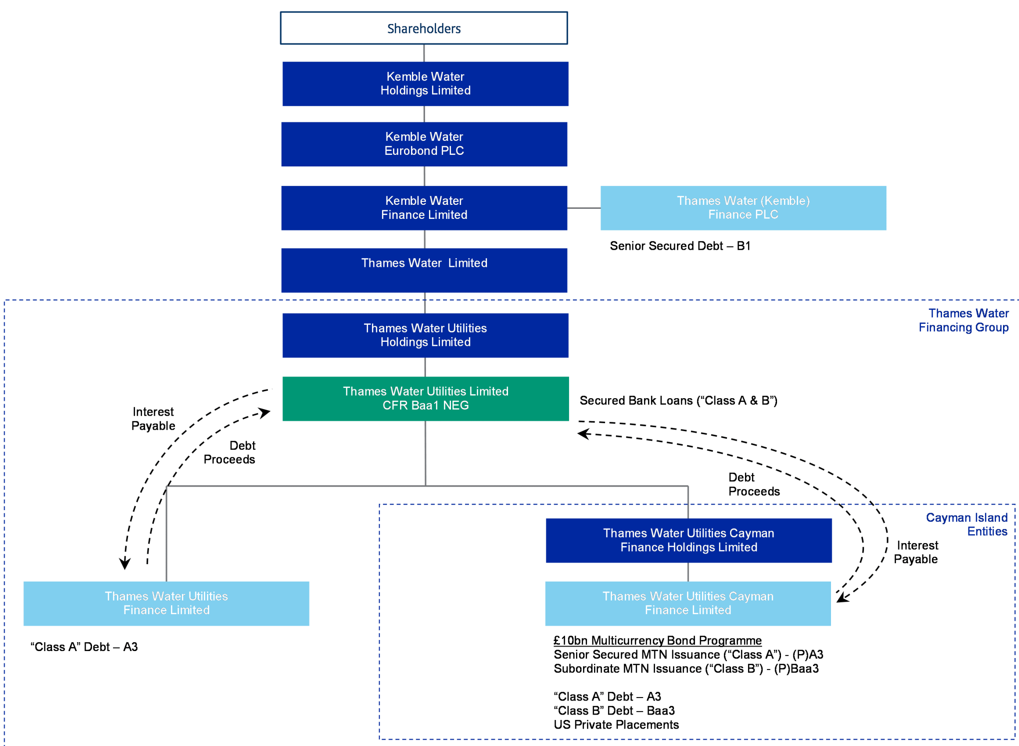
Profile

Thames Water (Kemble) Finance PLC is the financing subsidiary of Kemble Water Finance Limited, the company owning Thames Water Limited. The principal operating subsidiary in the group is Thames Water Utilities Limited (Thames Water), a regulated water and sewerage company operating in London and the Thames Valley area.

Thames Water is the largest of the ten water and sewerage companies in England and Wales by both RCV and number of customers served. It provides drinking water to around 9 million customers and sewerage services to around 15 million customers in London and the Thames Valley.

Exhibit 3

Thames Water's group structure



Note: Thames Water is currently in the process if removing is Cayman Island entities.

Source: Moody's

Kemble is ultimately owned by a consortium of national and international infrastructure and pension funds, with the largest single shareholders being OMERS (27.4%) and the Universities Superannuation Scheme (10.9%).

Detailed Credit Considerations

Credit quality of operating subsidiary, Thames Water, key credit driver

Kemble's credit quality is a function of (1) the low business risk profile of its key operating subsidiary, Thames Water; (2) the very high leverage of up to 90% of Thames Water's RCV at Kemble group level; and (3) the priority position in relation to operating cash flows as well as recovery proceeds in a default scenario pertaining to creditors at Thames Water, resulting in the deeply subordinated position for the Kemble noteholders.

In its final methodology consultation for the 2019 price review, published in December 2017, Ofwat indicated a significant cut in allowed returns for the water companies under an assumption that the current low interest-rate environment continues to persist, albeit partially offset by the switch in indexation measures. Furthermore, efficiency challenges will increase, particularly for average performers, which could put a further strain on companies' cash flows.

Companies will benefit from the low interest rate environment over time as they raise new debt. However, companies, such as Thames Water, with debt tenors beyond that assumed by the regulator may be exposed as allowed returns will converge to market rates, unless historical funding costs have been below average. The latter has been the case for Thames Water, so the immediate risk is reduced. Nevertheless, a significant cut in future allowed returns will pressure interest cover ratios and companies may need to reduce gearing if they are to maintain credit quality. This, in turn, will reduce cash flows available for distribution, increasing the risk for the holding company of receiving cash flows insufficient to service the Kemble notes.

We also note that the low-yield environment may have eroded equity buffers. Taking into account the fair value of existing borrowings and derivatives, Thames Water had gearing (including Moody's standard adjustments) around 110% as at March 2016, and closer to 120% for March 2017 (adding Kemble's debt, fair value leverage would have been closer to 120-130%). A visible erosion of the equity value could weaken incentives for shareholders to provide further funding.

We continue to view the overall developments as credit negative for the sector, with increased risk of cash flow volatility likely from 2020 (please see 'UK Water Sector: Ofwat signals challenging price review', July 2017).

On 26 April 2018, Ofwat published a consultation on proposals for companies' business plan submissions for PR19. The consultation includes proposals intended to bolster companies' financial resilience and address concerns around the sector's legitimacy, including a sharing of financing outperformance and additional restrictions on dividend payments. These measures mark a change in direction for the regulator in reaction to mounting political and public pressure on the sector. Ofwat's proposal that the regulator should in future assess operating companies' dividend policies and its indication that dividend yields above the level it regards as "reasonable" would not be acceptable in the absence of outperformance or explicit customer support is reflected in the negative outlook for Kemble.

In our view, the measures further evidence increasing regulatory risk, and Moody's has recently revised its scoring for the stability and predictability of the regulatory regime to Aa from Aaa (please see 'Regulated Water Utilities - UK: Regulator's proposals undermine the stability and predictability of the regime', May 2018).

Please refer to the Credit Opinion for Thames Water for further details of the rating and rationale.

Terms and conditions of the Kemble Notes ring-fence Kemble from additional shareholder claims

There is a distribution lock-up at Kemble if consolidated total net debt to RCV exceeds 92.5%. This mechanism potentially traps cash at the holding company, for the benefit of lenders, if the financial condition of the group is deteriorating. Moody's notes, however, that this arrangement may be of limited value as the occurrence of a dividend lock-up, or a trigger event, at Thames Water would result in there being no dividend payments to be trapped at Kemble.

Actual leverage at Kemble level has historically been below the distribution lock-up level at around 88% consolidated net debt to Thames Water's RCV. This is primarily due to the financial policies implemented by the group and a restriction in absolute debt amounts allowed to be raised at Kemble, which is currently limited to £900 million (net of cash held in accounts, but excluding debt subordinated to the Kemble notes). Regardless of the current cap, the rating on the Kemble Finance Notes reflects our expectation that consolidated gearing would remain at or below 90% of net debt to Thames Water RCV, providing some headroom against financial covenants. Moody's understands that it is management's intention to maintain at least a £65 million facility at Kemble to provide liquidity to meet interest payments in the event that there are no dividend payments by Thames Water but there is no contractual requirement to maintain any form of debt service reserve. Drawings under this facility will result in a dividend lock-up at Kemble.

Noteholders and bank lenders to Kemble benefit from security granted by the Issuer and Guarantor, including over the shares held by Kemble in Thames Water Limited. Moody's notes, however, that lenders under the Thames Water Programme also benefit from security over the shares in Thames Water held by its immediate parent. If security granted under the Thames Water Programme were to be enforced then the security at Kemble may have little or no value and, for this reason, the expected loss for lenders to Kemble is very high.

Whilst we consider the above creditor protections of the Kemble Finance Programme as sufficient to effectively ring-fence the Kemble group, we do not believe they warrant any ratings uplift.

Dividend distributions constrained to preserve credit quality of Thames Water

Moody's expects that dividend distributions from Thames Water will largely be limited to amounts needed to cover the debt service of the Kemble notes and other external debt as well as administrative costs, i.e. the cash dividend cover will likely average 1.0-2.0x over the current regulatory period to March 2020 (AMP6). This reflects management's strategy to increase financial flexibility within the operating company to address challenges of lower allowed returns and high investment requirements. While Thames Water's final determination includes scope for outperforming total expenditure allowances, which could see cash dividend coverage increasing beyond 2.0x in the later years of AMP6, the operating company has also faced performance set-backs and will focus on additional investments to rectify these. The additional cash maintained within the Kemble group (around £93 million at March 2017), together with a £65 million revolving credit facility also provides adequate back-stop liquidity at current rating levels.

Liquidity Analysis

Thames Water demonstrates a solid liquidity profile. Liquidity at Kemble is driven by the dividends upstreamed by Thames Water to the holding company, which we expect to cover at least the interest payments at Kemble Finance and other administrative holding company costs over the next 12-18 months. As discussed above, we expect the dividend cover to remain subdued over AMP6 leaving less financial flexibility for the holding company. Whilst there is no requirement to maintain liquidity to meet debt service at Kemble Finance, the group has a track record of a prudent cash management policy by maintaining cash reserves and/or liquidity facilities, and we expect these sources to cover at least 12-18 months of Kemble's debt service requirements.

We also note Kemble's issuance, in July 2015, of £175 million 5.875% senior secured notes, with the proceeds applied to refinance existing bank facilities, which illustrates the company's good access to funding in the current market environment. We understand the use of proceeds also included the closeout of £200m long dated fixed interest rate swaps with breaks, reducing the group's exposure to future adverse mark-to-market movements.

Structural Considerations

In general terms, creditors of holding companies are structurally subordinated to creditors at the operating company level, as they are further removed from the operational cash flows that are generated at the operating company level and which will first and foremost serve the operating company debt. Holding companies have to rely exclusively on the operating company's ability to pay dividend distributions from excess cash available after operating company debt service.

Such simple structural subordination can be amplified where the operating company's ability to pay distributions is further restricted.

In the case of Thames Water, the operating company has a highly-covenanted financing structure, which restricts management's ability to alter the business and financial risk profile of the operating company to the detriment of its creditors.

As part of these restrictions, the operating company is subject to financial covenants, including cash lock-up triggers. Whilst preventing distributions, such trigger events also allow creditors at the operating company level additional oversight by appointing an independent advisor to provide a remedial plan or discuss remedial measures with the regulator.

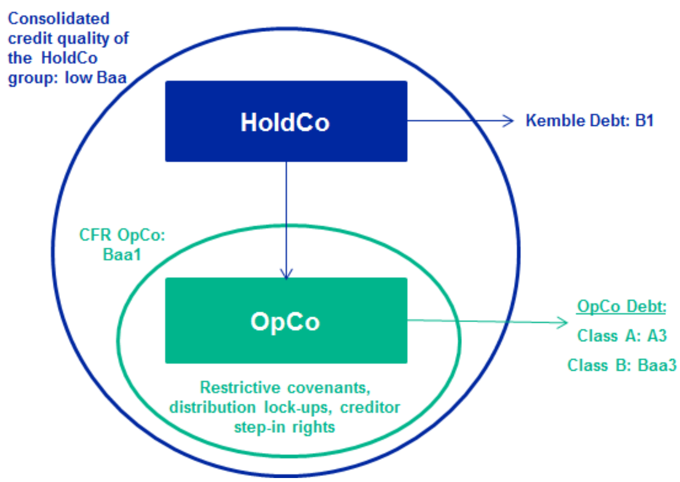
Whilst Thames Water's covenant and security package provides additional protection for creditors at the operating company level, it is detrimental to the credit quality at the holding company. The holding company relies exclusively on distributions from the operating company to service its debt, and the distribution lock-up covenants at the operating company increase the risk of limited or no dividends being paid to the holding company.

When assessing the credit risk for the holding company creditors, we first evaluate the credit quality of the overall consolidated group. The approach is similar to assigning a corporate family rating at the highly-leveraged operating company, with the exception that here we also take into account the holding company debt, assuming the entire group's debt is raised in one single class and at one single entity.

However, the consolidated credit quality of the holding company group does not take into account (1) the higher probability of default that creditors at the holding company level are facing; and (2) the higher severity of loss in an actual default scenario because of holding company creditors' structural and contractual subordination to operating company creditors.

Exhibit 4

Kemble - simplified group structure and ratings



Source: Moody's

To adequately reflect the deeply subordinated nature of the holding company debt obligations, we apply a wider notching than would normally be the case in a typical corporate OpCo-HoldCo structure, where the probability of default between the operating and holding companies is not materially different.

Rating Methodology and Scorecard Factors

Moody's assessment of Kemble reflects the application of our rating methodology for Regulated Water Utilities, published in December 2015.

We consider the consolidated credit quality of the Kemble group to be consistent with a rating at the bottom of the Baa range, broadly in line with the indicated rating under our rating methodology. Under the methodology, we assign the same scoring for Kemble and Thames Water in respect of the qualitative factors, while scoring for coverage and leverage reflects the consolidated metrics at the holding company level. Given the challenging price review, we expect financial metrics for the consolidated Kemble group to deteriorate slightly over the next 12-18 months horizon. Whilst the consolidated financial profile may not - absent additional economic pressures - weaken significantly, Kemble's dividend cover will fall over the next regulatory period.

The assigned B1 rating to the Kemble notes is notched down from Kemble's consolidated credit quality and reflects the deeply subordinated nature of creditor claims at Kemble level given the group's financial and contractual arrangements.

Exhibit 5

Rating Factors Grid - Kemble Water Finance Limited

Regulated Water Utilities Industry Grid [1][2]	Current FY 31/03/2017		Moody's 12-18 Month Forward View As of May 2018 [3]	
Factor 1 : Business Profile(50%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Environment	Aaa	Aaa	Aa	Aa
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)	A	A	A	A
d) Revenue Risk	A	A	A	A
e) Scale and Complexity of Capital Programme & Asset Condition Risk	Baa	Baa	Baa	Baa
Factor 2 : Financial Policy (10%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Factor 3 : Leverage and Coverage (40%)				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	1.7x	Baa	1.2x - 1.5x	Ba
b) Net Debt / Regulated Asset Base (3 Year Avg)	88.6%	B	85% - 90%	B
c) FFO / Net Debt (3 Year Avg)	8.1%	Ba	5% - 8%	Ba
d) RCF / Net Debt (3 Year Avg)	4.1%	Ba	3% - 6%	Ba
Rating:				
Indicated Rating from Grid Factors 1-3		Baa3		Baa3
Rating Lift	**0**	**0**	**0**	**0**
a) Indicated Rating from Grid		Baa3		Baa3
b) Actual Rating Assigned				B1

Note: (1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) At at 31/03/2017. (3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate any significant acquisitions or divestitures.

Source: Moody's Financial Metrics™

Ratings

Exhibit 6

Category	Moody's Rating
THAMES WATER (KEMBLE) FINANCE PLC	
Outlook	Negative
Bkd Senior Secured -Dom Curr	B1

Source: Moody's Investors Service

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