



## Rating Action: Moody's downgrades Thames Water (Kemble) Finance to B2 from B1, maintains negative outlook

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London, July 21, 2023 -- Moody's Investors Service (Moody's) has today downgraded to B2 from B1 the backed senior secured rating of the GBP400 million medium term notes due 2026, issued by Thames Water (Kemble) Finance PLC (Kemble). The outlook remains negative.

The rating action on Kemble follows a decision by the Water Services Regulation Authority (Ofwat), announced on 20 March 2023, to modify the regulatory ring-fencing conditions in the licences of the water companies in England and Wales [1], and increased scrutiny of the financial resilience of Kemble's core operating subsidiary Thames Water Utilities Ltd. (Thames Water, corporate family rating: Baa2 stable) after the sudden resignation of the former CEO in June.[2]

### RATINGS RATIONALE

Today's rating action on Kemble reflects Moody's view that (1) the risk of a dividend block at Thames Water increased with heightened scrutiny of Thames Water's financial resilience; (2) these factors will weigh on lender appetite in the context of Kemble's forthcoming refinancing needs, likely to the detriment of the availability and cost of capital for the holding company; and (3) while shareholders have reiterated their support for Thames Water, further equity injections are subject to conditions and may fall short of what is needed to underpin the credit quality of the holding company in the context of a challenging turnaround and heightened political and regulatory scrutiny.

Regulatory scrutiny and social expectations that may have an adverse impact on a company's access to capital markets is a key social risk consideration under Moody's approach for assessing environmental, social and governance (ESG) risks. Accordingly, the rating agency has changed its social risk issuer profile score for Kemble to S-4 from S-3.

Under current licence conditions, regulated water and wastewater companies may not, without Ofwat's consent, pay dividends (or make similar distributions, including through upstream loans) while their credit rating is Baa3 (or equivalent), with a negative outlook, or lower by any one credit ratings agency. The regulator has decided to raise this threshold to Baa2, negative from April 2025. The higher rating requirement will serve to trap cash at an earlier point as the credit quality of an operating water company deteriorates. The lock up will be subject to a three months grace period, during which companies may seek to persuade Ofwat that their financial resilience is not at risk. Exceptions to a dividend block could apply where companies can evidence significant improvement under an ongoing recovery plan or where they can demonstrate that it may be in the best interest of customers, including, for example, where the prospect of a distribution being permitted may assist with attracting new equity during a turnaround period. If a rating subsequently falls to Baa3 or lower, the lock up will apply automatically.

The likelihood of an actual lock-up will be influenced by factors including progress in Thames Water's ongoing turnaround programme and Ofwat's 2024 price review. The turnaround is being supported by the company's shareholders who provided a GBP500 million equity injection in March 2023 and have agreed to provide a further GBP750 million over the remainder of the current AMP7 regulatory price control period which runs to March 2025. The additional equity is, however, subject to "preparation and production of a business plan that underpins a more focused turnaround that delivers targeted performance improvements for customers, the environment and other stakeholders over the next three years and is supported by appropriate regulatory arrangements".[3] Shareholders have also

indicated further support of around GBP2.5 billion over the next regulatory period (1 April 2025-31 March 2030), with final amounts dependent upon finalisation of the operating company's business plan due to be submitted to Ofwat in early October this year.

Liquidity and financial strategy at Kemble will determine, how long the holding company may be able to withstand a (temporary) distribution block if it were to occur. Kemble is obliged to make reasonable endeavours to maintain sufficient cash cover for 12 months interest payments, and the group has a track record of a prudent cash management policy through maintaining cash reserves and/or liquidity facilities. Liquidity is currently supported by a GBP150 million revolving credit facility at Kemble. The facility, which matures in November 2027, is sized to cover 18 months of interest payments. In addition, the company held around GBP45 million of cash at March 2023.

Considering Kemble's ongoing interest payments, existing cash and available undrawn amounts under facilities may not fully support repayment of a GBP190 million bank loan maturing in April 2024, unless Thames Water can continue to make distributions. In its compliance certificate as at March 2023, Thames Water is forecasting compliance with all covenants, and Moody's base case assumes that distributions will continue.

Kemble faces further sizeable maturities of GBP510 million between July and December 2025 as well as GBP150 million in April 2026, followed by the GBP400 million rated backed senior secured bonds issued by Thames Water (Kemble) Finance PLC. To date, over the current regulatory period, Thames Water continued to distribute to Kemble, but in amounts lower than the overall cost of servicing Kemble's interest payments, reflecting existing cash reserves at Kemble. While Kemble debt service remained assured by this element of cash reserves, these are being exhausted and – absent additional liquidity – future dividend payments from Thames Water would need to be sized to cover Kemble interest costs in full.

Kemble's credit quality at the B2 rating level assumes continued shareholder support for the operating company, Thames Water, and additional equity injections to improve its operational and financial performance. Equity support for Thames Water benefits lenders to the holding company directly by supporting the turnaround and reducing the risk of a distribution block but also indirectly because of the – in Moody's view – implied willingness to provide support to the holding company, should it be necessary. Kemble's own senior secured financing structure includes a fixed charge over all of the investments by Kemble Water Finance Limited, including in its shares in its finance subsidiary Thames Water (Kemble) Finance PLC as well as its shares in Thames Water Limited, the intermediate holding company owning Thames Water Utilities Holdings Limited and the Thames Water group. Therefore, any event of default under Kemble debt, would allow Kemble creditors to enforce their share security and take over ownership of the operating company group. This would cause shareholders to lose the investment made to date in the operating company

More broadly, Kemble's credit quality is a function of (1) the low business risk of its key operating subsidiary, Thames Water; and (2) very high leverage at the Kemble group level, up to 90% of Thames Water's regulatory capital value (RCV). It also takes into account the higher probability of default that creditors at the holding company level are facing and the higher severity of loss in an actual default scenario because of holding company creditors' structural and contractual subordination to operating company creditors.

## RATING OUTLOOK

The outlook is negative, reflecting the increased risk of a distribution block being triggered under Thames Water's licence and ultimately also its debt documentation, uncertainty around the successful execution of the turn-around programme and Kemble's ability to meet its forthcoming refinancing needs without a significant increase in its funding costs over time.

Moody's could stabilise the outlook upon a strengthening of the business or financial risk profile of the operating company and/or sizeable liquidity support at the holding company, including from additional shareholder commitment, that would allow it to sustain a multi-year dividend block.

## FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING

Given the current negative outlook as well as the deeply subordinated nature, structurally as well as contractually, of the Kemble notes in the context of the operating group's financing structure and regulatory protections, Moody's does not expect any upward rating pressure for the Kemble notes.

Kemble's rating could be downgraded further if the ratings of Thames Water were downgraded, or the risk of a dividend lock up at the operating company was not reduced, absent additional liquidity at the holding company to increase its resilience to dividend blocks. Financial triggers in Thames Water's financing structure include (1) Class A RCV gearing in excess of 75% or senior RCV gearing in excess of 85%, or (2) Class A adjusted interest cover ratio below 1.3x or senior adjusted interest cover ratio below 1.1x in a single year. Rating triggers, in addition to any licence provisions, include a Class A or corporate rating below Baa3/BBB- from any agency. In assessing the downward rating potential, Moody's will consider the holding company's liquidity position, the likelihood of potential shareholder support as well as the potential for the regulator to permit certain distributions upon the licenced company's request.

The principal methodology used in this rating was Regulated Water Utilities published in June 2018 and available at <https://ratings.moodys.com/rmc-documents/55428>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

Thames Water (Kemble) Finance PLC (Kemble) is the financing subsidiary of Kemble Water Finance Limited, which owns Thames Water through intermediate holding companies including Thames Water Limited. Thames Water is the largest of the 10 water and sewerage companies in England and Wales by both RCV (GBP 19 billion at March 2023) and the number of customers served. It provides drinking water to around nine million customers and sewerage services to around 15 million customers in London and the Thames Valley. Kemble is ultimately owned by a consortium of national and international infrastructure and pension funds, the largest being OMERS (31.8%) and the Universities Superannuation Scheme (19.7%).

## REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at [https://ratings.moodys.com/documents/PBC\\_1288235](https://ratings.moodys.com/documents/PBC_1288235).

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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## REFERENCES/CITATIONS

[1] [https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Decision\\_document\\_financial\\_resilience\\_proposals.pdf](https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Decision_document_financial_resilience_proposals.pdf)

[2] <https://www.londonstockexchange.com/news-article/BA18/resignation-of-chief-executive/16016820>

[3] <https://www.londonstockexchange.com/news-article/BA18/shareholder-funding-update/16033297>

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