

Research Update:

Thames Water Class A And B Debt Ratings Lowered On Delayed Shareholder Support; Outlook Negative

April 4, 2024

Rating Action Overview

- Thames Water Utilities Ltd. (Thames Water) announced last week that a £500 million tranche of shareholder equity for the current regulatory period, previously expected by end-March 2024, will not be provided imminently. This is because shareholders view the PR24 business plan as uninvestible under their current understanding of the arrangements that would be expected to apply to Thames Water during the next regulatory period (AMP8; from April 2025). Discussions with the regulator are still ongoing, and Thames Water is pursuing all options to secure the required equity from both existing and new shareholders.
- We think the difficult macroeconomic backdrop of the regulatory settlement and the numerous bespoke elements in Thames Water's PR24 business plan might complicate discussions. The outcome of these is a key part of our analysis since the £3.25 billion equity injection would enhance Thames Water's financial health and enable it to deliver a £18.7 billion investment plan critical to the restoration of operating performance in the next regulatory period. Furthermore, we note that its holding company, Kemble Water Finance Limited, is now in default on its debt obligations, which could potentially change Thames Water's ownership structure.
- Despite the delayed equity injection, Thames Water intends to carry out its planned capital expenditure this year to maintain the trajectory of its current three-year turnaround plan--which supports its business risk profile. But, alongside higher new financing costs, this spending will further intensify the pressure on financial metrics.
- We therefore lowered to 'BBB-' from 'BBB' our ratings on Thames Water's class A debt and to 'BB' from 'BB+' on the company's class B debt. At the same time, we removed all ratings from CreditWatch negative, where we had placed them on June 30, 2023.
- The negative outlook indicates the higher uncertainty on additional equity investment in Thames Water that would be essential, in our view, to improve operating performance as part of the company's turnaround plan in the next regulatory period.

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Rating Action Rationale

Shareholders' current view of Thames Water's business plan as uninvestable questions the availability of equity support and increases the uncertainty around the company's operational performance for the next regulatory period. Thames Water's shareholders had previously announced £750 million in new equity, £500 million of which would have been injected by end-March 2024. One of the conditions for the injection was to have an investable business plan for the next five-year regulatory period (AMP8) commencing April 2025. The equity injection has not yet been made because Thames Water's nine shareholders do not view this condition as being met based on their current understanding of the regulatory arrangements that would be expected to apply to Thames Water in AMP8.

Thames Water's £18.7 billion PR24 business plan--submitted to the regulator in October 2023--contained some bespoke elements to make it an investable proposition for its shareholders. These included, inter alia, £1.9 billion of proposed asset deficit repair spending, unique to Thames Water's business plan submission with the aim to remedy the health of the company's assets over multiple regulatory periods at an overall costs of £19 billion. The business plan also captured a customized set of risk and reward parameters, maximum level of penalties incurred under the outcome delivery incentives (ODI) regime, an assumption of 4.25% on the weighted-average cost of capital, relative to Ofwat's early view of 3.23%, and customer bill increases of over 40% over the five-year period, before factoring in inflation.

Although Ofwat will not share its draft determinations on all water utility PR24 business plans before the end of June, we understand that the regulator has provided some initial feedback. It is on the basis of incorporating this feedback that Thames Water's shareholders view the plan as uninvestable. We understand that there are scenarios under which the shareholders could still inject the equity investment required for its turnaround and the execution of its business plan--a total of £3.25 billion (£750 million in the current regulatory period and £2.5 billion in the next). However, such injections depend on a favorable regulatory outcome, or a favorable appeal proceedings at the Competition and Markets Authority (CMA), both of which we assume will involve complex discussions.

In the absence of adequate equity support for its turnaround and business plans, we think that Thames Water's already constrained operational performance--which has consistently attracted regulatory penalties over the years--may suffer further. In turn, this could constrain our view of Thames Water's business risk profile, which we currently assess as excellent, in line with that of other U.K. water utilities operating in a supportive and predictable regulatory environment. Given it has £2.4 billion of available liquidity as of end-February 2024, Thames Water has stated its intention to further its capital expenditure (capex) plan during the current regulatory period despite the delayed injections. This supports the business and operational performance in the medium term. However, without the previously expected £500 million of equity at end-March, alongside the impact of higher new financing costs, we think the pressure on its already-stretched S&P Global Ratings-adjusted financial metrics will increase. Thames Water's recent market issuances resulted in new debt costs materially higher than that of the company's existing debt.

The possibility of a default at Kemble Water Finance Limited (KWF; not rated) has potential to change Thames Water's shareholder structure and complicate the agreement on required equity injection. KWF announced that it would not service debt, nor will it refinance or repay a £190 million bond maturing on April 30, 2024. This is tantamount to default, in our opinion. Although it does not directly affect Thames Water, which is legally ringfenced from KWF, the

latter's creditors have security over shares in Thames Water Limited that they could enforce. If this were to result in a new ownership structure for Thames Water, there would likely be further complications for the agreement on the additional £3.25 billion of equity injections.

Outlook

The negative outlook reflects persistent uncertainties on support from existing or new shareholders for Thames Water's AMP8 business plan, deemed uninvestable by its shareholders based on initial regulatory feedback. Delays in injecting equity during the currently regulatory period bring into question shareholder support and the recovery in the company's operational performance in the next regulatory period. Without the equity injections needed to execute the business plan, Thames Water could endure longer periods of weak performance, prompting us to reassess its business risk profile as strong from excellent currently.

Negotiations between Ofwat and Thames Water are ongoing, and we expect to have greater visibility on the feasibility of the business plan and shareholder support by end-2024. Because investment grade-ratings are part of Ofwat's considerations when deciding on water companies' licenses, we assume that the various parties will constructively seek a mutually acceptable solution.

At this stage, special administration is not our base case; we understand that credit impacts in this scenario would remain at the discretion of the special administrator.

Downside scenario

We could lower the ratings in case of significant reductions, or delays, in equity injections, jeopardizing Thames Water's investment plan, constraining operational performance and liquidity.

Upside scenario

We could revise the outlook to stable or the raise the rating if Thames Water receives sufficient additional shareholder support for the current regulatory period; binding shareholder commitments for the next period to uphold its operational turnaround through 2030 on the back of a supportive regulatory decision for AMP8; and clarity around the implications on Thames Water's ownership structure arising from credit stress at KWF.

Company Description

Thames Water is the U.K.'s largest water and sewerage company, with a regulatory capital value (RCV) of £19.6 billion as of end-September 2023. Thames Water serves 16 million customers (about 25% of the population of England and Wales), generating EBITDA of about £1.1 billion annually.

Liquidity

We assess Thames Financing Group's liquidity position as adequate, based on our calculation that the company's liquidity sources will exceed its needs by 1.19x in the 12 months from March 31, 2024.

Principal liquidity sources:

- Available cash and committed funding of £2.4 billion as of Feb. 29, 2024 (excluding the dedicated debt-service reserve and operations and maintenance facility); and
- Cash FFO of about £800 million.

Principal liquidity uses:

- Upcoming debt maturities of approximately £830 million;
- Expected capex of approximately £1.9 billion; and
- Minimal dividends.

Covenants

The company will operate with tight headroom under its covenants, notably with conformed senior regulatory asset ratio (RAR or debt to RCV) being forecast to reach 84.0% by March 2025, relative to the company's restricted distribution level of 85%.

Thames Water—Key covenants

(%)	Actual performance March 31, 2023	Actual performance Sept. 30, 2023	Forecast performance March 31, 2024*	Forecast performance March 31, 2025*
Class A RAR	68.7	72.6	71.6	71.9
Conformed senior RAR	77.4	79.5	79.5	84.0
Conformed Class A ICR	6.11	--	5.83	5.65
Additional conformed class A adjusted ICR	2.05	--	2.07	1.81
Additional conformed senior adjusted ICR	1.60	--	1.65	1.34
Additional conformed class A average adjusted ICR	1.98	--	1.98	1.98
Additional conformed senior average adjusted ICR	1.53	--	1.53	1.53

RAR--Regulatory asset ratio. ICR--Interest coverage ratio. *Includes a company assumption of additional equity of £500 million and £250 million by March 31, 2024 and 2025, respectively. Source: Thames Water Investor Presentation, Sept. 30, 2023.

Thames Water Utilities Finance PLC--Transaction key features

Collateral	Fixed and floating charges over all assets.
Country of origination	U.K.
Financial covenants	Class A adjusted ICR less than 1x; senior RAR greater than 95%
Trigger events	Senior RAR greater than 90%; class A adjusted ICR less than 1.3x; senior adjusted ICR less than 1.1x; class A RAR greater than 75%.
Restricted distribution conditions	Senior RAR greater than 85%.

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Economic Outlook Q2 2024: The U.K. Is Slowly Turning A Corner, March 26, 2024
- U.K. Utilities Outlook 2024: Cloudy With Sunny Spells, Jan. 30, 2024
- Industry Credit Outlook 2024: EMEA Utilities, Jan. 9, 2024
- Water Investments In England And Wales Poised To Nearly Double Over 2025-2030, Oct. 5, 2023
- Thames Water Utilities Finance PLC, Sept. 28, 2023
- Thames Water Class A And B Debt Ratings On Watch Negative On Management Transition, Unknown Timing Of Equity Injection, June 30, 2023
- EMEA Utilities Outlook 2023: United Kingdom: Tailwinds For Energy, Cross-Currents For Water, Jan. 24, 2023
- High Level Of Index-Linked Debt Exacerbates Effect Of Inflation On U.K. Water Companies, Dec. 1, 2022
- Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable, Sept. 16, 2022
- Why We See England And Wales' Water Regulatory Framework As Strong, July 1, 2022

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Thames Water Utilities Finance PLC		
Senior Secured	BBB-/Negative	BBB/Watch Neg
Subordinated	BB/Negative	BB+/Watch Neg

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