S&P Global Ratings

Research

Thames Water Utilities Finance PLC

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Related Research

Thames Water Utilities Finance PLC

Credit Highlights

None

Overview

Key strengths	Key risks
Focus on low risk, regulated water and wastewater monopoly activities in Greater London and the Thames Valley, two of the most affluent and economically stable regions in the U.K.	Highest regulatory gearing in the U.K. regulated water sector, with debt-to-regulatory capital value (RCV) of 77.4, as of March 31, 2023, versus an average gearing of 68% for the sector.
Transparent, credit-supportive regulatory framework, resulting in financial stability during regulatory periods.	Financial headroom and flexibility are very limited due to high debt, more than half of which is inflation-linked.
Structural features designed to increase cash flow certainty for debt holders.	Bottom-of-the-sector operational track record, resulting in sector-high penalties and significant regulatory scrutiny amid the sudden departure of the CEO.
Supportive shareholders, with financial commitment for turnaround plan during the current regulatory period, and indication of further requirement during next period.	Negative free cash flow and limited deleveraging prospects over the next few years due to high capital intensity and funding requirements.

S&P Global Ratings believes the CEO's unexpected resignation with immediate effect in June 2023 increases risks to implementation of the transformation plan, amid uncertainty regarding the timing of additional shareholder injections. The CEO's resignation comes in the second year of the company's eight-year transformation plan. CFO, Alastair Cochran, as well as Strategy and External Affairs Director and previous Ofwat CEO, Cathryn Ross, will act as interim co-CEOs until the company formally appoints a replacement, providing a degree of continuity. We also note that many members of the management team at Thames were put in place in order to execute the turnaround plan. Even then, we believe implementation risks around tackling long-standing operational issues have increased following the CEO's sudden departure, which comes before the company submits its business plan for the next regulatory period in October 2023.

Equity support for the current regulatory period has been scaled down while the overall size of the investment plan remains the same. Thames has received £500 million of equity injections in this regulatory period (AMP7) toward financing its turnaround. Shareholders have previously indicated further equity support of £1.0 billion by the end of the current regulatory period, ending March 2025. At the annual results announcement this amount was revised down to £750 million and is conditional on the company's submission of its business plan for the next regulatory period and ongoing operational and financial improvements. Therefore, the exact timing of additional injections is unknown, but is expected before the end of March 2025. While equity support during this period is lower than previously announced, we understand that some investment will instead be shifted to AMP8. We estimate that the company will have total expenditure of about £4.2 billion in the last two years of AMP7. In addition to the support until March 2025, Thames Water has acknowledged that an additional £2.5 billion of equity would be required during the next regulatory period. However, the company has stated that the nature and level of such medium-term shareholder support will depend on the framework that will apply to the next regulatory period.

Thames Water's financial metrics would come under further pressure if the support was not forthcoming. Financial headroom is limited, and we project key metrics will remain below thresholds commensurate with the ratings for another year. We estimate the class A's funds from operations (FFO)-to-debt ratio will average 4.1% for the fiscal years ended March 31, 2024, and 2025, compared with our 5% downside threshold, and debt to EBITDA will average 10.9x over that period compared with our 11x downside threshold for the current rating. Negative free operating cash flows (FOCF) will prohibit deleveraging, despite limited dividend payments. We forecast that Thames Water will operate relatively close to its financial covenants for the remainder of the regulatory period, with debt to RCV at 77.5%, versus its 85% lock-up level. The regulatory model allows for RCV growth in line with inflation, which should reduce leverage, all else being equal.

We view liquidity as adequate, as defined by our criteria, with sources covering uses by 1.47x over the next 12 months (see liquidity section below for details).

Potential fines related to noncompliance with environmental obligations could affect our ratings on Thames Water. The U.K.'s Water Services Regulation Authority (Ofwat) has a live enforcement case on Thames Water for potential failures at sewage treatment works that may have led to sewage discharges. Although the outcome of the investigation and size of fines are currently unclear, Ofwat's investigation could lead to litigation-related costs and fines, which the regulator indicated could be up to 10% of annual turnover. There is, presently, no clear timeline for the release of the investigations' results.

CreditWatch

The negative CreditWatch placement indicates that we could lower the issue ratings by one notch within the next three to six months if we do not gain clarity on additional equity support from shareholders or on progress on the company's eight-year turnaround plan. Depending on the risks we see with the implementation of the transformation plan, we could revise our assessment of the company's business risk profile to strong from excellent.

We could lower our ratings on the debt issued by Thames Water if we do not believe equity support is forthcoming, if there are signs that the turnaround plan is not making sufficient progress, or if the company's results for fiscal 2023 are much weaker than we currently expect (see "Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics, Outlook Stable," published Sept. 16, 2022).

We could affirm the issue ratings and remove them from CreditWatch when we gain sufficient clarity on the turnaround plan and a firm timeline for the additional equity injections committed to the regulator.

Our Base-Case Scenario

Assumptions

- Revenue growth as set out in the regulatory allowance.

Retail price index (RPI) and consumer price index including owner occupiers' housing costs (CPIH) as per our in-house projections. We forecast an RPI in the U.K. of 3.1% and 2.0 the fiscals 2024 and 2025, respectively. We forecast average CPIH of 3.2% and 1.7% for fiscals 2024 and 2025, respectively.

- An adjusted EBITDA margin of roughly 50%-55% annually between 2024 and 2025.
- Fairly consistent leverage of about 79%-84% for the consolidated debt and 69%-73% for the class A debt for the rest of AMP7.
- Significant outcome delivery incentive penalties of during AMP7.
- Capex of about £3 billion during the next two years.
- Limited dividend distributions of about £85 million-£120 million, for servicing of holding company debt.

Key metrics

Thames Water Utilities Finance PLC--Key metrics*

	--Fiscal year ended March 31--				
(Mil. £)	**2021a**	**2022a**	**2023a**	**2024f**	**2025f**
Revenue	2,032.9	2,092.0	2,180.7	2,000-2,500	2,000-2,500
EBITDA margin (%)	46.7	47.4	43.9	54-55	54.5-55.5
Capital expenditure	1,035.3	1,228.7	1,390.2	1,500-1,600	1,300-1,400
Class A Debt	11,270.0	12,104.0	13,324.4	13,700-13,900	13,700-13,900
Consolidated Debt	12,812.3	13,703.8	14,924.4	15,300-15,500	15,300-15,500
Class A					
Debt to EBITDA (x)	11.9	12.2	13.9	10.5-11.5	10.0-11.0
FFO to debt (%)	6.2	2.3	(2.8)	4.0-4.4	6.0-6.4
Class B (consolidated)					
Debt to EBITDA (x)	13.5	13.8	15.6	11.5-12	11-11.5
FFO to debt (%)	5.1	1.3	(3.2)	3-3.5	5-5.5

*All figures adjusted by S&P Global Ratings. They refer to Class B debt. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. DCF--Discretionary cash flow.

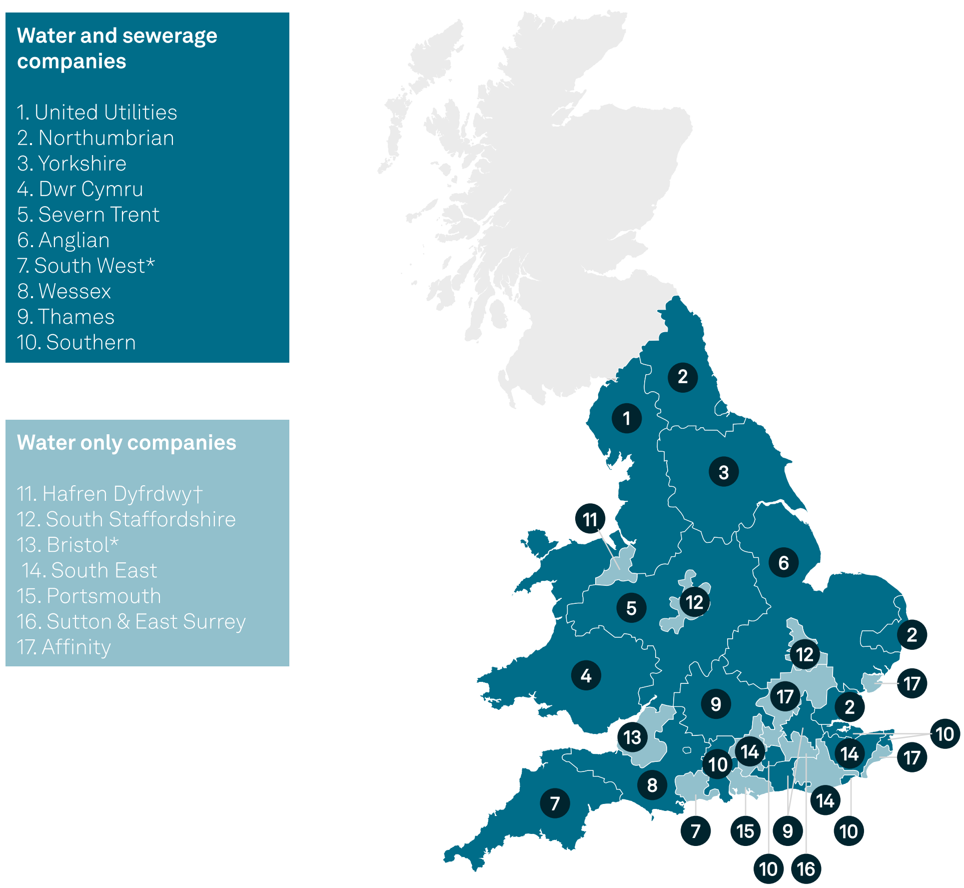
Credit metrics will recover to our target thresholds only toward March 2025, the end of the current regulatory period. We forecast that Thames Water's adjusted FFO to debt will remain below our 5% threshold for the senior debt (class A) and our 4% threshold for the consolidated debt (class A and class B) until March 2025. These metrics will likely recover toward a level we see as commensurate with the rating by fiscal 2025. The recovery hinges on a gradual normalization in inflation by 2025. There is significant uncertainty around this assumption, however, due to the sensitivity of the company's credit metrics to movements in inflation.

Company Description

Thames Water is the U.K.'s largest water and sewerage company, with an RCV of £18.85 billion on March 31, 2023. It serves 16 million customers across London and the Thames Valley, or about 25% of the population of England and Wales, generating EBITDA of about £1 billion annually.

Chart 1

England and Wales water supply areas of operation and key players



*Part of Pennon Group. †Part of Severn Trent PLC. Source: Ofwat.

Thames Water Utilities Ltd. (TWUL) abstracts, stores, and transports raw water; treats and distributes water; and treats, transports, and disposes of sewage and sludge liquors. It also engages in billing and revenue collection for household customers. To deliver a supply of 2.6 billion liters of water per day and transport and treat 4.6 billion liters of sewage per day, it operates 97 water treatment works and 354 sewage works. The company was incorporated in 1989 and is based in Reading, U.K.

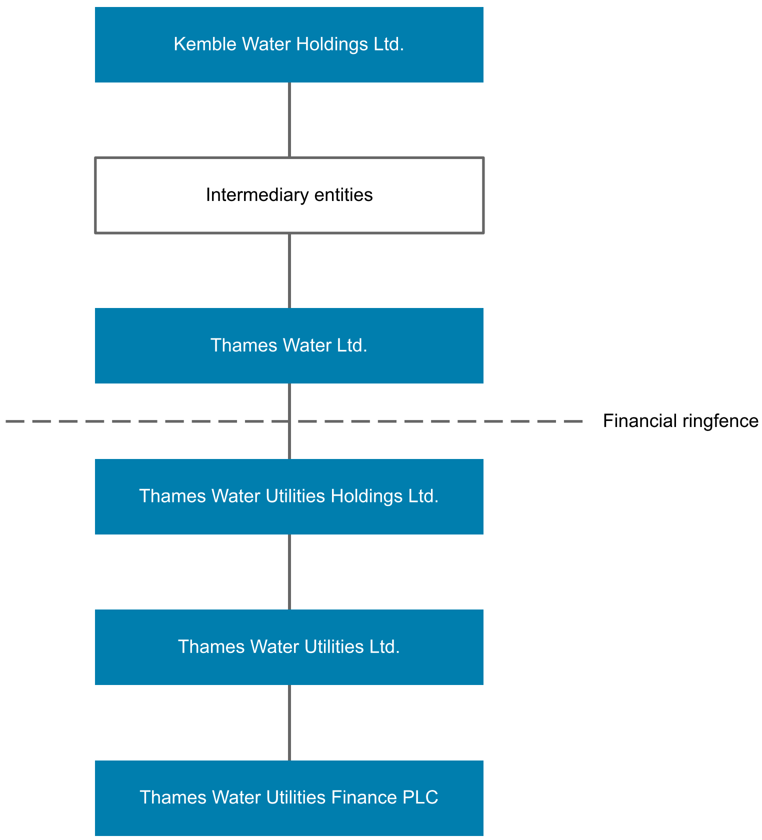
- TWUL is a subsidiary of Thames Water Utilities Holdings Ltd.

- Thames Water Utilities Finance PLC (TWUF), is a subsidiary of TWUL, acting as a financing company that raises finance and lends debt to TWUL.

Kemble Water Holdings Ltd., which is Thames Water's ultimate parent, is owned by a consortium of infrastructure investors. The largest shareholders are pension funds OMERS (31.8%) and USS (19.7%), which have together held over 50% since USS increased its shareholding in late 2021. This structure effectively isolates the credit quality of TWUL, Thames Water Utilities Holdings Ltd. and Thames Water Utilities Finance PLC from any entities and associated debt outside of the financial ringfence.

Chart 2

Simplified Thames Water Utilities Group Corporate Structure

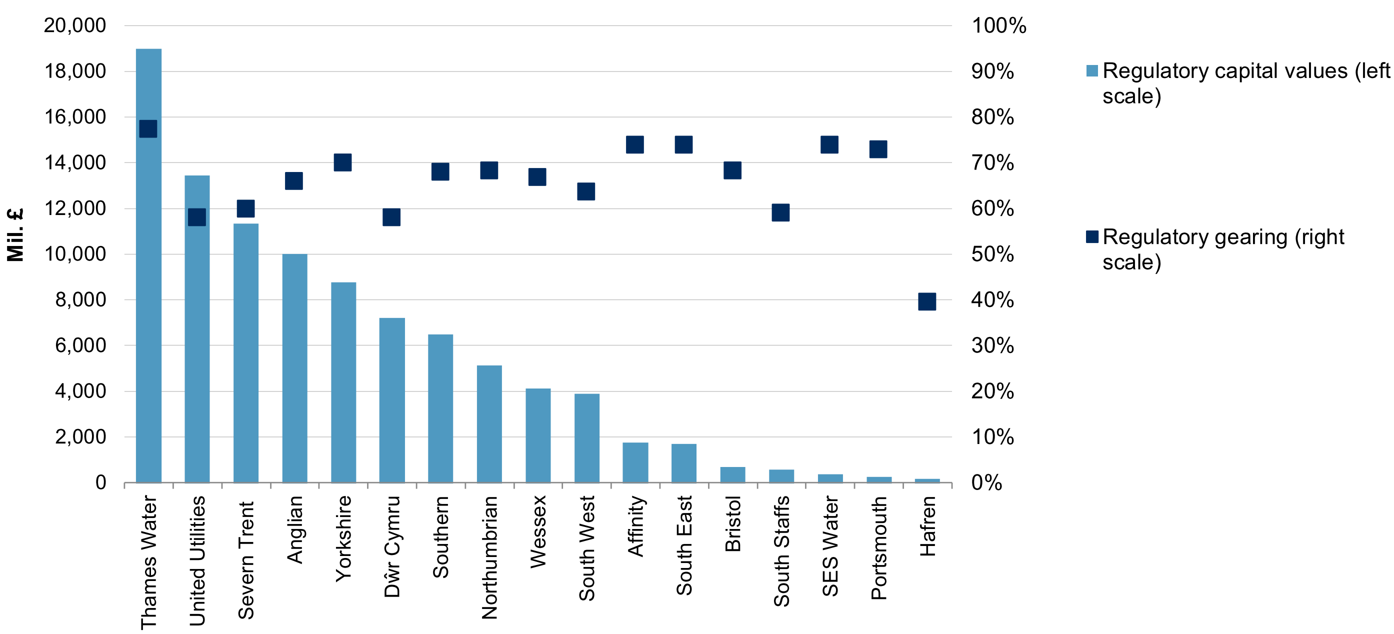


Peer Comparison

Thames Water is the biggest water and sewerage utility in the U.K. based on RCV on March 31, 2023. We mainly compare Thames Water with other structurally enhanced debt-issuing regulated water and wastewater companies that operate in England and Wales. We rate Thames Water's senior debt ('BBB') and subordinated debt ('BB+') tranches two notches below most of these peers, compared with a more typical 'A-' and 'BBB'. In addition, we rate Thames Water's senior debt one notch below that of Southern Water Services (Finance) (namely at 'BBB' rather than 'BBB+'). Thames Water's peers also have excellent business risk profiles but tend to have better operational performance than Thames Water. In Ofwat's latest Water Company Performance Report 2022-23, fiscal 2023 is the third year that both Thames Water and Southern Water are in the bottom, or "lagging behind" category. Anglian, Dwr Cymru, Yorkshire, Bristol, and South East Water also fall into this category. Ofwat will push companies that are "lagging behind" to take appropriate action to improve performance. Thames Water has the lowest customer satisfaction as measured by the Customer Measure of Experience (C-MeX) score in the U.K. water sector (at 67.06 versus a sector median of 79.08 in 2023). Thames Water's operating issues lead to lower profitability, rendering its financial risk profile weaker than its peers. We consider Thames Water to be highly leveraged, versus the sector's more typical profile of "aggressive" with issuer credit ratings (ICR) of 'BBB'. Thames Water's debt to RCV, on a consolidated level, is the highest in the sector. Its debt metrics are also high compared with peers in the European transmission system operator (TSO) sector, which have average debt to regulatory asset base of about 67%.

Chart 3

U.K. water utilities' regulatory capital values and gearing



Source: Ofwat. RCV and gearing as of March 31, 2023.

Table 1

Thames Water Utilities Finance PLC--Peer comparison

Industry sector: Water

	Thames Water Utilities Finance PLC	**Anglian Water Services Financing PLC**	**DWR Cymru (Financing) UK PLC**	**Southern Water Services (Finance) Ltd.**
	--Fiscal year ended March 31, 2023--			
(Mil. £)				
Revenue	2,180.7	1,388.9	843.8	795.4
EBITDA	957.9	664.5	382.6	308.4
Funds from operations (FFO)	(478.2)	(139.9)	(145.4)	(227.3)
Interest expense	912.8	776.4	339.9	311.2
Cash interest paid	240.1	243.0	149.6	122.4
Cash flow from operations	942.0	395.5	244.5	146.8
Capital expenditure	1,390.2	535.2	335.2	640.9
Free operating cash flow (FOCF)	(448.2)	(139.7)	(90.7)	(494.1)
Dividends paid	45.2	169.0	0.0	0.1
Discretionary cash flow (DCF)	(493.4)	(308.7)	(90.7)	(494.2)
Gross available cash	1,829.3	633.1	379.4	115.8
Debt	14,924.4	6,446.3	3,993.5	4,496.8
Preferred stock	0.0	0.0	0.0	64.7
Equity	1,825.1	2,306.2	1,526.7	929.3
Debt and equity	16,749.5	8,752.5	5,520.2	5,426.1
Adjusted ratios				
EBITDA margin (%)	43.9	47.8	45.3	38.8
Return on capital (%)	1.8	3.8	0.7	(0.6)
EBITDA interest coverage (x)	1.0	0.9	1.1	1.0
FFO cash interest coverage (x)	(1.0)	0.4	0.0	(0.9)
Debt/EBITDA (x)	15.6	9.7	10.4	14.6
FFO/debt (%)	(3.2)	(2.2)	(3.6)	(5.1)
Cash flow from operations/debt (%)	6.3	6.1	6.1	3.3
FOCF/debt (%)	(3.0)	(2.2)	(2.3)	(11.0)
DCF/debt (%)	(3.3)	(4.8)	(2.3)	(11.0)
Return on common equity (%)	(13.4)	9.8	(9.4)	34.7
Common dividend payout ratio, unadjusted (%)	(150.2)	63.0	0.0	0.0

N.M.--Not meaningful

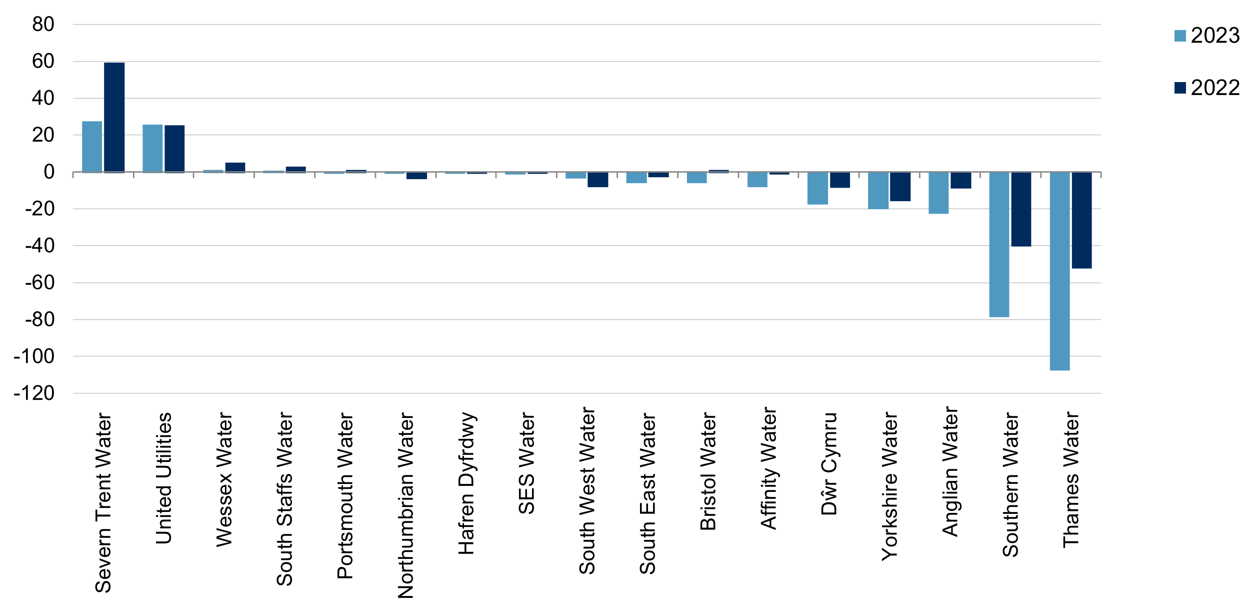
Business Risk

Thames Water benefits from the strong regulatory framework for U.K. utilities, which supports cash flow predictability and stability. Our assessment of Thames Water's business risk as excellent reflects the stable and predictable revenue and cash flow streams from the low-risk regulated water and waste water businesses, the company's natural monopoly position in its service area (Greater London and the Thames Valley), and a generally supportive and transparent regulatory framework. We consider the regulatory framework for the water sector in England and Wales, which is designed and monitored by Ofwat, to be supportive to both credit and the industry, due to its transparency and stability. Revenue is set prospectively for periods of five years, ensuring transparent and predictable earnings and cash flows (see "Why We See The Regulatory Frameworks For U.K. Utilities As Supportive," Sept. 26, 2017, and "European Water Regulatory Frameworks," Feb. 22, 2022). Given Thames Water's status as a natural monopoly within its service area, the regulation aims to protect end-customers.

Thames Water lags peers in operating performance. Although the company benefits from a stable and predictable regulatory framework, its operational performance has been poor and consistently below its peers. That has led to fines from the environment agency and consistent outcome delivery incentive (ODI) penalties. In March 2023, Thames received an ODI penalty of £88.7 million (excluding CMex and DMex) as the company only met 26 out of its 52 performance commitments (PC). Performance commitments are agreed with the regulator through the price review process. Most of the PCs have ODI rewards or penalties tied to them. Customer service measures continue to lag and the company was placed last in the March 2022 league tables.

Chart 4

Outcome delivery incentive (ODI) performance: peer comparison
Fiscal 2022 and fiscal 2023



Source: Ofwat.

Thames Water is two years into its eight-year turnaround plan, which was announced by the company's former CEO, Sarah Bentley, in 2021. This plan targets improved operational performance, especially with regards to customers and environmental issues. We understand the company remains committed to the plan, but in a more focused and targeted form.

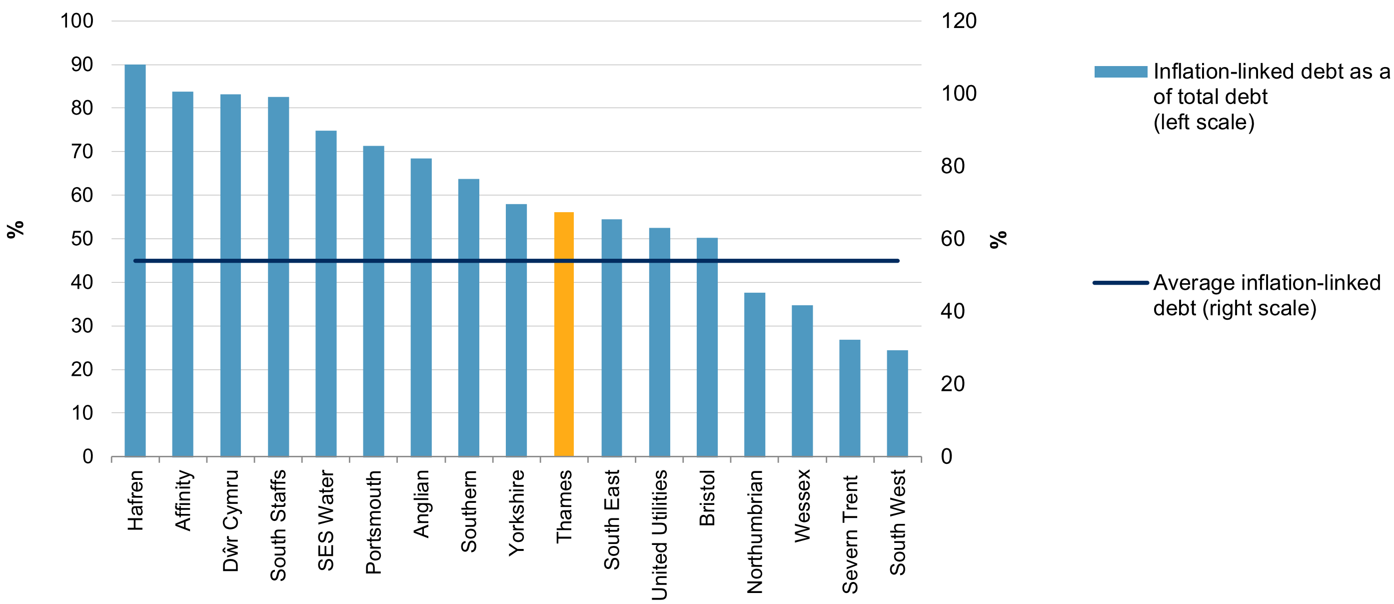
The water sector will likely be required to invest substantial amounts to improve environmental performance during the next regulatory period. The water industry will embark on a new price review (PR24) for the next five-year regulatory period in April 2025 (AMP 8). Ofwat published its final methodology in December 2022, which reiterated its focus on investments to improve water quality and network resilience and reduce the sector's environmental impact. Water companies' "early view" weighted average cost of capital (WACC) of 3.29% for PR24 is higher than the 2.96% used in the prior price review, PR19, the 3.29% will evolve as the cost of debt changes. Ofwat has opted for gearing of 55%, 5% lower than for the current regulatory period. PR24 foresees a significant increase in investments for AMP8, with increasing focus on customer and environmental performance. For the calculation of ODIs, the methodology sets out two to three bespoke performance commitments per company, a reduction from the current AMP's two to five per company. Water companies have until October 2023 to submit their business plans before the draft determination and final decision in 2024.

Financial Risk

Inflation has sharply increased noncash accretion on index-linked debt, which weighs heavily on our calculation of Thames Water's adjusted FFO. High inflation has raised financing costs for the water sector in 2022-2023, particularly for those companies with a large exposure to index-linked debt. About 58% of Thames Water's debt is inflation-linked. In fiscal 2023, the annual accretion amount was £1,178 million, up from roughly £550 million in the previous years. Accretion is the addition to the principal sum that remunerates debt investors for inflation, and is noncash. As a result of the large accretion number, FFO was negative £478 million in March 2023. The steep increase in energy costs, and to a lesser degree rising chemical and employee costs, also weighed on the company's metrics. EBITDA was relatively stable at £957 million compared with £990 million in March 2022. Nonetheless under the regulatory framework, revenue will catch up with inflation, albeit with a significant delay, leading to recovery in credit metrics. For instance, customer bill increases in April 2023 reflected inflation as of November 2022.

Chart 5

U.K. water utilities' inflation-linked debt as a percentage of total debt
As of March 31, 2022



Source: Ofwat.

Possible shareholder injections during the transformation plan will likely fund capex rather than support financial resilience. The consortium of institutional shareholders that owns Thames Water has not taken dividends for the past six years, and we forecast only modest shareholder distribution during the remainder of the regulatory period, while the company focuses on improving its operational performance.

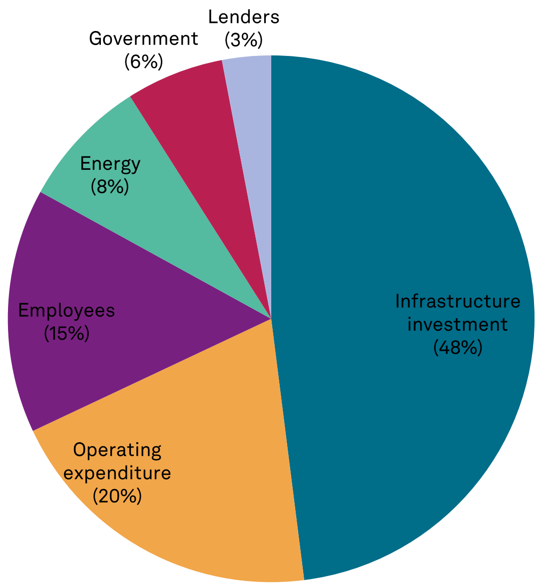
On March 30, 2023, the company received a £500 million equity contribution to fund accelerated improvement in the water networks. The owners intend to provide a further £750 million by the end of this regulatory period which concludes on March 31, 2025. They have also indicated the need for a further £2.5 billion during the next regulatory period spanning until March 31, 2030.

Nonetheless, we expect Thames Water's financial ratios, namely debt to EBITDA and FFO to debt, to continue to be below target until March 2025, absent any further deleveraging initiatives from shareholders.

Despite Thames Water's high leverage, only about 8% of the customer bill goes toward servicing debt. Nearly half of bill proceeds go toward investment (see chart 6) while 3% is earmarked for the construction of the Thames Tideway Tunnel. Customers' bills increased 11.6% from April 1, 2023, representing an increase aligned with inflation.

Chart 6

Thames Water: Composition of customers' bill



Source: Thames Water.

Financial summary

Table 2

Thames Water Utilities Finance PLC--Financial summary

Industry sector: Water

	--Fiscal year ended March 31--					
	2023	**2022**	**2021**	**2020**	**2019**	**2018**
(Mil. £)						
Revenue	2,180.7	2,092.0	2,032.9	2,108.5	2,036.9	2,016.3
EBITDA	957.9	992.5	949.4	1,054.0	969.5	971.6
Funds from operations (FFO)	(478.2)	183.2	652.4	630.8	482.8	410.6
Interest expense	912.8	625.8	464.5	523.0	515.3	565.5
Cash interest paid	(240.1)	278.1	219.2	324.2	379.3	414.3
Cash flow from operations	942.0	801.9	740.1	826.1	717.9	739.0
Capital expenditure	1,390.2	1,228.7	1,035.3	1,126.4	1,079.7	1,062.5
Free operating cash flow (FOCF)	(448.2)	(426.8)	(295.2)	(300.3)	(361.8)	(323.5)
Dividends paid	45.2	37.1	32.9	56.5	60.0	55.0
Discretionary cash flow (DCF)	(493.4)	(463.9)	(328.1)	(356.8)	(421.8)	(378.5)

Table 2

Thames Water Utilities Finance PLC--Financial summary (cont.)

Industry sector: Water

	--Fiscal year ended March 31--					
	2023	**2022**	**2021**	**2020**	**2019**	**2018**
Cash and short-term investments	1,829.3	419.8	490.9	1,055.8	154.4	110.3
Gross available cash	1,829.3	419.8	490.9	1,055.8	154.4	110.3
Debt	14,924.4	13,703.8	12,812.3	12,353.1	12,167.6	11,524.5
Equity	1,825.1	1,830.7	2,794.6	3,147.5	2,787.1	3,147.4
Debt and equity	16,749.5	15,534.5	15,606.9	15,500.6	14,954.7	14,671.9
Adjusted ratios						
EBITDA margin (%)	43.9	47.4	46.7	50.0	47.6	48.2
Return on capital (%)	1.8	2.0	2.2	3.2	2.8	3.1
EBITDA interest coverage (x)	1.0	1.6	2.0	2.0	1.9	1.7
FFO cash interest coverage (x)	(1.0)	1.7	4.0	2.9	2.3	2.0
Debt/EBITDA (x)	15.6	13.8	13.5	11.7	12.6	11.9
FFO/debt (%)	(3.2)	1.3	5.1	5.1	4.0	3.6
Cash flow from operations/debt (%)	6.3	5.9	5.8	6.7	5.9	6.4
FOCF/debt (%)	(3.0)	(3.1)	(2.3)	(2.4)	(3.0)	(2.8)
DCF/debt (%)	(3.3)	(3.4)	(2.6)	(2.9)	(3.5)	(3.3)

N.M.--Not meaningful.

Reconciliation

Table 3

Thames Water Utilities Finance PLC--Reconciliation of reported amounts with S&P Global Ratings' adjusted amounts (Mil. £)

	--Fiscal year ended March 31, 2023--							
Thames Water Utilities Finance PLC reported amounts								
	Debt	**Revenue**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
	15,737.9	2,265.2	1,086.2	356.0	690.9	957.9	1,116.2	1,605.4
S&P Global Ratings' adjustments								
Cash interest paid	--	--	--	--	--	(186.8)	--	--
Cash interest paid: Other	--	--	--	--	--	161.9	--	--
Reported lease liabilities	57.0	--	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	132.6	--	1.5	1.5	6.7	--	--	--
Accessible cash and liquid investments	(1,829.3)	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	215.2	(215.2)	(215.2)	(215.2)
Deconsolidation/consolidation	--	(84.5)	(84.4)	(84.4)	--	(17.8)	(1.8)	--
Nonoperating income (expense)	--	--	--	61.7	--	--	--	--

Table 3

Thames Water Utilities Finance PLC--Reconciliation of reported amounts with S&P Global Ratings' adjusted amounts (Mil. £) (cont.)

	Debt	Revenue	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations	Capital expenditure
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	42.8	--
Debt: Fair value adjustments	831.7	--	--	--	--	--	--	--
Debt: Other (situational)	(5.5)	--	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	3.0	3.0	--	--	--	--
EBITDA: Other income/(expense) (principle based)	--	--	(48.4)	(48.4)	--	--	--	--
Funds from operations: Other (principle based)	--	--	--	--	--	(1,178.2)	--	--
Total adjustments	(813.5)	(84.5)	(128.3)	(66.6)	221.9	(1,436.1)	(174.2)	(215.2)
S&P Global Ratings' adjusted amounts	14,924.4	2,180.7	957.9	289.4	912.8	(478.2)	942.0	1,390.2

Reported debt includes: (1) Unamortised debt issuance costs and discount; (2) Unamortized IFRS 9 transition adjustment.

Liquidity

We assess Thames Water's liquidity position as adequate under our criteria, supported by our view that its liquidity resources will exceed its funding needs by 1.47x in the 12 months from March 31, 2023.

Principal liquidity sources

- Available cash and committed funding of £4.4 billion (excluding the dedicated debt-service reserve and operations and maintenance facility); and
- Cash FFO of about £750 million.

Principal liquidity uses

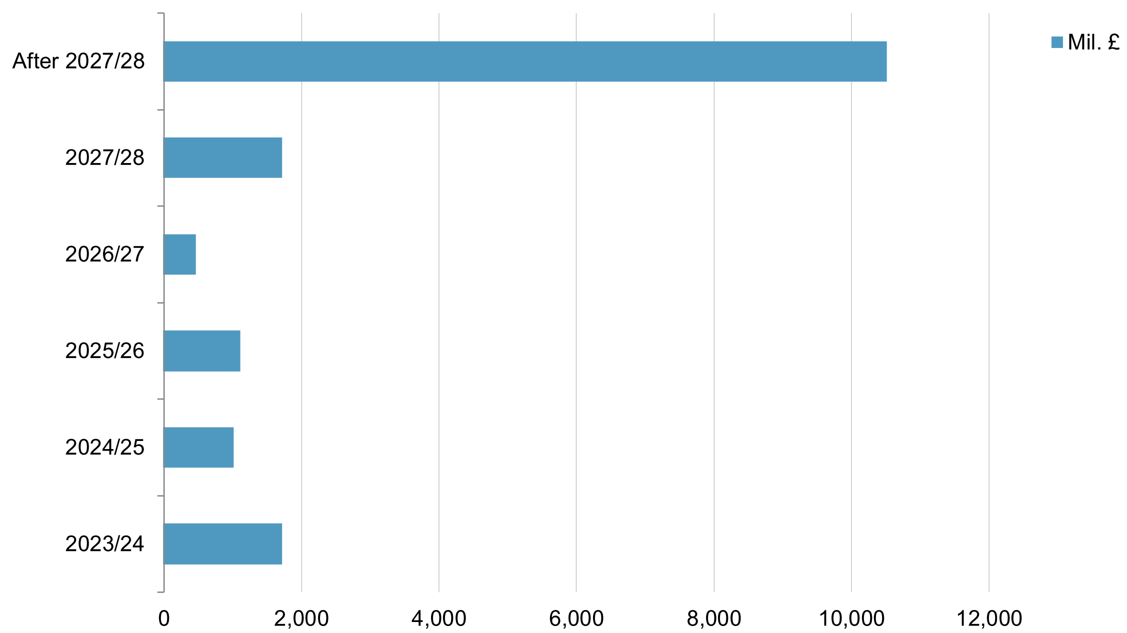
- Upcoming debt maturities of approximately £1.8 billion;
- Expected capex of approximately £1.60 billion; and
- Dividends of approximately £80 million-£100 million to the holding company to pay debt interest.

Debt maturities

Thames Water has a medium-dated maturity profile, with a weighted-average maturity of five years as of March 31, 2022. The total bond debt outstanding is about £13 billion.

Chart 7

Thames Water's debt maturity profile



Source: Thames Water Investor Report 2022/23.

Covenant Analysis

Compliance expectations

Though we forecast that Thames Water will operate relatively close to its financial covenants for the remainder of the regulatory period, we expect that the financing group will remain compliant with its financial covenants.

At the end of the current regulatory period, we expect the class A debt-to-RCV ratio will around 73%, compared with a 75% lock-up level. Consolidated debt to RCV is likely to increase toward 84%, compared with a lock-up threshold of 85% for restricted distribution conditions. The regulatory model allows for RCV growth in line with inflation, which should naturally reduce leverage, all else being equal.

We also expect interest cover ratios will remain above covenant levels.

Requirements

Thames Water needs to comply with a number of covenants. We believe that this benefits the cash flow certainty to senior lenders by limiting distributions and leverage at the operating company while also requiring the maintenance of a liquidity facility to service senior debt in the case of a lock-up. These measures include:

- Restrictions on mergers, acquisitions, and asset disposals, and share pledges in the operating and holding company's assets (to the extent allowed by legislation) and shares;
- Dividend-restricted and debt-restricted payment conditions and dedicated liquidity facilities that should, in our opinion, allow the financing group to manage temporary cash flow shocks; and
- The implementation of an automatic 18-month standstill period after breaching a debt restriction covenant (commonly called event of default). During this period, secured creditors are (with certain limited exceptions) prevented from taking any enforcement action or accelerating liabilities. However, they are allowed to enforce their pledge (subject to a vote by majority of the class A creditors, or class B if no class A debt is outstanding) of 100% of the shares in TWUL held through Thames Water Utilities Holding Ltd. (TWUHL) through a sale. This is in place to reduce the probability of administration.

The financial covenants include:

- A distribution lock-up, which would be triggered if the class A regulated asset-to-debt ratio is greater than 75% and 85% (consolidated) or if drawings under the debt service reserve liquidity or operating and maintenance facilities occur.
- A trigger event is the second early warning to creditors, it occurs when senior RAR is above 90% or class A adjusted ICR is below 1.3x or class A adjusted ICR is below 1.1x. During a trigger event there can be no distributions until the breach is remedied. In additional the company may not incur any additional debt other than drawing on existing bank lines.
- An event of default, if the operating company's senior debt-to-RCV ratio reaches 95% or if the adjusted interest coverage ratio based on consolidated debt is below 1.0x. Once an event of default has occurred, an automatic standstill of claims takes effect, and no enforcement action can be taken by creditors for 18 months.

Table 4

Thames Water (TWUL)--Key covenants

	Trigger events	Events of default	Actual performance March 31, 2021	Actual performance March 31, 2022	Forecast performance March 31, 2023	Forecast performance March 31, 2024	Forecast performance March 31, 2025
Class A debt to RCV (%)			72.5	70.6	68.8	72.5	73.1
Total debt to RCV (%)	90.0	95.0	83.2	80.6	78.7	80.6	84.0
Class A adjusted ICR (x)	1.3	1.0	2.2	2.1	1.6	1.7	1.8
Total debt adjusted ICR (x)	1.1		1.7	1.8	1.3	1.3	1.4

RAR--Regulatory asset ratio. ICR--Interest coverage ratio. Source: Actual and Forecasted Performances from Thames Water Utilities Limited Investor Reports.

Environmental, Social, And Governance

Environmental and governance factors are moderately negative considerations in our credit rating analysis of Thames Water, whose operating performance is below the sector average in certain areas, such as supply interruptions. The large turnover in senior management in recent years leaves uncertainty regarding a continuous and effective strategy for the company. The recently departed CEO had only been at the company since September 2020, while the new co-CEOs, Alastair Cochran and Cathryn Ross, joined the company in September and June 2021, respectively. Improving operating performance is a key priority for the company, which is in the midst of an eight-year transformation plan. Although improvements have been visible in some areas, Thames Water is still failing to meet certain key targets.

Social factors are a moderately negative consideration. As one of the U.K.'s largest water and wastewater network operators, Thames Water provides a key service with a significant social impact. This exposes the company to additional scrutiny from regulators and the government to ensure not only high quality and reliability, but also affordable costs for customers. This scrutiny is evident from the latest price review in April 2020.

Other Credit Considerations

We consider that the class A stand-alone credit profile (SACP) benefits from stronger cash flow coverage ratios (with FFO to debt 30 basis points (bps) to 100 bps higher) for senior debt only, compared with consolidated metrics. This is due to the cushion of subordinated debt and the better positioning of senior creditors in terms of security enforcement and decision-making power. This leads to an uplift to Thames Water's senior SACP.

Structural Features

The financing group operates under financial and nonfinancial covenants that support its overall credit quality. We rate the debt issued by TWUF using our criteria, "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published on Feb. 24, 2016. TWUF issues two types of debt, senior (class A) and subordinated (class B) under a single structural transaction (the transaction). We analyze the company in two steps because we assess the subordinated debt as having a greater risk of default than the senior debt. This is because the subordinated debt would be repaid after the senior debt, has no claim on the security until the senior debt is repaid, and because its default could not cause the senior debt to default.

- We rate the class A debt 'BBB' based on credit metrics that exclude the subordinated debt. We include one notch of uplift for various structural features, in particular the additional protection from the deferral of the interest and principal payments on the subordinated debt if the financing group has insufficient cash to make payments.
- We rate the class B debt 'BB+' based on credit metrics including both the senior and subordinated debt.

Various structural features of the transaction are designed to increase cash flow certainty for debtholders. That includes restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable TWUF to manage temporary cash flow shocks. In particular, debtholders benefit from:

- Ring-fencing of the group--due to TWUF's special-purpose status; some business, legal, and regulatory restrictions; and significant independent representation on the Thames Water Utilities PLC board (five of the 10 members). As per the issuer's website, "The Thames Water Utilities Limited Board is made up of the Chairman, the interim Chief Executive Officer (CEO) and Chief Financial Officer (CFO), and eight Non-Executive Directors, five of whom are independent.;
- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control of TWUF at an early stage of financial or operational difficulty, or following material changes in business circumstances. The covenants minimize the probability of default and create an additional credit cushion;
- Liquidity facilities of £550 million available to cover a standstill. These are provided by suitably rated counterparties and can only be drawn in limited circumstances. These facilities are sufficient to cover finance charges, and dedicated to drawings if the company enters a standstill. The facilities (£330 million in a debt service reserve and £220 million in an operations and capital maintenance reserve) are renewed in August annually and remained undrawn on Dec. 31, 2022; and
- A strong covenant package, 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.

Table 5

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
Restricted distribution conditions	Senior RAR greater than 85%; class A RAR greater than 75%

ICR--Interest cover ratio. RAR--Regulated asset ratio.

Related Criteria

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- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses , Feb. 24, 2016
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- EMEA Utilities Outlook 2023: United Kingdom: Tailwinds For Energy, Cross-Currents For Water, Jan. 24, 2023
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- Northumbrian Water Ltd. And Northumbrian Water Group Ltd. Downgraded To 'BBB' From 'BBB+'; Outlook Stable, Oct. 12, 2022
- Severn Trent Water Ltd. 'BBB+' And Parent Company Severn Trent PLC 'BBB' Ratings Affirmed; Outlook Stable, Sept. 30, 2022
- Outlook On Southern Water Services (Finance)'s Debt Revised To Negative On Inflationary Pressure, Sept. 20, 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, Jul. 1, 2022

Ratings Detail (As Of September 28, 2023)*	
Thames Water Utilities Finance PLC	
Senior Secured	BBB/Watch Neg

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable

Ratings Detail (As Of September 28, 2023)*(cont.)

across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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