

MOODY'S

RATINGS

Rating Action: Moody's Ratings downgrades Thames Water's CFR to Ba2, outlook negative

24 Jul 2024

London, July 24, 2024 -- Moody's Ratings (Moody's) has today downgraded to Ba2 from Baa3 the long-term corporate family rating (CFR) of Thames Water Utilities Ltd. (Thames Water). Concurrently, we assigned a probability of default rating of Ba3-PD. We have also downgraded the backed senior secured debt ratings of Thames Water's guaranteed finance subsidiary Thames Water Utilities Finance Plc (TWUF) to Ba1 from Baa2 and its backed subordinated debt ratings to B3 from Ba3. The outlook on Thames Water and TWUF remains negative.

Today's rating action follows the announcement, on 11 July 2024, by the Water Services Regulation Authority (Ofwat), the economic regulator for water companies in England and Wales, of its draft determination for the five-year regulatory period commencing 1 April 2025 (AMP8). [1] The rating action also reflects Thames Water's results for the financial year ending 31 March 2024, indicating its weakening liquidity position and breach of forecast trigger event financial ratios for March 2025. [2]

A complete list of affected ratings is included at the end of this press release.

RATINGS RATIONALE

In its FY 2023/24 results, Thames Water reiterated that its current liquidity position as at March 2024 (GBP1.3 billion of cash and cash equivalents as well as GBP1.2 billion undrawn amounts available under committed credit facilities, plus GBP550 million dedicated debt service and working capital reserves) continues to support all its ongoing cash outflows, including planned investment, until May 2025. While we believe that the liquidity runway could be extended into Q3 2025 through cost savings or lower investment, the company will need to continue its investment plan to ensure successful delivery of its regulatory requirements for the current period as well as achievement of its ambitious turnaround plan. In the absence of any new equity contributions ahead of an AMP8 final determination, the company may only be able replenish its near-term liquidity through raising additional debt or other liability management. However, Thames Water also forecasts a breach in its trigger event financial ratios, which will require creditor consent for any debt options.

The ability of the company to achieve creditor consent will depend, among other things, on management being able to provide a credible pathway towards raising new equity. In light of a challenging draft determination, as published by Ofwat on 11 July 2024, we see elevated risk that existing or future equity investors may view the proposed risk and return profile as not sufficiently attractive to provide the sizeable equity requirement of at least GBP2.5 billion under Thames Water's current business plan and likely more in the context of the proposed determination.

Financial strategy and risk management is a key consideration under our approach for assessing governance risks under our ESG framework. In light of the company's diminishing financial flexibility we have adjusted downward our view of financial policy and revised our ESG Governance issuer profile score to G-4 from G-3. We have also changed our overall credit impact score to CIS-5 from CIS-3, meaning that the rating is materially lower because of the presence of high environmental (E-4, associated with pollution incidents), social (S-4 due to heightened public and political attention on operational and financial performance) and governance (G-4) risks.

In its July draft determination, Ofwat proposed that Thames Water will be placed under a 'turnaround oversight regime', with enhanced monitoring of detailed delivery plans, particularly related to the improvement of asset health and transformation of its operational performance.

The draft determination includes an allowed return of 3.66% (CPIH-deflated) for the wholesale activities, which is above Ofwat's early view (3.23%) and current allowed returns (2.92%) but below the company's business plan assumptions of 4.25%, on the same basis. Thames Water's business plan was assessed as inadequate, which may result in an additional penalty, equivalent to around GBP141 million (in 2022/23 prices), to be deducted from its opening RCV or AMP8 revenue allowance if not mitigated by its response to the draft determination.

The draft determination poses a sizeable 22% cost challenge (before frontier shift and other adjustments) compared with the company's request for overall total expenditure (totex). Proposed base expenditure is GBP11.7 billion (company's plan: GBP13 billion, including cost adjustment claims) and enhancement expenditure is GBP5.7 billion (company's plan: GBP9.2 billion). According to Ofwat, the estimated 10% base cost efficiency gap reduces to 5% after removing energy costs and business rates, which will be subject to ex-post inflation adjustments and enhanced cost sharing. On enhancement expenditure, the most sizeable adjustments relate to (1) Thames Water's request for additional asset health expenditure, where Ofwat provisionally allowed GBP1 billion (equally split between water and wastewater activities) compared with the company's GBP1.9 billion request (of which GBP1.2 billion had been related to wastewater); and (2) a conditional allowance of GBP944 million (compared with a GBP1.9 billion request) for dedicated investment into storm overflows, phosphorus removal, chemicals and industrial emissions directive requirements. Ofwat states that the company could provide additional evidence on

these, but also highlights overlap with base allowances, which we would consider more akin to a cost efficiency challenge.

The draft determination also includes challenging targets for operational performance, with heightened incentive rates for areas associated with environmental improvement, asset health and customer service. We estimate that this could expose Thames Water to average annual penalties of at least GBP80-90 million (in 2022/23 prices) over AMP8, if targets remain unchanged and the company performs in line with its business plan assumptions. Main areas of penalties are linked to pollution events and sewer flooding. Additional penalties for weak service provision, which amounted to roughly GBP20 million per year during the current period are also likely to continue and would be in addition to the above. Penalties could be materially higher if the company failed to improve its performance from current levels.

Along with the other wastewater companies, Thames Water remains subject to ongoing investigations by Ofwat and the Environment Agency (EA) into wastewater treatment works compliance. Ofwat indicated that it may publicise its findings during summer 2024, while we expect the EA not to opine before 2025. If the company is found to be in breach of its duties, it could receive a fine of up to 10% of wastewater turnover from Ofwat (approximately GBP90 million based on FY 2023/24) and unlimited civil penalties from the EA. Separately, the company faces inquiries on its dividend payments during FY 2023/24, which could lead to regulatory action if the company was found in breach of its licence condition requiring that distributions should, among other things, take account of service delivery over time, reward efficiency and management of risks and not impair the ability to finance the business.

Overall, Thames Water's Ba2 CFR remains supported by the company's position as a monopoly provider of essential water and sewerage services and certain protections within its financing structure, including separate liquidity reserves as well as creditor oversight during a trigger event. The CFR remains constrained by relatively high gearing of currently around 80%, and challenging performance targets, which coupled with a weak performance track record have resulted in sizeable performance penalties that we expect to continue.

Our CFR is one of the ratings that Ofwat monitors for Thames Water's compliance with a minimum investment-grade rating licence requirement. To meet this requirement, a company will need to have at least two investment-grade credit ratings from two separate credit rating agencies (unless Ofwat permits a company to have only one investment-grade credit rating). Being in breach of this requirement could trigger enforcement action by Ofwat, which we would expect to include a remedial plan.

The senior secured Ba1 rating of the Class A bonds issued by Thames Water's finance subsidiary, one notch above the CFR, reflects their senior ranking in the cash waterfall and after any enforcement of security. The B3 rating of the Class B bonds, four notches below the CFR, reflects our expectation of a heightened expected loss

severity for the Class B lenders, given their deeply subordinated position in the cash flow waterfall.

RATING OUTLOOK

Thames Water's outlook remains negative, reflecting the increased likelihood that (1) the final determination expected later this year would deter existing or new shareholders from providing sufficient additional equity during the next regulatory period to allow the company to deliver its investment programme; and (2) in the absence of a pathway to future equity support, existing lenders may be reluctant to provide the company with the required flexibility to improve its immediate liquidity runway by raising new debt.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Given the negative outlook, we currently do not envisage upward pressure on Thames Water's ratings. Upward pressure could nonetheless arise if there was a substantial deleveraging, most likely as a result of a significant equity injection, accompanied by improvement of operational performance.

Thames Water's ratings could be downgraded further if the company faced difficulties in replenishing its forward-looking liquidity and a credible pathway to new equity funding cannot be generated over the coming months.

LIST OF AFFECTED RATINGS

..Issuer: Thames Water Utilities Ltd.

Downgrades:

....LT Corporate Family Rating (Domestic), Downgraded to Ba2 from Baa3

Assignments:

....Probability of Default Rating, Assigned Ba3-PD

Outlook Actions:

....Outlook, Remains Negative

..Issuer: Thames Water Utilities Finance Plc

Downgrades:

....Backed Subordinate Medium-Term Note Program (Domestic), Downgraded to (P)B3 from (P)Ba3

...Backed Senior Secured Medium-Term Note Program (Domestic), Downgraded to (P)Ba1 from (P)Baa2

...Backed Subordinate Regular Bond/Debenture (Domestic), Downgraded to B3 from Ba3

...Backed Senior Secured Regular Bond/Debenture (Domestic), Downgraded to Ba1 from Baa2

...Backed Senior Secured Regular Bond/Debenture (Foreign), Downgraded to Ba1 from Baa2

Outlook Actions:

...Outlook, Remains Negative

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Regulated Water Utilities published in August 2023 and available at <https://ratings.moodys.com/rmc-documents/406788>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

Thames Water is the largest of the ten main water and sewerage companies in England and Wales by both RCV (GBP20 billion at March 2024) and number of customers served. The company provides drinking water to around nine million customers and sewerage services to around 15 million customers in London and the Thames Valley.

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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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

At least one ESG consideration was material to the credit rating action(s) announced and described above. 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_1355824.

The Global Scale Credit Rating(s) discussed in this Credit Rating Announcement was(were) issued by one of Moody's affiliates outside the EU and is(are) endorsed for use in the EU in accordance with the EU CRA Regulation.

REFERENCES/CITATIONS

[1] <https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/draft-determinations/>

[2] <https://www.thameswater.co.uk/media-library/home/about-us/investors/our-results/2024-reports/thames-water-annual-report-2023-24.pdf>

Please see <https://ratings.moodys.com> for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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