MOODY'S RATINGS

CREDIT OPINION

8 October 2024

Update

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RATINGS

**Thames Water Utilities Ltd.**

| | |
|---|---|
| Domicile | United Kingdom |
| Long Term Rating | Caa1 |
| Type | LT Corporate Family Ratings - 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 Utilities Ltd.

## Update following downgrade to Caa1 negative

## Summary


The credit profile of Thames Water Utilities Ltd. (Thames Water, CFR Caa1 negative) reflects the company's weak liquidity position and our view that this will likely lead in the near term to a distressed exchange, where creditors agree to some form of amendment or extension of credit terms that results in a loss, or a loss is otherwise imposed on them, relative to the original promise to pay. A distressed exchange of this type constitutes a default by Moody's definition.

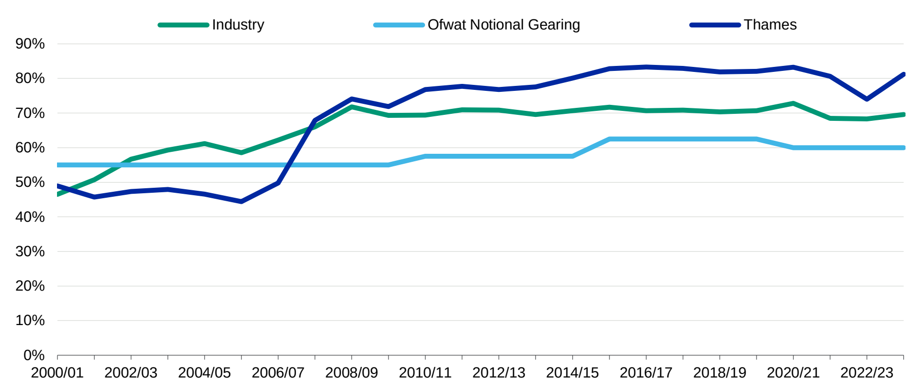
A tough draft determination for the five-year regulatory period commencing 1 April 2025 (AMP8) as well as continuing heightened public, political and regulatory scrutiny will hinder the required new equity funding and create uncertainty about long-term financeability. Any near-term liquidity provisions may include requirements to amend existing debt terms or extend maturities, which could result in a loss to creditors. In the medium term, inability to attract new equity funding may ultimately lead to a creditor-led debt restructuring or one that is imposed as part of a special administration process, should the company meet the criteria for special administration to be called.

Thames Water's business risk profile remains supported by its position as monopoly provider of essential water and sewerage services. Lenders also benefit from certain protections within its financing structure, including separate liquidity reserves as well as creditor oversight during a trigger event or event of default under its finance documents. However, relatively high leverage compared with peers left the company with limited financial flexibility to address its weak operational performance, and a tougher regulatory approach leading to sizeable penalties as well as closer oversight on distributions has led to a loss of investor confidence.


Exhibit 1

**Thames Water's gearing remains above the sector average and regulatory assumptions**

**Regulatory gearing as reported to Ofwat**




*Source: Companies' annual performance reports, Ofwat*

## Credit strengths

» Monopoly position for the provision of water and wastewater services in London and the Thames Valley

» Debt structural features, including distribution lock-up covenants, dedicated liquidity, and intercreditor and security arrangements, which provide some, albeit limited, creditor protection

## Credit challenges

» Weakening liquidity profile and heightened risk of distressed exchange in the coming months

» Challenging draft determination and continuing heightened public, political and regulatory scrutiny may deter existing and new investors from providing new equity

» Track record of weak operating performance, which coupled with more demanding targets has led to increasing penalties, which we expect to continue into AMP8

» Relatively high financial leverage, which constrains financial flexibility

## Rating outlook

Thames Water's outlook remains negative, reflecting the risk that any potential creditor loss following a default may be higher than embedded in current ratings.

## Factors that could lead to an upgrade

An upgrade of the ratings is unlikely in the near term. However, upward pressure could arise in the medium to long term if there was a substantial deleveraging, either as a result of a significant equity injection or following a debt restructuring process.

## Factors that could lead to a downgrade

Thames Water's ratings, specifically its CFR or senior secured Class A debt ratings, could be downgraded further if creditors incurred more significant losses than embedded within current ratings.

## Key indicators

Exhibit 2

**Thames Water Utilities Ltd.**

| | Mar-20 | Mar-21 | Mar-22 | Mar-23 | Mar-24 | Mar-25 E |
|---|---|---|---|---|---|---|
| Adjusted Interest Coverage Ratio | 1.5x | 1.1x | 0.7x | 0.5x | 0.6x | 0.6x-0.9x |
| Net Debt / Regulated Asset Base | 86.3% | 83.7% | 82.7% | 79.1% | 82.9% | 85-90% |
| FFO / Net Debt | 6.0% | 6.0% | 4.6% | 3.8% | 4.3% | 4%-5% |
| RCF / Net Debt | 5.6% | 5.7% | 4.3% | 3.5% | 3.1% | 4%-5% |

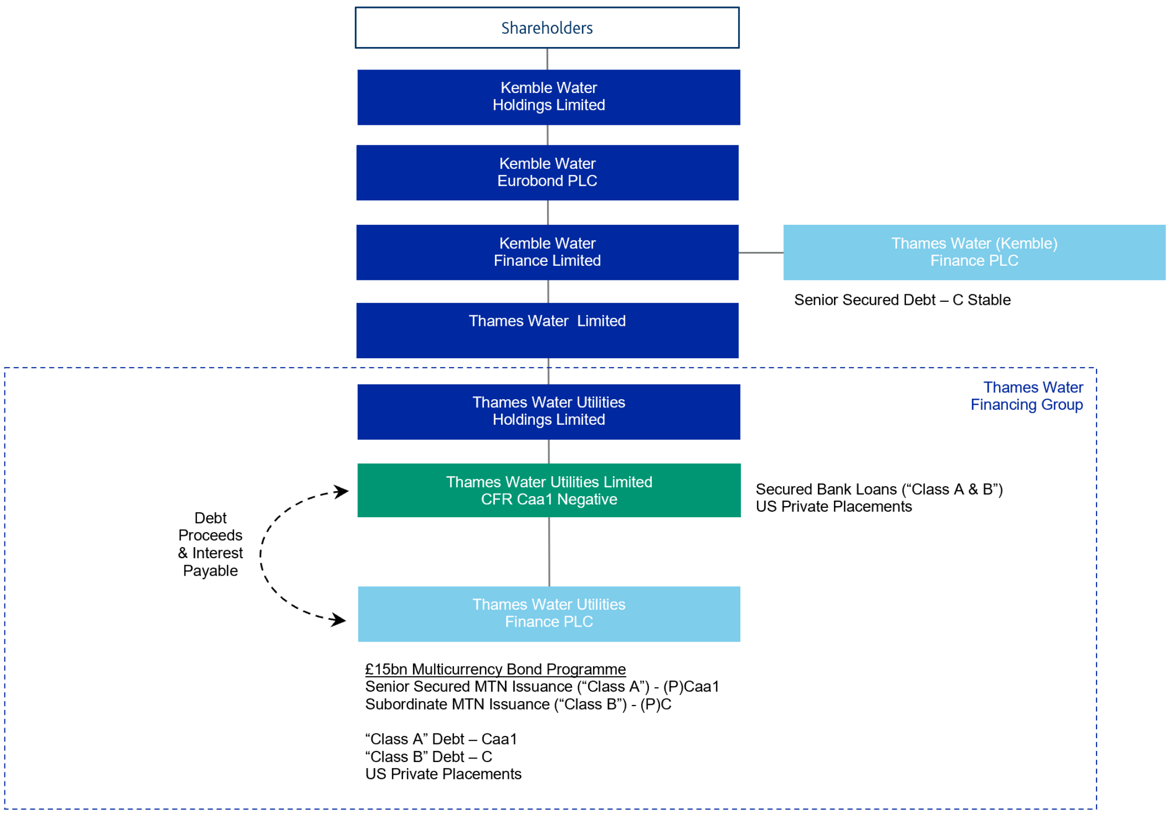
All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. We note that the company includes income from grants and contributions to support new network connections within revenues and operating cash flow. From FYE March 2021, we remove this income from FFO and offset against capex; otherwise the company's AICR would be up to 0.2x higher. Moody's forecasts are Moody's opinion and do not represent the views of the issuer. For definitions of Moody's most common ratio terms, please see the accompanying User's Guide.
*Source: Moody's Financial Metrics™ and Moody's Ratings forecast*

## Profile

Thames Water is the largest of the 10 water and sewerage companies in England and Wales by both RCV 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. It is the primary operating subsidiary of Thames Water Limited, which is in turn owned by Kemble Water Finance Limited (Kemble, the financing subsidiary of which is Thames Water (Kemble) Finance PLC, senior secured C, stable).

Since May 2017, the largest shareholders of Kemble are the Ontario Municipal Employees Retirement System (31.8%) and the Universities Superannuation Scheme (19.7%).

Exhibit 3
**Simplified group structure**




*Source: Company website, Moody's Ratings*

## Recent developments

On 20 September 2024, Thames Water announced that, as at 31 August 2024, it had £1.57 billion of liquidity consisting of £1.15 billion of cash and cash equivalents (including dedicated reserves of £0.38 billion) and £0.42 billion of Class A and Class B undrawn committed facilities. The company's announcement indicates that the company will run out of cash by December 2024 unless it utilises its reserves with creditor consent, rather than the company's previously stated liquidity runway to May 2025.

The dedicated cash reserves are maintained to facilitate forecast debt service related to interest payments as well as an element of operating and maintenance expenditure over a 12 months forward-looking period. Drawing on these facilities, if not replenished once drawn, would trigger an event of default under the company's debt documentation. Thames Water stated in its announcement that it remains in discussion with creditors to release these cash reserves, likely requiring a waiver of the event of default that would otherwise result.

Remaining undrawn revolving facilities can be drawn while the company remains subject to a trigger event, as is currently the case due to its breach of minimum rating requirements as well as forecast trigger event ratio thresholds. However, these would no longer be available during an event of default.

Thames Water has a further £0.55 billion of undrawn reserve liquidity facilities, which are available during an event of default and resulting standstill under the finance documents.

According to Thames Water's announcement, current cash reserves, including from drawn facilities, would be used up by December 2024, if neither of the dedicated reserves or undrawn amounts under revolving credit facilities can be drawn. Extending the liquidity runway to May 2025, the company's previously stated period to which liquidity was available, effectively requires the use of all emergency reserves.

The company, along with its peers, is currently subject to a regulatory price review, which will set cost allowances, returns and bills for the next five-year regulatory period starting on 1 April 2025. It is also expecting to launch a formal equity solicitation process in the coming weeks, to attract new equity funding of at least £3.25 billion. We believe that new equity funding is unlikely to be provided before a final regulatory determination is received. Ofwat, the economic regulator for water and wastewater companies in England and Wales, is expected to publish its final tariff settlement in December 2024 or January 2025. However, Thames Water will have the option to appeal this decision and a re-determination by the Competition and Markets Authority could delay a final settlement well into the second half of 2025 or beyond.

Given the worsening liquidity situation and a potentially lengthy process to attract new equity funding, we believe that a distressed exchange over the coming months is now a highly likely scenario. This could initially take the form of amending and extending existing terms of outstanding debt.

In addition, a final determination that does not move materially from a tough draft regulatory determination may not provide an attractive risk-return balance for existing or new investors. Inability to attract new equity funding may ultimately lead to a creditor-led debt restructuring or one that is imposed as part of a special administration process, should the company meet the criteria for special administration to be called.

As a consequence of the heightened risk of potential creditor losses, on 25 September 2024, we downgraded Thames Water's CFR to Caa1 from Ba2. This followed a previous downgrade, on 24 July 2024, to Ba2 from Baa3, after the company received a tough draft determination, which we viewed as potentially deterring new investors, and a tightening liquidity position, as indicated in Thames Water's results for the financial year ending 31 March 2024.

Our CFR falls under the definition of "issuer credit rating" 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). Following the initial downgrade below investment-grade territory, Ofwat agreed certain steps with the company that would allow remediation, including (1) appointment of an independent monitor to report back to the regulator on the company's progress, including against its transformation plan; (2) development and delivery of an achievable turnaround plan; (3) taking steps to deliver an equity raise; and (4) appoint new non-executive board members.

## Detailed credit considerations

### Transparent regulatory regime, but challenging draft determination and tighter regulatory oversight for AMP8

The UK water sector benefits from a transparent regulatory regime administered by economic regulator Ofwat.

On 11 July 2024, Ofwat published its draft determination for Thames Water and proposed that the company would 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. Thames Water will only be allowed to exit if it (1) achieves a sustained improvement in its performance; (2) can secure the delivery of its capital programme in line with obligations; and (3) creates a capital structure that ensures adequate financial resilience over the medium term. According to Ofwat, the latter could be achieved by "commitments to include a future gearing cap in its licence, the establishment of an equity exchange listing for substantial equity in the company structure or the separation of the company into two or more separately licensed entities."[1] Ofwat is considering a gearing cap of 70% for companies with identified concerns around long-term financial stability, including Thames Water, but may also introduce this for the sector as a whole.

The draft determination also 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. In its representation to the draft determination, published in August 2024, Thames Water indicated an updated range for the allowed return between 4.01-4.69%, with a point estimate of 4.60%.

Exhibit 4
**Evolution of allowed returns**

| | Ofwat PR04 | Ofwat PR09 | Ofwat PR14 | Ofwat PR19 | CMA PR19 | Ofwat PR24 Methodology | Ofwat PR24 DD |
|---|---|---|---|---|---|---|---|
| | | | | | WaSCs | September 2022 cut off | March 2024 cut-off |
| | RPI-based | RPI-based | RPI-based | CPIH-based | CPIH-based | CPIH-based | CPIH-based |
| **Notional gearing** | **55.0%** | **57.5%** | **62.5%** | **60.0%** | **60.0%** | **55.0%** | **55.0%** |
| Existing debt | | 3.40% | 2.65% | 2.42% | 2.47% | 2.34% | 2.46% |
| New debt | | 4.20% | 2.00% | 0.53% | 0.19% | 3.28% | 3.36% |
| Existing: new debt ratio | | 75% | 75% | 80% | 83% | 83% | 74% |
| Explicit debt issuance cost | | | 0.10% | 0.10% | 0.10% | 0.10% | 0.15% |
| **Cost of debt (pre-tax)** | **4.3%** | **3.60%** | **2.59%** | **2.14%** | **2.18%** | **2.60%** | **2.84%** |
| Risk-free rate | 2.5-3.0% | 2.0% | 1.25% | -1.39% | -1.34% | 0.47% | 1.43% |
| Equity risk premium | 4.0-5.0% | 5.4% | 5.50% | 7.89% | 8.15% | 5.99% | 5.15% |
| Total market return | 6.5-8.0% | 7.4% | 6.75% | 6.50% | 6.81% | 6.46% | 6.58% |
| Equity beta | 1.00 | 0.90 | 0.80 | 0.71 | 0.71 | 0.61 | 0.60 |
| Point estimate above mid-point | | | | | 0.25% | | 0.26% |
| **Cost of equity (post-tax)** | **7.7%** | **7.1%** | **5.65%** | **4.19%** | **4.73%** | **4.14%** | **4.80%** |
| **Vanilla WACC (appointee)** | **5.8%** | **5.1%** | **3.74%** | **2.96%** | **3.20%** | **3.29%** | **3.72%** |
| Retail Margin | n/a | n/a | 0.14% | 0.04% | 0.08% | 0.06% | 0.06% |
| **Wholesale WACC** | **n/a** | **n/a** | **3.60%** | **2.92%** | **3.12%** | **3.23%** | **3.66%** |
| Wholesale WACC Differential CPIH - Ofwat PR19 | | | | | | 0.30% | 0.74% |
| Wholesale WACC Differential CPIH - CMA PR19 | | | | | | 0.10% | 0.54% |

*Source: Ofwat, CMA*

Thames Water's business plan was assessed as inadequate, which may result in an additional penalty, equivalent to around £141 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 also poses a sizeable cost efficiency challenge and includes tighter performance commitments and increased incentive rates, which significantly heightens the risk of performance penalties across the sector.

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. Future dividend payments are now blocked as the company is in breach of trigger event financial ratios as well as rating triggers under its finance documentation and licence.

## High leverage and growing interest burden constrains credit quality

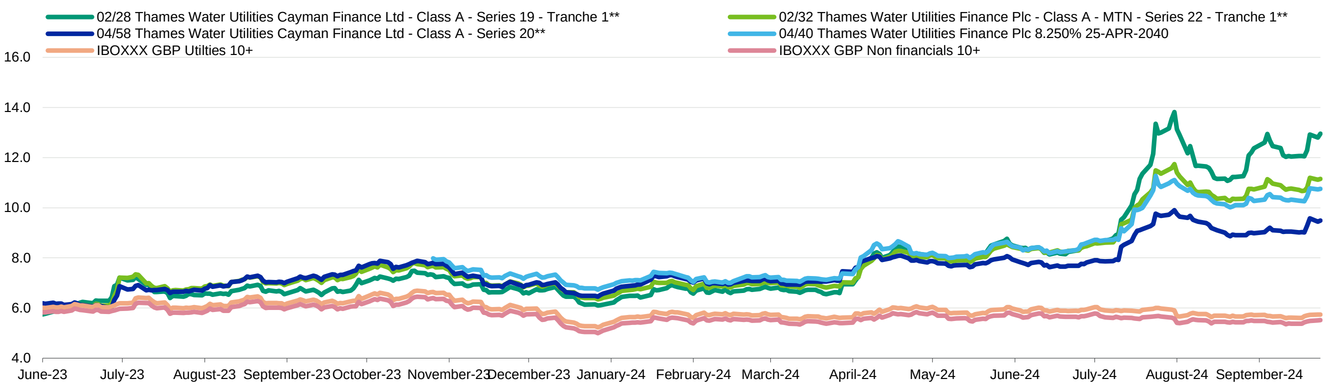
Thames Water's credit quality is constrained by its relatively high debt burden. While management had committed to reduce leverage at the operating company over AMP7, a growing investment programme will lead to gearing to rise towards 86-87% by the end of the period. Although the receipt of a £500 million equity injection in March 2023 temporarily reduced gearing to below 80%, failure to raise the remaining £750 million of equity previously envisaged to support an ongoing turnaround plan will lead to the forecast covenant breach by March 2025.

Despite high leverage, Thames Water historically carried relatively competitive cash cost of debt (3.0% at March 2024, broadly in line with the sector average). However, since the resignation of its previous CEO last summer, the company has incurred a sizeable debt premium compared with peers, which has been exacerbated by the delay in equity injections into the operating company and subsequent event of default at its holding company. While water companies will receive a positive adjustment for rising interest rates at the next price review, because the cost of new debt assumed to be raised within the current period had been linked to the average A/BBB IBoxx indices, this will not capture the company-specific risk premium attributed to Thames Water. A longer term issuer-specific premium will weigh on future interest coverage, given the sizeable refinancing as well as investment needs over the coming AMP8 period. Based on its recent draft determination, we estimate that Thames Water may have to raise in excess of £10 billion over the AMP8 period, roughly equally split between new debt and refinancing.

Exhibit 5

**Thames Water's bond yields continue to widen, with a substantial increase visible post FY2023/24 results and draft determination announcements**

**Yield to maturity on selected bonds and iBoxx**




*Source: Factset*

Thames Water also carries a high proportion of inflation-linked debt, with around 55-60% of its debt linked to RPI inflation.[2] A portion of Thames Water's RPI-linked debt is synthetically created through derivatives. At March 2024, derivatives with a notional amount of £4.6 billion were linked to RPI, of which £594 million notional is subject to five-year accretion pay-down and a further £940 million notional is contracted for a short period of five years to 2024.

Accretion on the inflation-linked swaps has increased significantly with higher inflation. This has weakened the company's AICR, because we include accretion under swaps with frequent pay-down requirement or short maturities as interest expense for the purpose of calculating this ratio. Subject to the company being able to raise the required new debt and equity funding, we expect the ratio to strengthen somewhat over AMP8, but remain pressured by the likelihood of ongoing performance penalties.

## Weak performance and challenging targets will likely continue to lead to penalties in AMP8

Thames Water incurred performance penalties of around £178 million (in 2017/18 prices), which are cash effective during the current regulatory period. However, performance over the last two years of AMP7 will also feed into AMP8 revenue allowances. The company reported £39 million (in 2017/18 prices) of penalties in FY2023/24 (plus £11 million deferred into the RCV), excluding customer service penalties, which over the prior three years accounted for £18 million p.a. on average (in 2017/18 prices).

Performance areas with the largest contribution to penalties include supply interruptions, leakage, pollution and internal sewer flooding, with penalties exacerbated by more extreme weather events.

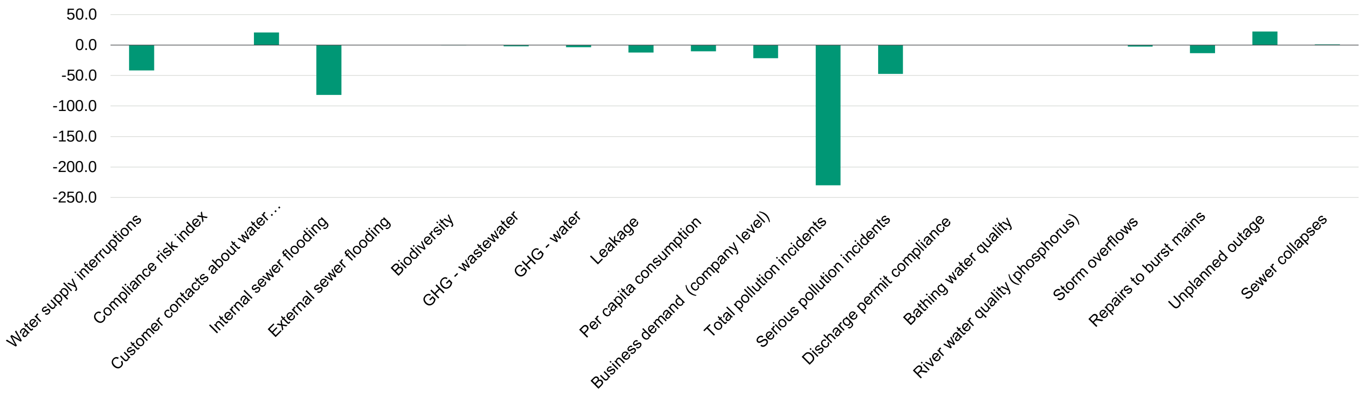
Ofwat's draft determination for AMP8 includes 24 common performance commitments, which apply to all companies. In addition, Thames Water has a bespoke commitment associated with collaborative streetworks in its service area. Performance targets have generally been set more stretching than companies' proposals and incentive rates have been widened, particularly for common environmental and asset health performance commitments as well as customer service.

For Thames Water, we expect this to lead to annual average penalties of at least £80-90 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 £20 million per year during the current period are also likely to continue and would be in addition to the above.

Exhibit 6

**Expected total forecast ODI penalties over AMP8, if draft determination is confirmed and company performs in line with business plan assumptions**

**Amounts in £ millions (in 2022/23 prices)**




Common ODIs, but excluding external sewer flooding incidents and customer, developer of business/retail service measures. There is an aggregate sharing mechanism, whereby incentive impact of more than +/-3%points on RORE is shared 50% with customers and more than 5%points is shared 90%.
*Source: Ofwat draft determinations*

The penalties could increase significantly, if the company's performance remains in line with current levels. In addition, targets for external sewer flooding have been set at industry leading levels, previously reported by Thames Water. However, the company has since revised its reporting, suggesting its performance could be worse going forward. If the current target remains unchanged and Thames Water performs in line with its revised expectation included in its business plan, this performance commitment alone could generate penalties in excess of £200 million per year. However, the target level for external sewer flooding could be revised subject to additional evidence provided by the company.

## Thames Water faces ongoing totex efficiency challenge into AMP8

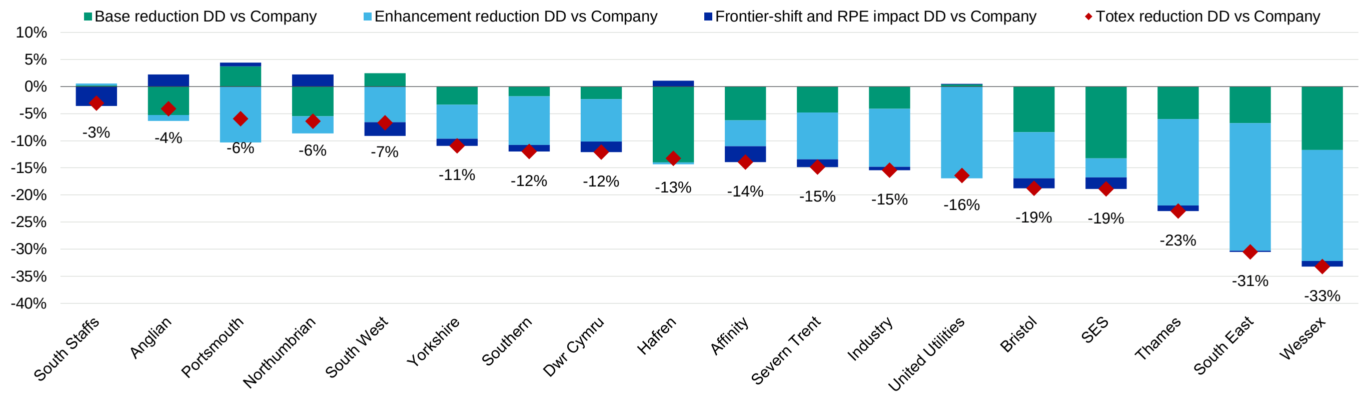
For AMP7, Ofwat's allowance for base operating and maintenance expenditure, excluding enhancement projects and costs associated with the Thames Tideway Tunnel but including retail costs, was £8.5 billion. This was roughly £400 million more than the company requested in its alternative, scaled-back investment plan following draft determinations but £600 million less than proposed in its April 2019 business plan (all amounts in 2017/18 prices).

In June 2022, Thames Water announced a £2 billion increase in its investment programme with an updated business plan including total expenditure of £11.5 billion over AMP7 (in outturn prices). This plan, aiming to facilitate a turnaround in operational performance, was closer to the company's original PR19 business plan submission. The additional investment was meant to be supported by up to £1.25 billion shareholder equity. An amount of £500 million was received in March 2023 via (partial) repayment of intercompany loans by one of its holding companies (Thames Water Utilities Holdings Limited) to the operating company.[3] Shareholders had agreed to provide a further £750 million over the remainder of the current AMP7 regulatory price control period which runs to March 2025 but subject to conditions that included “appropriate regulatory arrangements”.[4] However, any additional equity contribution will now not be forthcoming ahead of the final AMP8 determination.

Thames Water's AMP8 business plan submission in October 2023 also included further indicative shareholder support of around £2.5 billion over the next regulatory period, with final amounts dependent upon Ofwat's final determination. Based on Ofwat's draft determination we believe that achieving new equity commitment is highly uncertain.

The draft determination poses a sizeable 22% cost challenge compared with the company’s ask for overall total expenditure (totex) before adjustments for frontier shift efficiency (proposed at 1% p.a.) and costs that will be subject to real price effects true-up (such as energy as part of base costs and plant and equipment as part of enhancement costs). This is at the higher end of the sector.

Exhibit 7
**Thames Water faces one of the largest cost challenge under Ofwat's draft determination (DD)**
**Proposed cost reduction as % of requested amount**




Efficiency challenge calculated as cost difference between draft determination and company's plan divided by company's plan costs.
*Source: Ofwat's draft determinations*

Proposed base expenditure is £11.7 billion (against the company's plan of £13 billion, including cost adjustment claims) and enhancement expenditure is £5.7 billion (company's plan: £9.2 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. However, initial cost allowances may not reflect current cost expectations and any true-up will only be applied at the end of the AMP8 period. This means that companies will have to fund any interim increase in costs, which would weaken in-period financial metrics.

On enhancement expenditure, the most sizeable adjustments relate to (1) Thames Water's request for additional asset health expenditure, where Ofwat provisionally allowed £1 billion (equally split between water and wastewater activities) compared with the company's £1.9 billion request (of which £1.2 billion had been related to wastewater); and (2) a conditional allowance of £944 million (compared with a £1.9 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.

Exhibit 8

**Totex allowance per Ofwat's draft determination (DD) compared with company's business plan (BP) suggests sizeable efficiency challenge**

| | Challenge | BP | PR24 DD | Difference | % |
|---|---|---|---|---|---|
| **Base** | | | | | |
| Modelled | Efficiency | 11,485 | 10,402 | -1,083 | -9% |
| Unmodelled | Efficiency | 1,555 | 1,304 | -251 | -16% |
| **Total base** | | **13,040** | **11,706** | **-1,334** | **-10%** |
| | | | | | |
| **Water enhancement** | | | | | |
| Supply-demand | Efficiency | 466 | 482 | 16 | 3% |
| Metering | Efficiency | 257 | 187 | -70 | -27% |
| Drinking water quality | Efficiency | 273 | 260 | -13 | -5% |
| Resilience | Efficiency | 1,024 | 995 | -29 | -3% |
| Water WINEP | Efficiency | 151 | 81 | -70 | -46% |
| Other | Evidence/Scope | 952 | 598 | -354 | -37% |
| **Total** | | **3,123** | **2,602** | **-521** | **-17%** |
| | | | | | |
| **Wastewater enhancment** | | | | | |
| Nutrients | Efficiency | 1,532 | 988 | -544 | -36% |
| Storm overflows | Efficiency | 907 | 560 | -347 | -38% |
| Other WINEP | Efficiency | 453 | 319 | -134 | -30% |
| Resilience | Efficiency | 81 | 30 | -51 | -63% |
| Other | Evidence/Scope | 3,147 | 1,193 | -1,954 | -62% |
| **Total** | | **6,122** | **3,091** | **-3,031** | **-50%** |
| | | | | | |
| **Total enhancement** | | **9,245** | **5,693** | **-3,552** | **-38%** |
| | | | | | |
| **Overall totex challenge** | | **22,285** | **17,399** | **-4,886** | **-22%** |
| Estimated efficiency challenge | | | | -2,576 | -12% |
| Additional challenge subject to evidence/scope | | | | -2,308 | -10% |
| | | | | | |
| Frontier shift and RPE | | -295 | -526 | -231 | -1% |
| **Overall totex challenge post frontier shift** | | **21,990** | **16,873** | **-5,117** | **-23%** |

*Source: Ofwat's draft determination*

Aside from a special delivery mechanism for the above discussed £944 million, around £643 million of large enhancement schemes and £167 million related to strategic resource options will follow a gated approval process and £141 million are subject to increased engagement. Gated investments may not be included in upfront allowances but reflected via an end-of-period true-up adjustment. The company would, therefore, have to pre-fund such capital spending over the AMP8 period before being remunerated for this investment from AMP9. However, these specified larger schemes will benefit from better sharing rates for cost overruns, such that companies only bear 25% of any overspend (compared with 40% on other enhancement expenditure). More generally, Ofwat provided more favorable cost sharing rates on base allowances, which would allow Thames Water to recover 40% of any overspend, compared with 25% during the current period. Importantly, the higher sharing rate would already apply for FY 2024/25.

During AMP7, Thames Water already received conditional cost allowances, related to London water network improvements (roughly £300 million gated allowances, in 2017/18 prices) and London water system supply resilience (£180 million, in 2017/18 prices). The first element was unlocked in May 2023 and topped up with £400 million shareholder support. We understand that Ofwat will review overall AMP7 delivery against these amounts and return any unused amounts to customers. The second element will now not be spend during AMP8 and the £180 million conditional allowance returned to customers as part of the PR24 true-up adjustments. However, Ofwat ultimately allowed £417 million (in 2017/18 prices), with the majority to be spend as part of the AMP8 enhancement allowance.

In its representation to Ofwat's draft determination, Thames Water included additional total expenditure of over £2 billion compared with its original business plan. This includes £1.2 billion of additions to base costs (£0.9 billion on capital maintenance, £0.1 billion on mains renewal and £0.1 billion on retail related to bad debt) and smaller adjustments to enhancement spending. Compared with the draft determination's £1.9 million of funds under delivery schemes, the company's representation requests £1.3 billion of investments under a gated approach and £1.7 billion under a specified delivery mechanism.

### Ongoing pollution investigations pose risk of material fines

In November 2021, the UK government's Environment Agency (EA) and Ofwat launched parallel investigations into more than 2,000 sewage treatment works across all wastewater companies in England, “after new checks led to water companies admitting that they could be releasing unpermitted sewage discharges into rivers and watercourses.” In November 2022, Ofwat confirmed that it had opened enforcement cases against six companies and, on 16 July 2024, announced that all 11 wastewater companies in England and Wales are now under open enforcement.[5]

In December 2023, the regulator notified Thames Water of its provisional findings, and, on 6 August 2028, published its draft conclusions to impose financial penalties of around 9% of wastewater turnover or ca. £104 million.[6]

If confirmed as fines, the amount will have to be paid into HM Treasury's Consolidated Fund and would either have to be funded from shareholder equity or will otherwise eat into the companies' cash reserves and increase net debt. The regulator may consider a company-proposed alternative regulatory settlement instead of a financial penalty payment, including compensation to customers (via bill reductions) or remediation of failure, if appropriate. Nevertheless, the penalties are a reflection of heightened regulatory scrutiny, which increases the risk of cash flow volatility for the sector.

In addition to Ofwat's investigation, all wastewater companies operating in England are also subject to a parallel investigation by the Environment Agency (EA). We do not expect the EA to conclude its investigation before 2025, but its fines follow sentencing guidelines[7] and are unlimited, particularly for repeat or deliberate offenders.

Following changes to the definition of serious pollution incidents, Thames Water's environmental performance assessment dropped from 3 to 2 stars (defined as requiring improvement) in 2021 and remained at the same level in 2022 and 2023. The company reported 14 serious pollution incidents in 2023 (out of 47 for the English water companies), slightly down from 17 in 2022 (44 for the sector).

## ESG considerations

### Thames Water Utilities Ltd.'s ESG credit impact score is CIS-5

Exhibit 9

**ESG credit impact score**

**CIS-5**


ESG considerations have a pronounced impact on the current rating, which is lower than it would have been if ESG risks did not exist. The negative impact of ESG considerations on the rating is higher than for an issuer scored CIS-4.

*Source: Moody's Ratings*

The **CIS-5** ESG Credit Impact Score for Thames Water Utilities Limited indicates that the company's rating is lower than it would have been if ESG risk exposures did not exist and that the negative impact is more pronounced than for issuers scored CIS-4. This reflects high environmental, social and very high governance risk exposure. The regulated nature of water companies' activities and their investment requirements includes a forward-looking allowance for efficient cost. However, Thames Water is considered less efficient than many peers and also needs to significantly improve its performance. The company has been in the public and political spotlight, which may deter investors and adversely affect its ability to fund its growing investment programme. Given the company's tight liquidity, a distressed exchange is likely.

Exhibit 10
**ESG issuer profile scores**


*Source: Moody's Ratings*

### Environmental

Thames Water's **E-4** score primarily reflects the company's high risk exposure to water management and natural capital, which both take into account the effects of water pollution, and moderate exposure associated with physical climate risks, including climate change-related drought or flooding incidents. According to an analysis by the UK government's Environment Agency (EA), the southeast of England, which includes the service area of Thames Water, will require additional supply of 1,765 million litres a day by 2050, more than a third of current overall annual distribution input at just over 5,000 million litres per day for the region, to offset additional challenges from population growth and climate change as well as increase drought resilience. As a wastewater company, Thames Water is also exposed to the risk of pollution and associated fines. In November 2021, the UK government's Environment Agency and water regulator Ofwat launched investigations into wastewater treatment works, with companies more at risk of greater penalties than in the past. In August 2024, Ofwat issued Thames Water with a draft fine of £104 million or 9% of relevant turnover.

### Social

Thames Water's **S-4** score reflects elevated risk that public concern over environmental, social or affordability issues could lead to adverse regulatory or political intervention. While the risk is common to all regulated utilities, it is particularly acute for UK water companies, with public perception at an all-time low and heightened scrutiny over operational performance and dividend payments. Materially growing investment requirements to improve environmental performance and increase drought resilience will require bills to rise, exacerbating affordability concerns. In addition, Thames Water exhibits among the weakest customer service scores in the sector and requires significant investment to improve its overall performance. Currently negative public and political attention may deter investors and adversely affect the company's ability to raise funding.

### Governance

The **G-5** governance risk score reflects a weakening liquidity trajectory and uncertainty over the company's ability to attract capital in light of a challenging draft determination and an overall tough regulatory environment with substantial fines for weak operational performance. The company is currently unable to make distributions, both in relation to breaching financial covenant trigger ratios and minimum rating requirements under its licence and finance. Given the company's weak liquidity, we consider a distressed exchange, where creditors agree to some form of amendment or extension of credit terms that result in a loss relative to the original promise to pay, highly likely.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

## Liquidity analysis

Thames Water's liquidity is weak. On 20 September, the company announced that, as at 31 August 2024, it had £1.57 billion of liquidity consisting of £1.15 billion of cash and cash equivalents (including dedicated reserves of £0.38 billion) and £0.42 billion of Class A and Class B undrawn committed facilities.

Thames Water has a further £550 million of undrawn reserve liquidity facilities, which are available during an event of default and resulting standstill under the finance documents.

According to Thames Water's announcement, current cash reserves, including from drawn facilities, would be used up by December 2024, if neither of the reserved cash or undrawn amounts under revolving credit facilities can be drawn. Extending the liquidity runway to May 2025, the company's previously stated period to which liquidity was available, effectively requires the use of all emergency reserves.

The next major bond repayments relates to CAD250 million due in December 2024 and an original amount of £500 million due in June 2025, which has already been partially prepaid, such that the remaining outstanding amount is now around £315 million.

Given the worsening liquidity situation and a potentially lengthy process to attract new equity funding, we believe that a distressed exchange over the coming months is now a highly likely scenario.

## Structural considerations

The Caa1 CFR is assigned to Thames Water as if it was a single consolidated legal entity with a single class of debt. It reflects an opinion on the expected loss associated with the financial obligations within the Thames Water group, and consolidates the legal and financial obligations of Thames Water, its financing subsidiary Thames Water Utilities Finance PLC (TWUF) and the intermediate holding company within the group, Thames Water Utilities Holdings Limited. The Caa1 CFR also factors in some, albeit limited, credit enhancements of the financing structure.

We also rate the bonds issued by TWUF under a £15 billion MTN programme (the Programme), guaranteed by Thames Water. The bonds are issued either as part of a senior tranche (Class A debt) or a junior tranche (Class B debt) and are rated Caa1 or C, respectively.

The Caa1 rating of the Class A bonds issued under the Programme reflects their senior position in the cash waterfall and after any enforcement of security. However, it also takes into account additional super-senior obligations, including derivate liabilities with a mark-to-market value of around £1.3 billion at March 2024, as well as the potential for additional liquidity to be provided on a super-senior basis, which could further reduce cash flows available to service Class A creditors. The C rating of the Class B bonds reflects our expectation of a heightened expected loss severity for the Class B lenders, given their deeply subordinated position in the cash flow waterfall.

### Debt structural features provide some, albeit limited, rating uplift for additional creditor protection

Thames Water's Caa1 CFR takes into account the covenant and security package agreed by the company, which is designed to insulate its creditworthiness from that of its ultimate shareholders and improve creditors' protection in a default scenario.

The terms and conditions of its financing arrangements allow Thames Water to increase its indebtedness (on the basis of net debt/RCV) up to 85% before distribution lock-ups come into effect. Failure to maintain a level of adjusted interest cover of at least 1.1x in any single year (or 1.2x on a three-year rolling average) would also trigger the dividend lock-up mechanism. We note, however, that our calculation of both ratios differs from the definition of the financial covenants in the financing documents because of our specific adjustments. In particular, our calculation includes accretion under swaps with frequent pay-down requirement or short maturities, executed as part of the company's swap restructurings in November 2019, as interest expense.

Additional event risk protection provided by the bond covenant and security package also include, inter alia, restrictions on acquisitions and disposals (subject to limited defined exceptions), maturity concentration limits and limitation on non-core activities. In addition, we consider creditor step-in rights if certain trigger events occur.

Transaction documents also include a first-ranking fixed charge over the shares in the company, plus first-ranking fixed and floating charges over all the assets, rights and undertakings of Thames Water. However, the benefit of the security provided to bondholders is limited because of the regulated and essential nature of the services provided by Thames Water, as governed by its licence and the Water Industry Act 1991.

## Rating methodology and scorecard factors

Our assessment of Thames Water reflects the application of our Regulated Water Utilities rating methodology. The scorecard-indicated outcome is Ba3, whereas the Caa1 rating also factors in the company's weak liquidity and risk of a potential debt restructuring.

Exhibit 11

**Rating factors**

**Thames Water Utilities Ltd.**

| Regulated Water Utilities Industry [1][2] | Current FY 3/31/2024 | | Moody's 12-18 Month Forward View As of September 2024 [3] | |
|---|---|---|---|---|
| **Factor 1 : Business Profile(50%)** | **Measure** | **Score** | **Measure** | **Score** |
| a) Stability and Predictability of Regulatory Environment | Aa | Aa | Aa | Aa |
| b) Asset Ownership Model | Aa | Aa | Aa | Aa |
| c) Cost and Investment Recovery (Sufficiency & Timeliness) | Baa | Baa | Baa | Baa |
| d) Revenue Risk | Aa | Aa | Aa | Aa |
| e) Scale and Complexity of Capital Programme & Asset Condition Risk | Baa | Baa | Baa | Baa |
| **Factor 2 : Financial Policy (10%)** | | | | |
| a) Financial Policy | Caa | Caa | Caa | Caa |
| **Factor 3 : Leverage and Coverage (40%)** | | | | |
| a) Adjusted Interest Coverage Ratio (3 Year Avg) | 0.6x | Caa | 0.6x - 0.9x | Caa |
| b) Net Debt / Regulated Asset Base (3 Year Avg) | 81.5% | Ba | 85% - 90% | B |
| c) FFO / Net Debt (3 Year Avg) | 4.2% | B | 4% - 5% | B |
| d) RCF / Net Debt (3 Year Avg) | 3.6% | B | 4% - 5% | Ba |
| **Rating:** | | | | |
| Scorecard-Indicated Outcome Before Notch Lift | | B1 | | B1 |
| Notch Lift | | 1 | | 1 |
| a) Scorecard-Indicated Outcome | | Ba3 | | Ba3 |
| b) Actual Rating Assigned | | | | Caa1 |

(1) All ratios are based on adjusted financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) As of 31/12/2024 (3) Moody's forecasts are Moody's opinion and do not represent the forward view of the issuer.

*Source: Moody's Financial Metrics™*

## Ratings

Exhibit 12

| Category | Moody's Rating |
|---|---|
| **THAMES WATER UTILITIES LTD.** | |
| Outlook | Negative |
| Corporate Family Rating -Dom Curr | Caa1 |

*Source: Moody's Ratings*

# Appendix

Exhibit 13

## Selected peer comparison

### Thames Water Utilities Ltd.

| | Thames Water Utilities Ltd. Caa1 Negative | | | Anglian Water Services Ltd. A3 Stable | | | Yorkshire Water Services Limited Baa2/Ba1 Stable* | | | Southern Water Services Limited Baa3 RUR-DNG * | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (in GBP million) | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 |
| Revenue | 2,092 | 2,181 | 2,401 | 1,400 | 1,495 | 1,627 | 1,119 | 1,145 | 1,227 | 845 | 816 | 887 |
| EBITDA | 1,062 | 1,065 | 1,287 | 790 | 819 | 862 | 606 | 611 | 649 | 452 | 592 | 383 |
| Total Assets | 20,563 | 22,870 | 23,748 | 12,229 | 12,470 | 13,539 | 10,853 | 11,007 | 10,869 | 7,568 | 7,645 | 8,596 |
| Regulated Asset Base (RAB) | 16,664 | 18,945 | 19,947 | 8,780 | 9,959 | 10,676 | 7,746 | 8,715 | 9,132 | 5,665 | 6,455 | 6,798 |
| Total Debt | 14,201 | 16,809 | 17,803 | 6,534 | 7,254 | 8,366 | 5,738 | 6,571 | 6,379 | 4,127 | 4,622 | 4,984 |
| Net Debt | 13,781 | 14,979 | 16,528 | 5,663 | 6,621 | 7,361 | 5,709 | 6,278 | 6,329 | 3,677 | 4,476 | 4,468 |
| Net Debt / Regulated Asset Base | 82.7% | 79.1% | 82.9% | 64.5% | 66.5% | 69.0% | 73.7% | 72.0% | 69.3% | 64.9% | 69.3% | 65.7% |
| Adjusted Interest Coverage Ratio | 0.7x | 0.5x | 0.6x | 1.4x | 1.4x | 1.1x | 1.0x | 0.7x | 0.7x | -0.1x | -0.1x | -0.6x |
| FFO / Net Debt | 4.6% | 3.8% | 4.3% | 8.4% | 7.9% | 7.5% | 6.4% | 5.8% | 6.2% | 1.4% | -2.3% | 1.8% |
| RCF / Net Debt | 4.3% | 3.5% | 3.1% | 6.7% | 5.4% | 6.4% | 6.1% | 5.2% | 5.3% | 1.5% | -2.3% | 1.8% |

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months. RUR = Ratings under Review, where UPG = for upgrade and DNG = for downgrade. * Ratings represent senior secured and, where applicable, junior debt ratings assigned at the issuing finance subsidiary level.
*Source: Moody's Financial Metrics™*

Exhibit 14

## Moody's-adjusted debt breakdown

### Thames Water Utilities Ltd.

| (in GBP million) | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 |
|---|---|---|---|---|---|
| **As Reported Total Debt** | 13,196 | 12,829 | 13,360 | 15,795 | 16,528 |
| Pensions | 209 | 277 | 257 | 182 | 152 |
| Non-Standard Adjustments | (61) | 0 | 584 | 832 | 1,123 |
| **Moody's Adjusted Total Debt** | 13,344 | 13,106 | 14,201 | 16,809 | 17,803 |
| Cash & Cash Equivalents | (756) | (491) | (420) | (1,829) | (1,275) |
| **Moody's Adjusted Net Debt** | 12,588 | 12,615 | 13,781 | 14,979 | 16,528 |

All figures are calculated using Moody's estimates and standard adjustments. Non-standard adjustments add cumulative derivative accretion.
*Source: Moody's Financial Metrics™*

Exhibit 15

## Moody's-adjusted funds from operations (FFO) breakdown

### Thames Water Utilities Ltd.

| (in GBP million) | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 |
|---|---|---|---|---|---|
| **As Reported Funds from Operations (FFO)** | 1,189 | 1,007 | 1,158 | 1,125 | 1,307 |
| Pensions | 21 | 96 | 4 | 8 | 48 |
| Capitalized Interest | (98) | (70) | (115) | (215) | (159) |
| Alignment FFO | (192) | (148) | (546) | (1,139) | (610) |
| Unusual Items - Cash Flow | 6 | 0 | 0 | 0 | 0 |
| Cash Flow Presentation | (203) | (121) | (158) | 43 | (143) |
| Non-Standard Adjustments | 32 | (13) | 286 | 740 | 263 |
| **Moody's Adjusted Funds from Operations (FFO)** | 755 | 751 | 629 | 562 | 707 |

All figures are calculated using Moody's estimates and standard adjustments. Non-standard adjustments primarily add back annual inflation accretion on debt and eligible derivatives.
*Source: Moody's Financial Metrics™*

Exhibit 16

**Selected historical Moody's-adjusted financial data**

**Thames Water Utilities Ltd.**

| (in GBP million) | FYE Mar-20 | FYE Mar-21 | FYE Mar-22 | FYE Mar-23 | FYE Mar-24 |
|---|---|---|---|---|---|
| **INCOME STATEMENT** | | | | | |
| Revenue | 2,109 | 2,033 | 2,092 | 2,181 | 2,401 |
| EBITDA | 1,125 | 1,053 | 1,062 | 1,065 | 1,287 |
| EBITDA margin % | 53.3% | 51.8% | 50.8% | 48.8% | 53.6% |
| EBIT | 536 | 434 | 367 | 335 | 554 |
| EBIT margin % | 25.4% | 21.3% | 17.5% | 15.4% | 23.1% |
| Interest Expense | 526 | 349 | 841 | 1,477 | 985 |
| Net income | (94) | 66 | (668) | (956) | (359) |
| **BALANCE SHEET** | | | | | |
| Net Property Plant and Equipment | 15,818 | 16,274 | 16,880 | 17,842 | 19,249 |
| Total Assets | 20,231 | 19,933 | 20,563 | 22,870 | 23,748 |
| Total Debt | 13,344 | 13,106 | 14,201 | 16,809 | 17,803 |
| Cash & Cash Equivalents | 756 | 491 | 420 | 1,829 | 1,275 |
| Net Debt | 12,588 | 12,615 | 13,781 | 14,979 | 16,528 |
| Total Liabilities | 17,157 | 17,195 | 18,826 | 21,219 | 22,088 |
| Total Equity | 3,074 | 2,738 | 1,737 | 1,651 | 1,660 |
| **CASH FLOW** | | | | | |
| Funds from Operations (FFO) | 755 | 751 | 629 | 562 | 707 |
| Cash Flow From Operations (CFO) | 810 | 792 | 877 | 885 | 1,041 |
| Dividends | 57 | 33 | 37 | 45 | 196 |
| Retained Cash Flow (RCF) | 699 | 718 | 592 | 517 | 511 |
| Capital Expenditures | (1,137) | (1,001) | (1,192) | (1,326) | (1,767) |
| Free Cash Flow (FCF) | (384) | (242) | (352) | (487) | (922) |
| **INTEREST COVERAGE** | | | | | |
| (FFO + Interest Expense) / Interest Expense | 2.4x | 3.2x | 1.7x | 1.4x | 1.7x |
| Adjusted Interest Coverage Ratio | 1.5x | 1.1x | 0.7x | 0.5x | 0.6x |
| **LEVERAGE** | | | | | |
| FFO / Net Debt | 6.0% | 6.0% | 4.6% | 3.8% | 4.3% |
| RCF / Net Debt | 5.6% | 5.7% | 4.3% | 3.5% | 3.1% |
| Regulated Asset Base (RAB) | 14,594 | 15,070 | 16,664 | 18,945 | 19,947 |
| Net Debt / Regulated Asset Base | 86.3% | 83.7% | 82.7% | 79.1% | 82.9% |

All figures are calculated using Moody's estimates and standard adjustments.

*Source: Moody's Financial Metrics™*

## Endnotes

1 https://www.ofwat.gov.uk/wp-content/uploads/2024/07/Overview-of-Thames-Waters-PR24-draft-determination.pdf

2 RPI-linked debt is broadly equivalent 45-50% of RCV, which is largely in line with the RCV portion that still inflates with RPI over AMP7.

3 These intercompany loans were put in place at the time when the existing highly covenanted financing structure was put in place in 2007, to usptream amounts from the operating company to the holding company.

4 https://www.londonstockexchange.com/news-article/BA18/shareholder-funding-update/16033297

5 https://www.ofwat.gov.uk/ofwat-announces-enforcement-cases-against-four-more-companies-in-wastewater-treatment-investigation/

6 https://www.moodys.com/research/Northumbrian-Water-LtdThames-Water-Utilities-LtdYorkshire-Water-Services-Ltd-Ofwats-proposed-Issuer-Comment--PBC_1417752#290612199861c31d1036b185b4e69b75

7 Please see sentencing council's guidelines for environmental offences effective from 1 July 2014: https://www.sentencingcouncil.org.uk/offences/magistrates-court/item/organisations-illegal-discharges-to-air-land-and-water-unauthorised-or-harmful-deposit-treatment-or-disposal-etc-of-waste/

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