S&P Global Ratings

Research

Research Update:

Outlook On Thames Water's Debt Revised To Negative On Challenging Regulatory Pressure And Weaker Credit Ratios

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Overview

- Pressure on Thames Water's financial metrics has continued to build for the fiscal year ending in March 2018 on the back of higher indexation of inflation-linked debt instruments stemming from higher inflation rates and below-average operational performance.
- While we note positively the strong reduction in dividend distribution and the long-term build-up of regulated capital value, we believe that the relatively high leverage under which the company currently operates limits its ability to absorb any future additional weakening in profitability.
- Pressure may increase when the next regulatory period begins in April 2020, given the reduction in allowed cost of capital and more stretching benchmarks.
- We are revising the outlook to negative on Thames Water's class B (subordinated) and class A (senior) debt and affirming the ratings.
- The negative outlook reflects our view that Thames Water may struggle to maintain its credit metrics commensurate with their current ratings, given the limited headroom and potential future pressure from the next regulatory period.

Rating Action

On July 25, 2018, S&P Global Ratings revised to negative from stable the outlook on the class A debt issued by Thames Water Utilities Cayman Finance Ltd. (TWUCF) and Thames Water Utilities Finance Ltd. (TWUF) and on the class B debt issued by TWUCF. The issuers are both subsidiaries of Thames Water Utilities Ltd. (TWUL). At the same time, we affirmed our 'BBB+' rating on Thames Water's class A (senior) debt and our 'BBB-' rating on the class B (subordinated) debt.

Rationale

The outlook revision reflects our view of Thames Water's current financial pressure in the absence of improvement in operating performance. Overall, the operating performance posted by the company for the fiscal year ending in March 31, 2018 has continued to be largely subdued with penalties reaching £35.3 million, compared to £18.4 million the year before.

Despite substantial proactive measures implemented by management to reduce operating underperformance, and the fact that Thames Water's operating performance has improved on several regulatory measures such as pollution and internal flooding, the company has continued to miss several of the regulatory targets for U.K. regulated water companies. These relate to leakages, below-ground asset health water, supply interruptions, and security of supply. In this respect, we observe that Thames Water's operating performance continues to lag those of other U.K. water regulated companies.

We believe that Thames Water will face several challenges in its attempt to improve its operating performance by the end of the current regulatory period in March 2020. Following the findings of inefficient expenditure from a leakage investigation carried by the regulator (Ofwat), the company reached an agreement with Ofwat in June 2018 for a £120 million settlement in the form of penalties and customer rebates spread between the end of the current (2015-2020) and the next regulatory period (2020-2025). We note that about £55 million of the settlement amount pertains to historical and forecast automatic Outcome Delivery Incentive (ODI) penalties. We also note that the company has made progress on performance related to finding and fixing leakages as part of their recovery plan to bring performance back to target by the end of the current regulatory period.

The continued operating challenges of Thames Water's performance weighs on its financial metrics. In addition, a sizable increase in accretion on Retail Price Index (RPI)-linked debt instruments of close to £95 million, owing to markedly higher average RPI (3.7%) for 2017 compared to 2016 (2.1%), is raising the company's overall cost of debt on a non-cash basis. That said, there is a timing difference between the inflation index used to calculate indexation on debt and the bill profile, which could lead to an improvement in headroom in the following years. In addition, we recognize Thames Water is also increasing its regulated capital value (RCV), which will sustain longer-term revenue generation.

As a result, our consolidated funds from operations (FFO)-to-debt metrics stood below 4% for the fiscal year ending in March 2018, as opposed to our expectation of around 5% under our previous base case. Going forward, we expect this ratio will be around 4%-5% based on consolidated class A (senior) and class B debt (subordinated), and 5%-6% based on class A debt only for the next two years. The company also demonstrated weaker than expected coverage ratios with a cash EBITDA-to-interest ratio of 1.7x for the fiscal year ending in March 2018 compared to about 2.3x for the fiscal year ending in March 2017. We distinguish between the financing group's senior debt and subordinated debt as we think that the subordinated debt has a higher probability of default than the senior debt. This is because it has a lower ranking in the payment waterfall and deferral of interest and principal in case of insufficient funds.

Given Thames Water's relatively high leverage (debt to RAV of 81% as of fiscal year ending in March 2018), we think that the company has limited headroom to absorb any additional weakening in its profitability. In this respect, we note that Thames Water has been able to alter its dividend policy in limiting its dividend distributions to the minimal amount needed by the holding company (unrated) to service its interest on debt, which amounted to approximately £55 million for the fiscal year ended in March 2018. We understand that the proceeds of dividend reduction will be used to finance additional operating expenses and capital expenditure aimed at improving and modernizing its network. We currently do not expect dividend distribution to materially exceed this level for the next regulatory period. That said, while we believe this highlights the company's commitment to enhance its creditworthiness, we also believe that this, by itself, might not provide Thames Water with a large enough buffer to absorb a continuous below-par operating performance.

The operating underperformance posted by Thames Water comes at a time when the regulatory environment will likely be increasingly challenging for U.K. regulated water companies. This is illustrated by the final methodology for the regulatory period running from April 2020 to March 2025, published by Ofwat in December 2017. We consider some elements of the methodology to be challenging, particularly the reduction in the allowed cost of capital and introduction of more stretching benchmarks on costs efficiencies and service performance. These elements could pressure the ratings on U.K. water utilities (see "New Ofwat Regulations Will Keep U.K. Water Utilities On Their Toes," published on RatingsDirect) and we think that an improvement in operating performance is essential in order to adapt to new regulatory requirements. This is because companies will earn lower return on equity, either compensated or further reduced by higher, and potentially uncapped, incentive income or penalties based on operating measures.

Our base case assumes:

- RPI assumptions as per our in-house projections. We forecast RPI inflation in the U.K. of 3.5% in 2018, 3.1% in 2019, and 3% in 2020;
- Thames Water's revenues and asset base are solely linked to RPI until the end of AMP6;
- EBITDA margins hovering around 50%;
- Focus on the improvement of key performance areas such as leakage, metering, and strengthening of the network with net penalties of about £20 million;
- Gross capital expenditure averaging approximately £1 billion for the next two years; and
- Reduced dividend payments of about £55 million annually to support HoldCo debt service.

Based on these assumptions, we arrive at the following credit measures for 2018-2020:

- Average FFO to debt of 4.0%-5.0% on a consolidated level, and 5.0%-6.0% for class A debt; and
- EBITDA-to-interest ratio hovering around 2x, benefiting from the group having one of the lowest interest costs in the sector.

Liquidity

We assess Thames financing group's liquidity position as adequate, supported by our view that its liquidity resources will exceed its funding needs by more than 1.1x in the next 12 months as of March 31, 2018.

Principal liquidity sources are:

- Unrestricted cash and short-term investments of £107.1 million;
- Access to £950 million undrawn credit facilities expiring in 2021; and
- Cash FFO of about £860 million.

Principal liquidity uses are:

- Upcoming debt maturities of approximately £133 million;
- Expected capital spending of approximately £1,020 million; and
- Dividend payments of £55 million.

Outlook

Our negative outlook on debt issued by TWUL reflects our concern that the company will struggle to maintain FFO to debt levels we view as commensurate with the ratings (about 6% based on senior debt only and about 5% based on senior and subordinated debt) and ongoing operational challenges. The negative outlook also reflects our expectations of further pressure as the company enters the next regulatory period in April 2020, in light of the current lack of financial headroom.

Downside scenario

We could lower the ratings if FFO to debt remains below the level we see as commensurate with the current ratings (about 5% for class B and about 6% for class A debt) or deterioration in EBITDA to interest cover ratio to below 1.5x. A downgrade could also come from adverse impact from regulatory intervention or a challenging outcome from the new regulatory review if we felt the company would not be able to maintain sufficient headroom under its financial covenants.

Upside scenario

We would revise the outlook on the ratings to stable if TWUL's financial risk profile successfully recovers more headroom and continues to improve its operational performance, and if we anticipate that TWUL can sustain a weighted-average FFO-to-debt ratio of about 5% on average for its consolidated debt, and about 6% on its class A debt. The group could achieve this through its financial policy, cost outperformance, or an improvement in its profitability.

Ratings Score Snapshot

CLASS A
Business risk: Excellent
- Country risk: Low
- Industry risk: Very Low
- Competitive position: Strong

Financial risk: Highly leveraged
- Cash flow/Leverage: Highly leveraged

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb

CLASS B
Business risk: Excellent
- Country risk: Low
- Industry risk: Very Low
- Competitive position: Strong

Financial risk: Highly leveraged
- Cash flow/Leverage: Highly leveraged

Anchor: bbb-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)

- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb-

Related Criteria

- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses , Feb. 24, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

	To	From
Thames Water Utilities Cayman Finance Ltd.		
Senior Secured	BBB+/Negative	BBB+/Stable
Subordinated	BBB-/Negative	BBB-/Stable
Thames Water Utilities Finance Ltd.		
Senior Secured	BBB+/Negative	BBB+/Stable

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.