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CREDIT OPINION

25 April 2024

Update

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RATINGS

Thames Water Utilities Ltd.

Domicile	United Kingdom
Long Term Rating	Baa3
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 Baa3 negative

Summary

The credit quality of Thames Water Utilities Ltd. (Thames Water, CFR Baa3 negative) is supported by (1) its low business risk profile as monopoly provider of essential water and sewerage services; (2) relatively stable and predictable cash flow generation under a well-established and transparent regulatory framework; and (3) adequate liquidity.

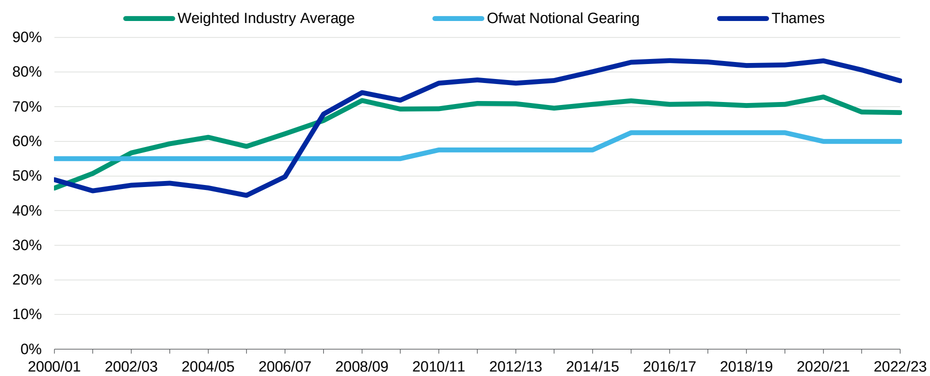
Credit quality is constrained by relatively high gearing, with net debt to regulatory capital value (RCV) around 80-85%, and weak operational performance, which has resulted in increasing penalties. While the company received £500 million of equity in March 2023, further proposed contributions of up to £750 million over the remainder of the current regulatory period have been delayed. This delay increases uncertainty over future equity injections for the material medium- to long-term investment needs.

The delay may also weaken the company's ability to access future capital on competitive terms, with the cost of its debt financing rising since the sudden resignation of its previous CEO in June 2023 and subsequently increasing regulatory, political and public scrutiny regarding its operational performance and financing structure.

Exhibit 1

Following the implementation of the highly covenanted financing structure in 2007, Thames Water's leverage increased to above 80% and remains the highest in the sector

Evolution of regulatory gearing, measured as reported net debt to RCV



Average gearing as reported by companies to Ofwat, and not reflective of Moody's standard adjustments, e.g. for pension obligations.
Source: Companies performance reports, Ofwat and Moody's Ratings

Credit strengths

- » Stable cash flows from the provision of water and wastewater services under a well-established, transparent and predictable regulatory regime
- » Debt structural features, including distribution lock-up covenants, dedicated liquidity, and intercreditor and security arrangements, which provide additional creditor protection for event risk
- » Historically, lower average cost of debt and smaller risk from derivative contracts than peers under highly covenanted financing arrangements

Credit challenges

- » Delay in equity injections increases uncertainty over long-term support of the company's turnaround programme and AMP8 business plan
- » Track record of weak operating performance, which coupled with more demanding targets has led to increasing penalties
- » Relatively high financial leverage, which constrains financial flexibility
- » Further cash flow volatility due to macroeconomic pressures, including rising inflation and interest rates, and significant increase in certain input costs, e.g. around power and materials
- » Ongoing investigations by Ofwat and the Environment Agency into the sector's performance with respect to wastewater assets may result in penalties or detrimental policy/regulatory interventions while increased public scrutiny heightens social risks

Rating outlook

Thames Water's outlook is negative, reflecting the risk that existing or new shareholders may not provide sufficient additional equity over the remainder of this regulatory period and in the next regulatory period, for example because of an adverse regulatory determination, to support the company's ongoing investment needs.

Factors that could lead to an upgrade

Given the negative outlook, we do not envisage upward pressure on Thames Water's ratings at this time. The outlook could be stabilised, if the company was able to secure a regulatory price determination that results in substantial equity injections being made to support the company's long-term investment needs. Upward pressure on the ratings could arise if there was progress under the turnaround programme that was accompanied by deleveraging, as measured by net debt to RCV.

Factors that could lead to a downgrade

Thames Water's ratings could be downgraded if the company faced difficulties in maintaining its forward-looking liquidity. Downward rating pressure could also arise if existing or new shareholders do not provide sufficient additional equity, for example because of an adverse regulatory determination, to support the company's ongoing investment needs.

Key indicators

Thames Water's key credit metrics remains weak amid inflationary pressures

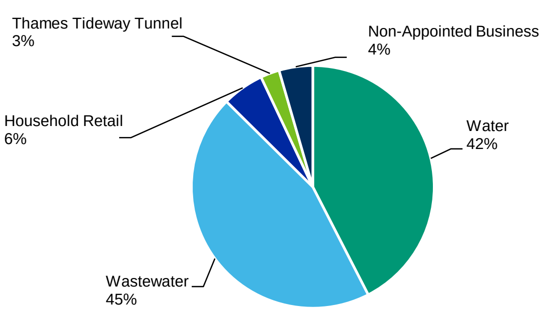
	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24 E
Adjusted Interest Coverage Ratio	1.2x	1.2x	1.5x	1.1x	0.7x	0.5x	0.5x-0.9x
Net Debt / Regulated Asset Base	82.4%	83.8%	86.3%	83.7%	82.7%	79.1%	80%-85%
FFO / Net Debt	5.2%	5.1%	6.0%	6.0%	4.6%	3.8%	4%-6%
RCF / Net Debt	4.7%	4.6%	5.6%	5.7%	4.3%	3.5%	4%-6%

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™

Profile

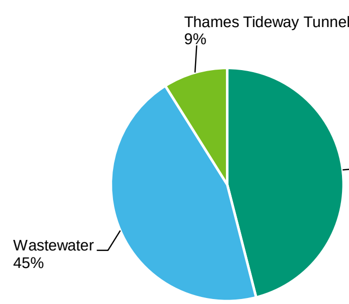
Thames Water is the largest of the 10 water and sewerage companies in England and Wales by both RCV and number of customers served. The company provides drinking water to around nine million customers and sewerage services to around 15 million customers in London and the Thames Valley. It is the primary 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 Ca, negative). 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
Thames Water's £2.2 billion revenue is primarily generated from water and wastewater wholesale activities
Revenue split for FY 2022/23



The Tideway segment includes revenue that is collected by Thames Water through customer bills on behalf of Bazalgette Tunnel Limited (Baa1, stable) the Tideway infrastructure provider. We adjust Thames Water's financial statement to remove the Tideway-related items for the purpose of calculating key credit metrics
Source: Company reports

Exhibit 4
Thames Water's RCV was £18.9 billion at March 2023
RCV split at March 2023



The RCV associated with Tideway is the element of the tunnel infrastructure investment that is carried out by Thames Water itself, in addition to any investment undertaken by Bazalgette Tunnel Limited.
Source: Ofwat, Company reports

Recent developments

On 28 March 2024, Thames Water announced that it will not receive any additional equity injection by 31 March 2024, as previously envisaged, and that any future equity contribution is unlikely to be forthcoming ahead of the draft determination for the upcoming regulatory period (1 April 2025-31 March 2030), which is expected by the end of June 2024.

The additional equity funding was subject to certain conditions, including "the preparation of a business plan that underpins a more focused turnaround that delivers targeted performance improvements for customers, the environment and other stakeholders over the next three years and is supported by appropriate regulatory arrangements."

Thames Water states that “Based on the feedback provided by Ofwat to Thames Water to date, the regulatory arrangements that would be expected to apply to Thames Water in AMP8 make the PR24 plan uninvestible.” and that “Discussions with Ofwat and other stakeholders are ongoing.” The company aims to “secure the required equity investment from new or existing shareholders” following receipt of the draft determination.[1]

While Thames Water continues to have access to £2.4 billion of liquidity, which would support ongoing cash outflows, including planned investment, until May 2025, the delay in equity injections could pressure financial metrics towards financial year-end March 2025 in the absence of future equity injections. The delay in the previously anticipated equity injection also increases uncertainty over the shareholders' commitment to provide further equity during the next regulatory period, in the context of the company's business plan indicating an additional equity requirement of £2.5 billion. As a consequence, on 3 April 2024, we downgraded Thames Water's Water's CFR to Baa3 with negative outlook.

Failure to successfully implement its turnaround programme or PR24 business plan because of an inability to finance its investment programme over an extended period of time could trigger regulatory investigations, which may in turn lead to enforcement action, such as performance penalties.

Our current view of Thames Water's credit quality reflects an expectation that the company will ultimately be able to secure a regulatory price determination, which provides a balance of risk and reward that would support future equity injections.

Potential contagion from HoldCo default

On 4 April 2024, Thames Water's holding company Kemble Water Finance Limited (unrated) and its financing subsidiary Thames Water (Kemble) Finance PLC sent formal notices of default to the holders of their debt instruments, including the £400 million 4.625% senior secured notes due in May 2026 (Ca, negative). This followed a missed interest payment on certain debt instruments of Kemble Water Finance Limited, which was due on 2 April 2024.

The Kemble companies have approached their lenders to request that they take no creditor action to allow for ongoing discussions with all stakeholders. Total external debt at Kemble, including the rated bonds, currently amounts to £1.35 billion or ca. 7% of Thames Water's RCV.

We believe that the operating company remains ring-fenced from the business and financial risk of its holding company through:

1. Licence provisions and other features of the regulatory framework, which require arms' length transactions with affiliates and prohibit financial support for other group companies. The licence also requires maintenance of an investment-grade rating and restricts distributions if minimum rating levels are not maintained.
2. Thames Water's covenant package further underpins the business independence prescribed by the licence and specifically limits distributions unless a minimum financial profile can be maintained.
3. A security package, which works in conjunction with the financial covenants, allows senior creditor to take control over the operating company, which would remove the ring-fenced operating company from the wider group and its obligations.

Nevertheless, we cannot fully exclude some contagion risk resulting from a holding company default. This is because a Kemble default would allow Kemble lenders to enforce their share security and take ownership of the wider Thames Water group. This would increase uncertainty around the amount and timing of future equity injections into Thames Water, reducing the company's ability to continue its growing investment programme.

The uncertainty created on potential future ownership changes should holding company lenders enforce their share security as well as the general reluctance of existing shareholders to commit to further equity injections at this point in time also continues to adversely affect Thames Water's ability to raise funding at competitive terms.

Detailed credit considerations

Transparent regulatory regime, but tighter regulatory oversight expected for AMP8, with Thames Water in the spotlight

The UK water sector benefits from a transparent, stable and predictable regulatory regime, which is based on clearly defined risk allocation principles and their consistent application in setting water tariffs by an independent regulatory body, the Water Services Regulation Authority (Ofwat).

In December 2022, Ofwat published its final methodology for the 2024 price review, outlining its approach to setting allowed returns, incentivising operational performance and establishing cost targets for the next regulatory period, which will run from 1 April 2025 to 31 March 2030 (known as AMP8).

The regulator's “early view” of the cost of capital, based on average market conditions during September 2022, is 3.23% for the wholesale activities, an increase from the current period. Ofwat also confirmed that it will transition to full CPIH indexation of companies' RCV in AMP8; because CPIH is structurally lower than RPI, the “early view” of the cost of capital implies an approximately 30% higher return in cash terms, compared to the current period. While “early view” equity returns may appear low in the context of rising cost of debt, Ofwat has committed to consider the latest market evidence when it sets the allowed return in its final determinations, expected in December 2024, and based on current market data we estimate that the allowed return could rise to 3.6%-3.9% if the regulator maintains the same methodology. A rise in allowed cash returns would be credit positive, particularly in the context of likely rising investment needs and associated funding requirements in a higher interest rate environment. In its AMP8 business plan, submitted in October 2023, Thames Water included its own return estimate of 4.25% (vanilla, real).

In addition to higher financing costs, the industry faces higher risks as a result of large investment programmes and public concerns about companies' performance that are likely to be exacerbated by large tariff increases. Ofwat also aims to further tighten performance requirements, which will mean greater penalties for companies that fall short of the regulator's expectations. Given its historically weak performance track record, Thames Water remains at risk of incurring future penalties, unless its turn-around programme can be successfully delivered. The company's business plan suggests a risk-reward profile that is skewed to the downside (which is in line with the representation by its peers).

In March 2023, Ofwat also published its decision to modify the regulatory ring-fencing conditions in the licences of the water and wastewater companies in England and Wales. With effect from 1 April 2025, the rating trigger resulting in a cash lock-up under the licence will be raised to Baa2/BBB negative from Baa3/BBB- negative currently. Additional licence changes, which apply from 17 May 2023, also allow the regulator to take enforcement action where companies do not link their dividend payments to operational performance or fail to be transparent about their dividend policy. On balance, the licence modifications are credit positive for the operating companies, but detrimental to holding company credit quality where the operating company is at an increased risk of triggering the lock-up.

The definition of "issuer credit rating" that Ofwat considers relevant for the rating trigger includes Moody's corporate family rating. With its current CFR at Baa3 negative, Thames Water is now in distribution lock-up under the licence. Given the expected tightening of the lock-up rating trigger, a prolonged distribution block over the AMP8 period is likely, unless the company can successfully implement its immediate turn-aound and long-term business plans, including planned equity injections.

Relatively high leverage 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, we expect that with the growing investment programme, gearing will remain broadly in the 80-85% range over the period. Although the receipt of the first £500 million equity injection in March 2023 temporarily reduced Moody's-adjusted gearing by approximately 3 percentage points to 79%, leverage is expected to rise again over the final two years of AMP7 with the investments required under the turnaround plan. We estimate that if equity injections remained delayed beyond March 2025, continuing all planned investments would lead to an overall gearing ratio in excess of 85%.

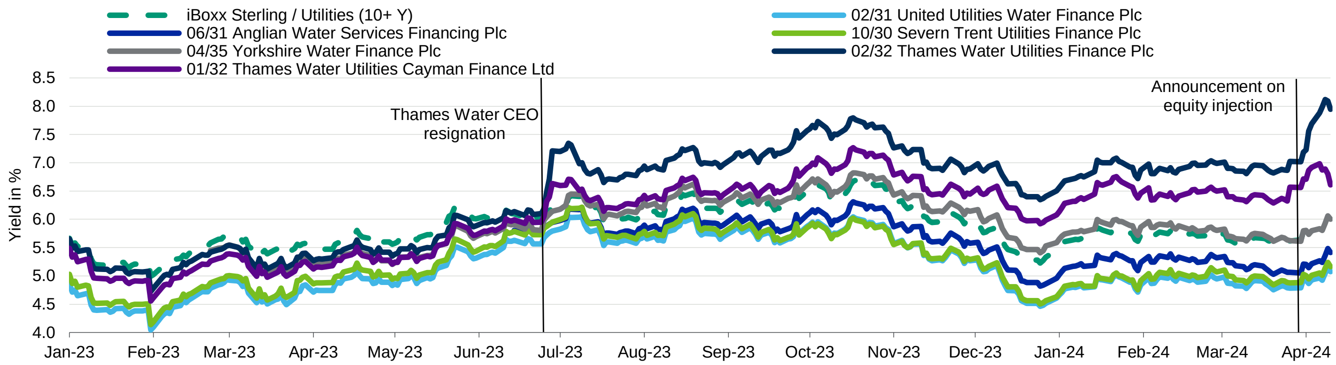
During the ongoing period of underperformance and high investment, management has curtailed dividend payments, with no distributions to external shareholders since 2017, and amounts limited to meet holding company debt payments and associated costs. Given the significant growth in the investment programme for AMP8 and current lock-up conditions under regulatory licence and financing structure, we expect no distributions to be made well into the next regulatory period.

... and interest coverage will be weakened by higher debt premium during ongoing period of uncertainty

Thames Water historically carried relatively competitive cash cost of debt (2.32% at March 2023), below the sector average (2.61%). 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 business plan submission, we estimate that Thames Water may have to raise up to £10 billion over the AMP8 period, roughly equally split between new debt and refinancing.

Exhibit 5

Thames Water bond yields continue to widen compared with peers
Yield to maturity on selected bonds and iBoxx



Source: FactSet

Thames 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 September 2023, 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.

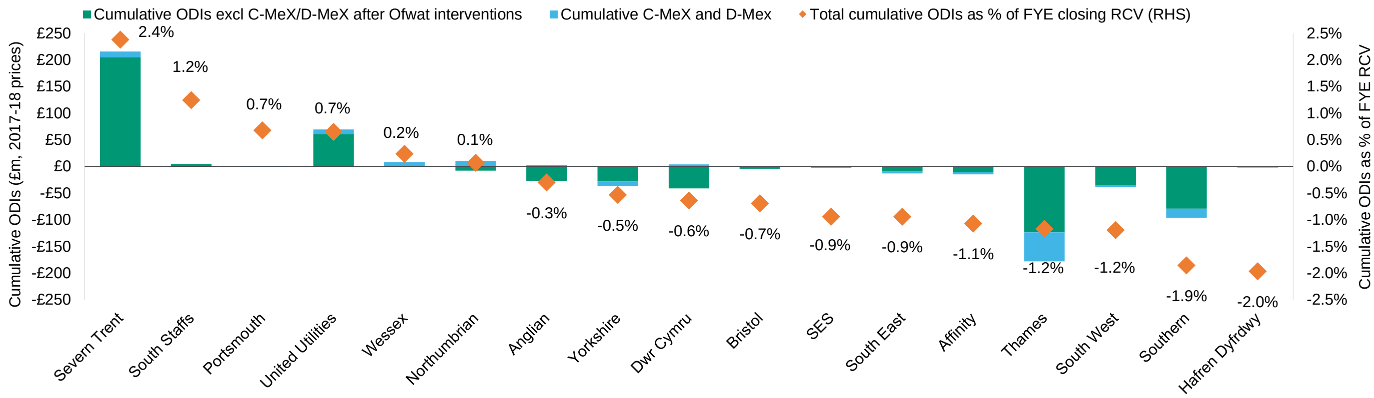
Continuously weak performance, exacerbated by extreme weather

The AMP7 final determination reflected a net revenue reduction for Thames Water of around £67 million (reduced by around £31 million through the so-called blind-year adjustment). This included aggregate penalties of £148 million for operational underperformance during the 2015-20 period under outcome delivery incentives (ODIs), while a further £149 million of ODI penalties resulted in a reduction of the starting RCV (all numbers in 2017/18 prices). Around £130 million (in 2012/13 prices) of underperformance penalties reported in the last financial year of AMP6 relate to a single project, where the company found a simpler and cheaper method to reduce internal sewer flooding incidents than envisaged at the 2014 price review; therefore the penalty is mostly offset by the company not spending the full allowance for this project.[3] The remaining net penalties are primarily associated with the company's performance against leakage and supply interruptions targets as well as the asset health of its water infrastructure in general.

Over AMP7 to date, Thames Water continued to incur performance penalties of around £178 million, of which £53 million reduced cash flows 2022/23, £51 million will have to be returned to customers in 2023/24 and £74 million in 2024/25 (all in 2017/18 prices).

Exhibit 6

Cumulative ODI reward and penalties for FY 2020-21 to FY 2022-23 in absolute terms and as % of March 2023 RCV (in 2017/18 prices)

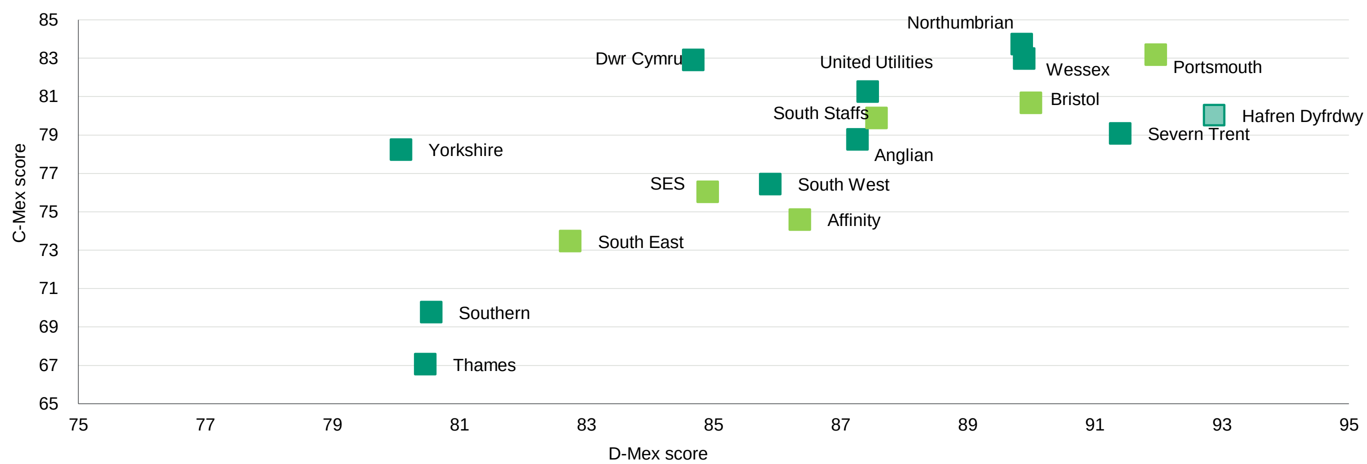


Source: Companies' annual performance reports and Ofwat's final ODI determinations

Performance areas with the largest contribution to penalties include supply interruptions (£37 million cumulative penalties to date), internal sewer flooding (£45 million) and weak customer service (£54 million, all amounts in 2017/18 prices). More extreme weather, including a severe drought in summer 2022 and a wetter than average autumn and heavy rains in January 2023 added further pressure on mains, resulting in performance weakening for leakage and pollution incidents.

Exhibit 7

Thames Water exhibited some of the weakest customer service among the sector for the first three years of AMP7
FY 2022-23 C-MeX and D-MeX results



Dark green squares are WaSCs (Hafren Dyfrdwy being fully owned by Severn Trent Water) and light green squares are WoCs.
Source: Companies' annual performance reports

In its annual performance report for FYE March 2023, Thames Water indicates up to £270 million (in 2017/18 prices) net aggregate penalties over the 2020-25 period, excluding customer service, a number significantly up from the prior year estimate of £125 million. The increase in expected penalties is concentrated on leakage, mains repairs and pollution incidents. ODI penalties incurred in the last two financial years of AMP7 will carry over into AMP8 with a two-year lag. In addition and subject to final assessment at the 2024 price review, any deferred penalties (mostly associated with per capita consumption levels) will likely be reflected as a legacy adjustment to revenue for the next regulatory period from 1 April 2025. Thames Water's business plan includes cumulative ODI penalties of around £72 million (in 2022/23 prices) as part of its AMP8 legacy revenue adjustment, associated with per capita consumption and customer service (including both customer, C-Mex, and developer, D-Mex, service measures).

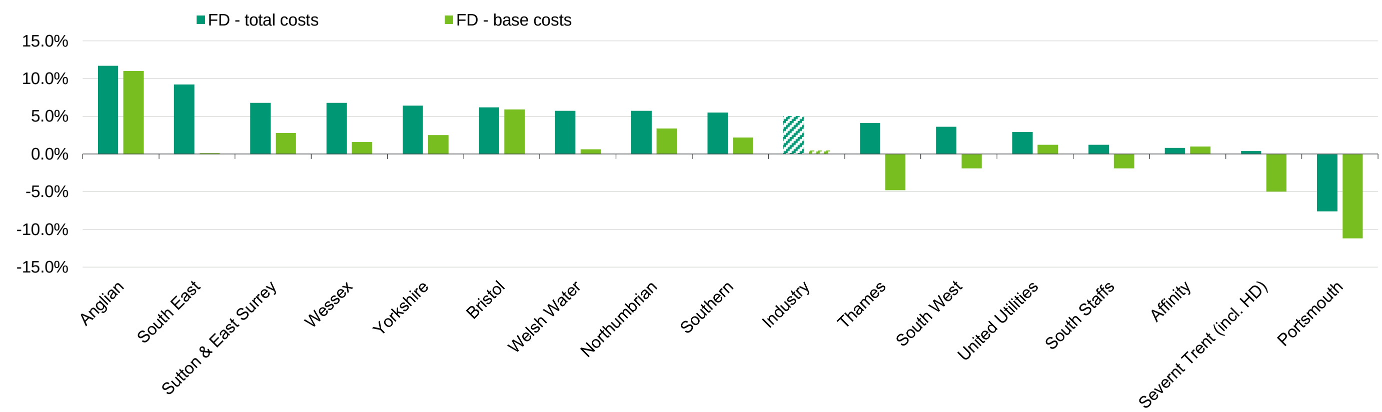
The company's re-focused three-year turn-around plan, which was approved by its board in late November 2023 and was one of the conditions for receiving further shareholder monies, will concentrate on performance areas that have attracted the most significant penalties, including meaningful improvements in supply interruptions, water quality, leakage, pollutions and customer complaints. However, achieving a step change will take time to bear fruit.

Thames Water faces totex efficiency challenge in AMP7 and sizable growth in investment programme for 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).

Exhibit 8

While Thames Water's efficiency challenge is below the sector average this reflects the company's alternative low-investment plan
Cost efficiency challenge at final determination (FD)



FD efficiency challenge compares FD allowance against companies' response to draft determination (DD) from August 2019. Comparison of base cost efficiencies may be affected by re-classification from base to enhancement expenditure (and vice versa) between DD and FD.
Source: Ofwat

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).[4] The new plan to facilitate a turnaround in operational performance was closer to the company's original PR19 business plan submission. The additional investment is 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.[5] 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".[6] However, as per Thames Water's recent announcement, the additional equity contribution is delayed until at least after the draft determination. While the company's liquidity is sufficient to allow continuation of the turnaround programme, doing so may pressure credit metrics, if no equity is received by March 2025.

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 AMP8 determination. Given the recent announcement, shareholder commitment to these additional amounts may be weakening.

Thames Water proposed totex of almost £19 billion (in 2022/23 prices) for AMP8, subsequently increased by £1.1 billion, with a further £1.9 billion conditional investment allowance.[7] The updated allowance is now a roughly 70% increase compared with AMP7 final determination allowances. Enhancement expenditure, which aims to improve services and is largely driven by new statutory requirements to reduce pollution as well as the environmental impact of water abstraction, accounts for £6.5 billion, more than triple the AMP7 enhancement levels. If confirmed by Ofwat in its 2024 determination, the updated investment plan would lead to a 36% real growth in RCV compared with ca. 11.5% for the current period.

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, which aside from Thames Water also included Anglian Water Services Ltd.(A3 stable), Northumbrian Water Ltd. (Baa1 stable), South West Water, Wessex Water Services Limited (funded through Wessex Water Services Finance Plc, rated Baa1 stable) and Yorkshire Water Services Limited (funded through Yorkshire Water Services Finance Limited and Yorkshire Water Finance plc, with senior debt rated Baa2 stable, and junior debt rated Ba1 stable).

In December 2023, the regulator notified Northumbrian Water, Thames Water and Yorkshire Water of its provisional findings. The companies had the opportunity to respond and provide further evidence, before a draft decision is published for consultation (it was expected in the first quarter of 2024). While these companies have been highlighted on the basis of the information provided, the remaining three enforcement cases are ongoing and all wastewater companies remain part of the regulator's wider investigation.

Thames Water could face a material fine if it was found to be in breach of its regulatory obligations. Ofwat can impose a financial penalties of up to 10% of relevant turnover (amounting to ca. £105 million based on the FY 2022/23 turnover of the wastewater activities), while Environment Agency fines follow sentencing guidelines[8] 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. The company reported a growing amount of serious pollution incidents, 17 in 2022 out of 44 in aggregate for the English wastewater companies, up from 12 in 2021 (over a total of 62), partly as a result of severe weather events affecting its service area.

ESG considerations

Thames Water Utilities Ltd.'s ESG credit impact score is CIS-3

Exhibit 9
ESG credit impact score

CIS-3

ESG considerations have a limited impact on the current rating, with potential for greater negative impact over time.

Source: Moody's Ratings

The **CIS-3** ESG Credit Impact Score for Thames Water Utilities Limited indicates that ESG considerations have a limited impact on the current credit quality with potential for greater negative impact over time. This reflects high environmental and social exposure and moderate governance risks. The overall credit impact score also recognises mitigating factors, in particular the regulated nature of water companies' activities and their investment requirements, including a forward-looking allowance for efficient cost. However, as investment needs continue to grow to tackle climate change and population growth, the resulting increase in regulated assets and their remuneration will have to continue to be supported by the regulatory tariff framework in order to avoid negative credit implications in the future.

Exhibit 10

ESG issuer profile scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-4	S-4	G-3

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 addition, Ofwat announced in March 2022, that it had served five companies (later extended to six), including Thames Water, formal notices to gather further information for enforcement purposes. While all water and wastewater companies in England and Wales remain subject to investigation, the five were singled out for one of (a) a significant number of potentially non-complaint works, (b) concerns about company's management of compliance, or (c) poor data. In December 2023, three companies, including Thames Water, were notified of provisional findings on which to respond, and we expect Ofwat to publish a draft decision during the first half of 2024. Thames Water's previous water pollution incidents have resulted in significant cumulative environmental fines. As of December 2023, Thames Water accounted for 25% of the £158 million cumulative fines in the industry.

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, we see moderately negative risk exposure related to customer relationships, with Thames Water having among the weakest customer service scores in the sector.

Governance

The **G-3** governance risk score takes into account regulatory requirements to ensure that independent directors account for the largest single group on the company's board and the company's regulatory licence prescribes a minimum credit profile. While Thames Water maintains a highly-leveraged financing structure, financial covenants restrict distributions once certain metrics are breached. At its current rating level, the company is in a dividend lock-up. Nevertheless, we expect Thames Water to maintain higher leverage over the near to medium term as its turnaround investment programme continues and sizeable enhancement expenditure is envisaged for the next regulatory period. Shareholders have delayed further equity support prior to the regulatory determination, with a draft expected in June 2024 and final determinations in December 2024. Managing the regulatory relationship is part of our assessment of management credibility. In addition, the moderate risk score for compliance and reporting reflects an ongoing investigation by the regulator and the UK's Environment Agency into potentially illegal wastewater discharges into rivers by the wastewater companies in England and Wales.

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 currently exhibits adequate liquidity, with £2.4 billion of cash and available committed facilities as at 29 February 2024, which are sufficient to cover ongoing needs, including upcoming debt maturities (which we estimate at around £1.0 billion until March 2025) and ongoing investments, until May 2025.

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.

In addition, Thames Water retains access to a £310 million debt service reserve facility and a £240 million O&M reserve facility, with a group of 16 relationship banks.

Structural considerations

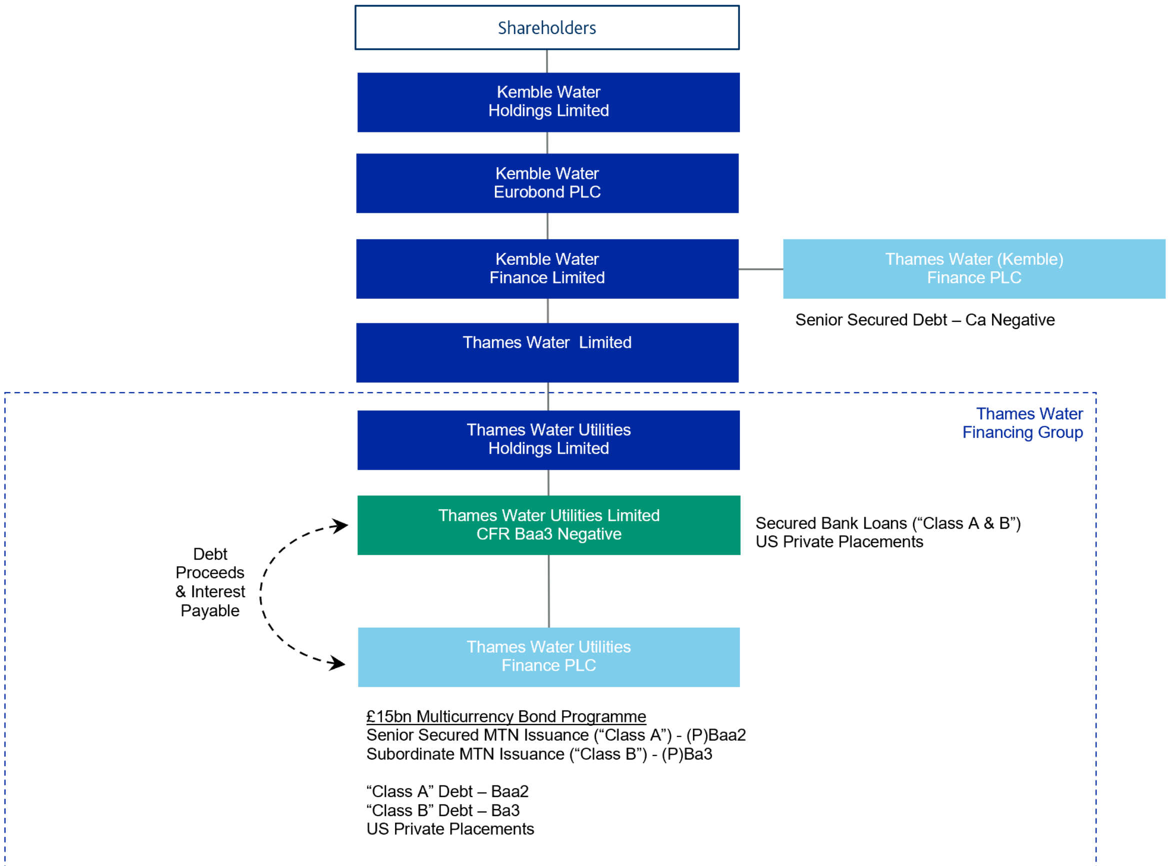
The Baa3 CFR is assigned to Thames Water as if it was a single consolidated legal entity with a single class of debt. It reflects an opinion on the expected loss associated with the financial obligations within the Thames Water group, and consolidates the legal and financial obligations of Thames Water, its financing subsidiary Thames Water Utilities Finance PLC (TWUF) and the intermediate holding company within the group, Thames Water Utilities Holdings Limited. The Baa3 CFR also factors in the 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 Baa2 or Ba3, respectively.

The Baa2 rating of the Class A bonds issued under the Programme reflects the strength of the debt protection measures for this class of bonds and other pari passu indebtedness (together, the Class A debt), the senior position in the cash waterfall and after any enforcement of security. The rating also, however, factors in the subordinated Class B debt (Class B bonds and other pari passu debt), which — while contractually subordinated — serves to reduce the operating company's financial flexibility because Class B debt would continue to be served even in a trigger event as long as sufficient cash remains available. In addition, a default of the Class B debt could have an impact on the viability of the company's funding model as a whole because the inability to raise additional Class B debt in the future could undermine the capital structure and, thus, affect the credit quality of the senior debt.

The Ba3 rating of the Class B bonds reflects our expectation of a heightened loss severity for the Class B debt following any default, given its subordinated position in the cash flow waterfall.

Exhibit 11
Simplified group structure



Source: Company website, Moody's Ratings

Debt structural features provide a rating uplift for additional creditor protection

Thames Water's Baa3 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 overall covenant and security package is similar to those for comparable highly leveraged financing transactions, and results in a rating uplift of around one notch for credit-enhancing features, embedded in the Baa3 CFR.

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.

Exhibit 12

Rating factors

Thames Water Utilities Ltd.

Regulated Water Utilities Industry [1][2]	Current LTM 9/30/2023		Moody's 12-18 Month Forward View As of April 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)	A	A	A	A
d) Revenue Risk	Aa	Aa	Aa	Aa
e) Scale and Complexity of Capital Programme & Asset Condition Risk	A	A	A	A
Factor 2 : Financial Policy (10%)				
a) Financial Policy	Ba	Ba	Ba	Ba
Factor 3 : Leverage and Coverage (40%)				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	0.6x	Caa	0.8x - 1.1x	Caa
b) Net Debt / Regulated Asset Base (3 Year Avg)	83.8%	Ba	83% - 87%	B
c) FFO / Net Debt (3 Year Avg)	4.2%	B	4% - 6%	B
d) RCF / Net Debt (3 Year Avg)	4.0%	B	4% - 6%	Ba
Rating:				
Scorecard-Indicated Outcome Before Notch Lift		Ba3		Ba3
Notch Lift	1.5	1.5	1.5	1.5
a) Scorecard-Indicated Outcome		Ba1		Ba1
b) Actual Rating Assigned				Baa3

(1) All ratios are based on adjusted financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) As of LTM 30/09/2023 (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 13

Category	Moody's Rating
THAMES WATER UTILITIES LTD.	
Outlook	Negative
Corporate Family Rating -Dom Curr	Baa3

Source: Moody's Investors Service

Appendix

Exhibit 14

Selected peer comparison

Thames Water Utilities Ltd.

(in GBP million)	Thames Water Utilities Ltd. Baa3 Negative			Anglian Water Services Ltd. A3 Stable			Yorkshire Water Services Ltd Baa2/Ba1 Stable*			Southern Water Services Ltd Baa3 Stable *		
	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-21	FYE Mar-22	FYE Mar-23
Revenue	2,033	2,092	2,181	1,352	1,400	1,495	1,101	1,119	1,145	820	845	816
EBITDA	1,053	1,062	1,065	706	790	819	568	335	1,533	353	452	592
Total Assets	19,933	20,563	22,870	11,274	12,229	12,470	10,010	10,853	11,007	7,265	7,568	7,645
Regulated Asset Base (RAB)	15,070	16,664	18,945	7,993	8,780	9,959	7,024	7,746	8,715	5,149	5,665	6,455
Total Debt	13,106	14,201	16,809	6,981	6,534	6,914	5,727	5,738	6,571	4,059	4,127	4,622
Net Debt	12,615	13,781	14,979	6,695	5,663	6,281	5,529	5,709	6,278	3,702	3,677	4,476
Net Debt / Regulated Asset Base	83.7%	82.7%	79.1%	83.8%	64.5%	63.1%	78.7%	73.7%	72.0%	71.9%	64.9%	69.3%
Adjusted Interest Coverage Ratio	1.1x	0.7x	0.5x	1.4x	1.4x	1.4x	0.9x	1.0x	0.7x	0.4x	-0.1x	-0.1x
FFO / Net Debt	6.0%	4.6%	3.8%	6.5%	8.4%	8.4%	6.2%	6.3%	5.8%	6.5%	1.4%	-2.3%
RCF / Net Debt	5.7%	4.3%	3.5%	6.5%	6.7%	5.7%	6.2%	6.1%	5.1%	6.6%	1.5%	-2.3%

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 15

Moody's-adjusted debt breakdown

Thames Water Utilities Ltd.

(in GBP million)	FYE Mar-19	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23
As Reported Total Debt	11,854	13,196	12,829	13,360	15,795
Pensions	339	209	277	257	182
Non-Standard Adjustments	58	(61)	0	584	832
Moody's Adjusted Total Debt	12,251	13,344	13,106	14,201	16,809
Cash & Cash Equivalents	(154)	(756)	(491)	(420)	(1,829)
Moody's Adjusted Net Debt	12,097	12,588	12,615	13,781	14,979

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

Exhibit 16

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

Thames Water Utilities Ltd.

(in GBP million)	FYE Mar-19	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23
As Reported Funds from Operations (FFO)	1,071	1,189	1,007	1,158	1,125
Pensions	0	21	96	4	8
Capitalized Interest	(109)	(98)	(70)	(115)	(215)
Alignment FFO	(146)	(192)	(148)	(546)	(1,139)
Unusual Items - Cash Flow	3	6	0	0	0
Cash Flow Presentation	0	(203)	(121)	(158)	43
Non-Standard Adjustments	(205)	32	(13)	286	740
Moody's Adjusted Funds from Operations (FFO)	613	755	751	629	562

All figures are calculated using Moody's estimates and standard adjustments. Non-standard adjustments relate primarily to the reclassification of interest paid and received to cash flow from operations and add back annual inflation accretion on debt and eligible derivatives.
Source: Moody's Financial Metrics™

Exhibit 17

Selected historical Moody's-adjusted financial data

Thames Water Utilities Ltd.

(in GBP million)	FYE Mar-19	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23
INCOME STATEMENT					
Revenue	2,037	2,109	2,033	2,092	2,181
EBITDA	1,059	1,125	1,053	1,062	1,065
EBITDA margin %	52.0%	53.3%	51.8%	50.8%	48.8%
EBIT	505	536	434	367	335
EBIT margin %	24.8%	25.4%	21.3%	17.5%	15.4%
Interest Expense	561	526	349	841	1,477
Net income	(33)	(94)	56	(728)	(1,093)
BALANCE SHEET					
Net Property Plant and Equipment	15,234	15,818	16,274	16,880	17,842
Total Assets	18,545	20,231	19,933	20,563	22,870
Total Debt	12,251	13,344	13,106	14,201	16,809
Cash & Cash Equivalents	154	756	491	420	1,829
Net Debt	12,097	12,588	12,615	13,781	14,979
Total Liabilities	15,835	17,157	17,195	18,826	21,219
Total Equity	2,710	3,074	2,738	1,737	1,651
CASH FLOW					
Funds from Operations (FFO)	613	755	751	629	562
Cash Flow From Operations (CFO)	724	810	792	877	885
Dividends	60	57	33	37	45
Retained Cash Flow (RCF)	553	699	718	592	517
Capital Expenditures	(1,108)	(1,137)	(1,001)	(1,192)	(1,326)
Free Cash Flow (FCF)	(443)	(384)	(242)	(352)	(487)
INTEREST COVERAGE					
(FFO + Interest Expense) / Interest Expense	2.1x	2.4x	3.2x	1.7x	1.4x
Adjusted Interest Coverage Ratio	1.2x	1.5x	1.1x	0.7x	0.5x
LEVERAGE					
FFO / Net Debt	5.1%	6.0%	6.0%	4.6%	3.8%
RCF / Net Debt	4.6%	5.6%	5.7%	4.3%	3.5%
Regulated Asset Base (RAB)	14,441	14,594	15,070	16,664	18,945
Net Debt / Regulated Asset Base	83.8%	86.3%	83.7%	82.7%	79.1%

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

Endnotes

1 https://www.londonstockexchange.com/news-article/AW14/shareholder-funding-update/16399045

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 At the 2014 price review, Thames Water was allowed £227 million to construct a new sewer. The £130 million underperformance penalty relates to the cancellation of the original project, and the reduction has been applied to the opening RCV for the AMP7 period.

4 Under the totex sharing mechanism, only 25% of any overspend will be added to the RCV in 2025. Ofwat decided to apply the lower significant scrutiny cost sharing rate for any underperformance to protect customers. Conversely, 56-68% of any underspend would be subtracted from the RCV or repaid to customers over the 2025-30 period.

5 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.

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

7 Thames Water's PR19 determination also included conditional allowances of £300 million to improve the performance of the London water network and £180 million to improve the resilience of water supply to North East London, both of which have been unlocked during the price control period.

8 Please see Moody's July 2015 comment 'UK Water Sector: Environmental damage likely to attract more material fines' as well as the 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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