Credit Opinion: Yorkshire Water Services Limited

Global Credit Research - 11 Mar 2013

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Baa1
Yorkshire Water Services Bradford Finance Ltd	
Outlook	Stable
Bkd Senior Secured -Dom Curr	A3
Bkd Subordinate -Dom Curr	Baa3
Yorkshire Water Services Odsal Finance Ltd	
Outlook	Stable
Bkd Senior Secured -Dom Curr	A3
Yorkshire Water Services Finance Limited	
Outlook	Stable
Bkd Senior Secured -Dom Curr	A3

Contacts

Analyst	Phone
Neil Griffiths-Lambeth/London	44.20.7772.5454
Stefanie Voelz/London	
Monica Merli/London	

Key Indicators

[1]**Yorkshire Water Services Limited**

	3/31/2012	3/31/2011	3/31/2010	3/31/2009
Adjusted Interest Coverage	**1.5x**	**1.5x**	**2.0x**	**2.7x**
Net Debt / Regulated Assets Value	**81.7%**	**74.6%**	**64.7%**	**66.2%**
FFO / Net Debt	**8.3%**	**9.3%**	**12.6%**	**13.1%**
RCF / Capex	**0.7x**	**1.3x**	**0.6x**	**0.2x**

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying *User's Guide*.

Opinion

Corporate Profile

Yorkshire Water Services Limited (YWS) is the fifth largest of the ten water and sewerage companies (WaSCs) in England and Wales by both Regulatory Capital Value (RCV) and number of customers served. YWS provides drinking water to around 4.9 million people and around 130,000 local businesses over an area of approximately

14,700 square kilometres encompassing the former county of Yorkshire and part of North Derbyshire in Northern England.

Kelda Group Limited, the parent company of the YWS group was acquired in February 2008 by Saltaire Water Limited (Saltaire), a special purpose vehicle formed by a consortium comprising Citi Infrastructure Investors, GIC Special Investments Pte Limited and Infracapital Partners LP

Recent Developments

In January 2013, the Water Services Regulation Authority, Ofwat, the economic regulator for water companies in England and Wales published its draft methodology on the framework and approach of setting price limits for the next five-year regulatory period commencing 1 April 2015 (AMP6). The proposals include (1) separate price controls for retail and wholesale services; (2) increased customer involvement in companies' business planning and focus on long-term outcomes rather than short-term outputs; (3) more tailored incentives, in particular on water trading and abstraction; and (4) a total expenditure (totex) assessment.

Moody's believes that the proposed framework is likely to be neutral for the credit quality of the UK water sector over AMP6. However, whilst the draft methodology contains confirmed directions for certain aspects of the framework, it still lacks details on some proposed new features, including totex and rewards/penalties under a more targeted incentive mechanism. In addition, we perceive some execution risk for the 2014 price review (PR14) given the limited time left to finalise the framework. (Please see Moody's Report Ofwat's Methodology for PR14 Likely to be Credit Neutral for further information).

Whilst the proposed changes are not expected to impact the sector in the short term, medium- to long-term credit risk may yet increase as Ofwat continues to work on introducing competition in other parts of the value chain, particularly in the upstream business, including water abstraction, resources and treatment.

Finally, we note that the recently appointed Chair of Ofwat has raised a series of fundamental questions around the sector as a whole and highly-leveraged companies such as YWS. These questions include `how should we respond to concerns about the growth and risks of highly geared or securitised structures for the public and customer interest' (see Observations on the regulation of the water sector, 5 March 2013). It remains to be seen where such questions may lead but they represent a challenge to which companies will need to respond.

Rating Rationale

Moody's maintains a corporate family rating (CFR) of Baa1 with stable outlook on YWS reflecting (i) the company's low business risk profile as the monopoly provider of essential water and sewerage services; (ii) the level of gearing; and (iii) the creditor protections incorporated within the company's financing structure.

A corporate family rating is an opinion on the expected loss associated with a company's financial obligations assuming that it has a single class of debt and is a single consolidated legal entity. The Baa1 CFR is in line with the corporate family ratings assigned in two out of the three similar transactions in the UK water sector -- Anglian Water and Thames Water -- but one notch higher than that for Southern Water (whose ratings were downgraded in July 2011). Like its peers, YWS's credit quality is constrained by the high likelihood that the company will maintain a highly leveraged financial structure and by its exposure to refinancing risk, i.e. dependence upon continued market access to fund ongoing capital expenditure and the risk of adverse financial market conditions that may prevent YWS from funding its ongoing capex programme, or refinancing its debt on reasonable terms.

The rating consolidates the legal and financial obligations of YWS, its funding vehicles (Yorkshire Water Services Bradford Finance Limited or YWSBFL, Yorkshire Water Odsal Finance Limited and Yorkshire Water Services Finance Limited) and the two holding companies (Yorkshire Water Services Holdings Limited and Yorkshire Water Services Odsal Finance Holdings Limited) that are in the ring-fenced group (the YWS Financing Group) as defined under the terms and conditions of YWS's multicurrency guaranteed bond programme (the Programme) and factors in the associated structural enhancements.

Rating Drivers

The assessment of YWS is based on Moody's global Rating Methodology for Regulated Water Utilities, published in December 2009. The methodology grid results in an indicated rating of A3, however, the assigned Baa1 CFR reflects Moody's expectation that the company will maintain gearing (net debt to RCV) at levels up to the 85% dividend lock-up level under its financing structure and the rating agency's guidance for a Baa1 rating (gearing of 75-85%) after taking into account uplift of around one notch for the creditor protections (see Factor 3 below). The following factors are considered under the rating methodology:

FACTOR 1: REGULATORY ENVIRONMENT & ASSET OWNERSHIP MODEL

YWS's factor scoring is representative of that of the UK water sector as a whole, which benefits from a very transparent, stable and predictable regulatory regime. We therefore assign a Aaa score to the UK regulatory framework based on the clearly defined risk allocation principles and their consistent application, which underpin the stability and predictability of the UK regulatory environment.

In relation to the asset ownership model, we score the UK water companies at Aa reflecting direct ownership of the water and sewerage assets under a licence. However, this licence can be terminated for failure to comply with the terms and conditions set out in the relevant instrument of appointment. As a consequence, the UK water companies can also be subject to a special administration regime, which can be invoked by the regulator or the UK government in case of severe underperformance or financial distress of a water company. The special administration order is meant to ensure the orderly transfer of the water and sewerage operations and assets to a new provider.

The tariff formula applied under the UK regulatory framework allows for the recovery of operating expenditure and depreciation, which broadly reflects capital maintenance requirements, as well as a return on the regulated asset base set to cover the cost of funding through a combination of debt and equity. The return on capital also reflects the funding cost of capital investments that grow the asset base. There is a moderate degree of risk allocation to the water utilities as cost recovery (both operational and financial) is based on ex-ante allowances set by the regulator at five-yearly price reviews. We score the tariff regime in England and Wales at A, reflecting the fact that there is strict regulatory oversight of tariff increases and that operators can be subject to challenging efficiency targets.

Ofwat, the UK water industry's economic regulator published its final price determination for the period from April 2010 to March 2015 (AMP5) in November 2009 and YWS has been allowed to increase prices by an average of 0.5% p.a. in real terms - permitting a 3.3% increase in average household bills in 2013-14. The 0.5% is equal to the average annual real price increase for the industry as a whole but below the 1.7% increase proposed in the final business plan submitted by YWS. The final determination allowed a weighted average cost of capital of 4.5% (real, post-tax) for the industry, modestly below the company's final business plan assumption of 4.8%.

In terms of revenue volatility, YWS has some exposure to potential volume risk in relation to its industrial and commercial customer base. However, the overall proportion of non-household revenues is slightly below the industry's average. Furthermore, revenue risk for the UK water companies is mitigated to some extent through the Revenue Correction Mechanism introduced in the 2009 price review, which will allow an ex-post adjustment at the following price review for any under- or over-recoveries in revenues during the preceding price review period. For AMP5, the regulator also allowed a notified item for increases in household bad debt resulting from worsening economic conditions, which allows companies to ask for an interim price determination if the increase in such costs breaches certain thresholds.

We assign a score of A for revenue risk.

FACTOR 2: OPERATIONAL CHARACTERISTICS & ASSET RISK

Operational performance for YWS has previously been assessed as better than other WaSCs. For 2011/12, Ofwat reported that the company's performance had been in line with, or better than expected, in 10 out of the regulator's 15 key performance indicators. Performance in three areas (pollution incidents sewerage, discharge permit compliance and serviceability water infrastructure) was, according to the regulator, not in line with expectations but had slipped only slightly. Performance for serious pollution incidents sewerage and pollution incidents (water) was reported to be significantly below target or expectation.

Under Ofwat's Service Incentive Mechanism, YWS achieved a mid-table position amongst the 10 WaSCs during 2011/12.

We score the company at Baa for Operational Performance, in line with the sector average.

As is the case for its peers, YWS faces some risk in the execution of its significant capital programme with anticipated spending for AMP5 of around GBP1.9 billion (according to Ofwat's final determination and in 2007/08 prices) - broadly in line with the amount proposed in the company's final business plan. The total includes a large amount of capital maintenance (GBP1.1 billion) and is therefore expected to result in only a moderate increase in

YWS's regulatory asset base, around 11% in real terms, over the five-year period. Broken down into five equal instalments, the annual investment over the AMP5 period compared to the average RCV equals approximately 8%, resulting in a A score for capital requirements.

FACTOR 3: STABILITY OF BUSINESS MODEL AND FINANCIAL STRUCTURE

YWS's scores in this category reflect the additional event risk protection provided by the bond covenant and security package which are designed to enhance the existing licence condition to ensure primary focus on the regulated activities.

We assign a score of Aa for ability and willingness to pursue corporate activity as, subject only to defined exceptions, companies within the financing group are not permitted to make any acquisition or investment. We further assign a score of A for ability and willingness to increase leverage as the financial covenants limit management's ability to increase leverage, with a dividend lock-up coming into effect if gearing for Class A Debt increases above 75% and if gearing for Senior Debt (the Class A and Class B Debt) increases above 85% of RCV.

The scores for this factor are in line with those assigned to other companies with a similar highly-levered financing structure but one-notch above those assigned to WaSCs such as United Utilities and Severn Trent which have more traditional funding arrangements.

YWS scores Aa for the targeted proportion of operating profit outside the core water and wastewater activities, in line with the other WaSCs.

FACTOR 4: KEY CREDIT METRICS

To assess the financial risk profile of a regulated water utility, Moody's uses four key credit metrics. However, the key focus remains on two particular ratios that have been applied to the credit analysis of UK Water companies in the past, namely Net Debt to RCV and the Adjusted Interest Cover (Moody's FFO Interest Cover adjusted for regulatory capital charges).

YWS's Baa1 CFR is constrained by the relatively highly leveraged financial structure adopted by the company. As described above, the terms and conditions of the Programme allow YWS to increase its indebtedness (on the basis of Net Debt to RCV) up to a maximum of 85% before distribution lock-ups come into effect. Failure to maintain a level of Adjusted Interest Cover of at least 1.2x would also trigger the dividend lock-up mechanism. We note, however, that Moody's calculation of both ratios may differ slightly from the definition of the financial covenants in the financing documents due to Moody's specific adjustments.

The current rating assumes Net Debt to RCV gearing below the dividend lock-up levels and Adjusted Interest Cover around 1.3x or more. Historic performance has been better than this guidance: Net Debt to RCV was 81.7% as at March 2012, up from 74.6% at March 2011, and Adjusted Interest Cover for the year to March 2012 was 1.5x, in line with the level for the prior year.

Structural Considerations

YWS's CFR also takes into account the covenant and security package agreed by the company, which is designed to insulate the company's 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 seen for the precedent highly-leveraged financing structures mentioned above.

Liquidity Profile

YWS's liquidity profile is considered sufficient to support the company's operating and capital expenditure over the next 12 months. It is underpinned by the stable and predictable cash flows generated by its regulated activity, cash balances of GBP47 million at 30 September 2012 and GBP490 million of committed revolving facilities of which GBP439 million was available as at 30 September 2012.

In May 2012, YWSBFL raised GBP50 million of 30-year Class A index-linked debt with the funds being on-lent to YWS. In the same month, YWS raised GBP75 million of floating rate debt from the European Investment Bank and in August 2012, YWSBFL issued a further GBP250 million 17-year Class A fixed rate bonds with the proceeds again be lent to the operating company.

In April 2017, GBP450 million of Class B debt due 2025 is callable. The next significant debt maturity is in October 2017 when GBP490 million of committed revolving facilities arranged by Yorkshire Water Services Odsal Finance

Limited (during October 2011) expire.

Rating Outlook

The stable outlook on the ratings reflects Moody's expectation that YWS's financing structure should be relatively resilient to downside scenarios due to the cash trapping triggers designed to ensure that cash is retained in the company if certain ratio thresholds are breached. Such cash could then be used to absorb the effect of possible downsides.

What Could Change the Rating - Up

Given the company's funding structure and Moody's expectation that YWS will likely maintain leverage close to the maximum level permitted by its financial covenants, there will be limited potential for an upgrade of its ratings. Upward rating pressure would require a material and permanent improvement in debt protection measures.

What Could Change the Rating - Down

Negative pressure on the ratings could derive from:

- Unexpected, severe deterioration in operating performance that results in the company remaining persistently in breach of the distribution lock-up triggers.

- A material change in the regulatory framework for the UK water sector leading to a significant increase in YWS's business risk.

- Unforeseen funding difficulties.

Rating Factors

Yorkshire Water Services Limited

Regulated Water Utilities [1][2]	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**B**	**Caa**
Factor 1: Regulatory Environment & Asset Ownership Model (40%)							
a) Stability and Predictability of Regulatory Regime	X						
b) Asset Ownership Model		X					
c) Cost and Investment Recovery (Ability & Timeliness)			X				
d) Revenue Risk			X				
Factor 2: Operational Characteristics & Asset Risk (10%)							
a) Operational Efficiency				X			
b) Scale & Complexity of Capital Programme & Asset Condition Risk			X				
Factor 3: Stability of Business Model & Financial Structure (10%)							
a) Ability & Willingness to Pursue Opportunistic Corporate Activity		X					
b) Ability & Willingness to Increase Leverage			X				
c) Targeted Proportion of Revenues Outside Core Water and Wastewater Activities		X					
Factor 4: Key Credit Metrics (40%)							
a) Adjusted Interest Coverage (3 year Avg)				X			
b) Net Debt/ Regulated Asset Value (3 Year Avg)					X		
c) FFO / Net Debt (3 Year Avg)					X		
d) RCF / Capex (3 Year Avg)					X		
Rating:							
a) Indicated Factor-Rating from Grid				Baa1			
+ Rating Uplift for Additional Creditor Protection				+1			
= Final Indicated Rating from Grid				A3			
b) Actual Rating Assigned				A3			

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 3/31/2012. Source: Moody's Financial Metrics