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Transaction Update: Yorkshire Water Services Ltd.

Primary Credit Analyst:
Mark J Davidson, London (44) 20-7176-6306; mark_j_davidson@standardandpoors.com

Secondary Contact:
Beata Sperling-Tyler, London (44) 20-7176-3687; beata_sperling-tyler@standardandpoors.com

Table Of Contents

Transaction Update: Yorkshire Water Services Ltd.

Table 1

Current Issue Ratings

Class	Rating	Amount
Senior secured multicurrency medium-term note program issued by the program issuer or the exchange issuer	A-	£8 bil.
Class A bonds	A-	£3,423 mil.
Class B bonds issued by Yorkshire Water Services Bradford Finance Ltd.	BBB	£450 mil.

Table 2

Transaction Participants

Issuer	Yorkshire Water Services Bradford Finance Ltd. and Yorkshire Water Services Odsal Finance Ltd.
Borrowers	Yorkshire Water Services Ltd.
Arranger	The Royal Bank of Scotland PLC, HSBC Bank PLC, and Santander U.K. PLC
Borrower/issuer security trustee	Deutsche Trustee Company Ltd.
Liquidity facility provider	The Royal Bank of Scotland PLC, HSBC Bank PLC, Barclays Bank PLC, BNP Paribas, Lloyds TSB Bank PLC, Commonwealth Bank of Australia, and Santander U.K. PLC
Interest hedge provider	Multiple institutions, predominantly the Royal Bank of Scotland PLC, Santander U.K. PLC, and HSBC Bank PLC
Bank account provider	National Westminster Bank PLC
Principal paying agent	Deutsche Bank AG, London branch

Table 3

Supporting Ratings

Institution/Role	Ratings
Santander U.K. PLC as interest hedge and liquidity provider	A/Negative/A-1
Barclays Bank PLC as liquidity facility provider	A+/Negative/A-1
BNP Paribas as liquidity facility provider	A+/Negative/A-1
Commonwealth Bank of Australia as liquidity facility provider	AA-/Stable/A-1+
Deutsche Bank AG as interest hedge provider	A+/Negative/A-1
HSBC Bank PLC as liquidity facility provider	AA-/Negative/A-1+
Lloyds TSB Bank PLC as liquidity facility provider	A/Negative/A-1
National Westminster Bank PLC as bank account provider	A/Stable/A-1
The Royal Bank of Scotland PLC as liquidity facility provider	A/Stable/A-1

Table 4

Financial Highlights*

Free operating cash flow (mil. £)	-34.2
EBITDA (mil. £)	442.4
Regulated asset value (mil. £)	5,279
Debt to regulated asset value (%)	80.4

*As of March 31, 2012. All figures adjusted by Standard & Poor's.

Table 5

Transaction Key Features	
Closing date	July 24, 2009
Collateral	Debt issued by Yorkshire Water Services Finance Ltd., Yorkshire Water Services Bradford Finance Ltd., and Yorkshire Water Services Odsal Finance Ltd. is secured by first fixed and floating charges on all assets, undertakings, revenues, and claims to the extent permitted by the Water Industry Act 1991
Country of origination	U.K.
Financial covenants	Senior RAR above 95%; class A ICR below 1.6x.
Operating covenants	Senior Debt/RCV above 85%; class A RAR above 75%; class A ICR below 1.3x; Senior ICR below 1.1x; Rating on class A below 'BBB' or class B below investment-grade; Super senior index-linked accretion above 6% of RCV
Restricted payment conditions	Senior Debt/RCV above 85%; class A RAR above 75%; class A ICR below 1.3x; Senior ICR below 1.1x; Rating on class A below 'BBB' or class B below investment-grade; Super senior index-linked accretion above 6% of RCV
Liquidity facility size (capital expenditure) (mil.£)	430
Working capital overdraft facility (revolving credit facility) (mil.£)	60

ICR--Interest coverage ratio. RCV--Regulated capital value. RAR--Regulatory asset ratio.

Rationale

This transaction update follows Standard & Poor's Ratings Services' full review of the Yorkshire Water transaction.

All ratings have been affirmed as a result of the review.

The ratings on the debt issued by Yorkshire Water Services Finance Ltd. (YWSF), Yorkshire Water Services Bradford Finance Ltd. (YWSBF), and Yorkshire Water Services Odsal Finance Ltd. (YWSOF) are underpinned by the consolidated credit quality of Yorkshire Water Services Ltd. (YWS), the issuing entities' parent and the licensed, regulated operating company focused on the provision of water and wastewater services in the Yorkshire region. Standard & Poor's considers the water sector in England and Wales to have low business risk, supported by revenues that are generated under a supportive and transparent regulatory framework, ensuring stable and predictable operating cash flows over five-year regulatory periods. In addition, YWS remains a solid operational performer in terms of the range of measures monitored by the regulator, the Office of Water Services (Ofwat).

These strengths are somewhat offset by our view of YWS' significant and ongoing debt-funded capital expenditure (capex) program, which generally results in negative discretionary cash flow (after capex and dividends); its relatively high financial leverage; and Standard & Poor's-adjusted cash flow-based debt coverage ratios which we consider low for the rating. Like all water companies in England and Wales, YWS is subject to regulatory reset risk every five years and is exposed to any changes related to wider reforms of the sector, such as increased competition for nonresidential customers.

In 2009, YWS implemented a corporate securitization of the regulated operating company and its subsidiaries. (For more information on this transaction, see "New Issue: Yorkshire Water Services Ltd.," published Aug. 4, 2009, on RatingsDirect on the Global Credit Portal). We rate at 'A-' the class A bonds issued by YWSBF (the program issuer) and YWSOF (the exchange issuer). We also rate at 'A-' the bonds issued by YWSF prior to the whole business securitization transaction, which migrated to the new structure. The 'A-' rating on these bonds reflects the underlying credit quality of YWS and the various structural features designed to improve cash flow and liquidity for senior secured bondholders.

We rate at 'BBB' the class B bonds issued by YWSBF. These bonds are subordinated to the class A bonds and do not benefit from the same structural enhancements.

The approximately £800 million of YWSF bonds now owned by the exchange issuer (as a result of its contribution to the exchange offer) remain as intercompany liabilities and have maintained their nominal amounts. A clause in the new structure's documentation prevents the exchange issuer from selling these bonds. Given their limited size (currently about £14 million), we no longer rate the bonds that were issued by YWSF and have now been transferred to the securitization structure.

The corporate securitization transaction includes index-linked swaps, some of which have mandatory breaks at the option of swap counterparties at regular intervals from 2018, according to the transaction hedging policy. We consider this a potential weakness, because if the swaps are "out of the money" (if real interest rates at that time are below the real interest rate initially agreed on the swap) and cannot be renegotiated or transferred to new swap counterparties, then there is a potential for cash outflow from the transaction. However, we believe this weakness to be offset by the relatively tight covenant restrictions on exposures arising from the swaps. In addition, YWS was recently successful in renegotiating swaps with mandatory breaks in 2012 and 2014, such that they now have significantly longer maturities.

Surveillance Analysis

YWS enjoys a natural monopoly in its service area, ensuring that the revenues from its water and wastewater activities will continue to be regulated by Ofwat. The five-year price control review on which Ofwat bases price limits is designed to provide predictable cash flows sufficient to enable efficient utilities to finance their operations, provided they meet specified and preagreed operational and financial targets. Like its peers, YWS is exposed to periodic regulatory reset risk, with the current asset management period (AMP5) running from April 2010 through to the end of March 2015. During AMP5, YWS benefits from an average annual real price increase of 0.5%, which included a decrease in 2010/2011 and 2011/2012 of 1.2% and 1.3%, respectively, which will be more than offset by increases from 2012/2013. Ofwat has granted YWS a 4.5% post-tax cost of capital to finance its £1.875 billion capex program. In addition, YWS benefits from a yearly premium of 0.1% for good results in previous regulatory overall performance assessments. We assess the AMP5 determination as more challenging for the sector as a whole than AMP4.

YWS has historically performed strongly under regulatory measures of operational performance, as evidenced by the company achieving the highest efficiency (band A) in AMP4 (2005-2010), which Ofwat used to set YWS' efficiency targets for AMP5 (2010-2015). That said, YWS has shown areas of operational weakness in the last two years, mainly related to extreme weather conditions. In 2010/2011, YWS was one of six companies that missed its leakage target as a result of an unusually cold winter. In 2011/2012, YWS met its leakage target but was affected by the wettest winter in Yorkshire in more than a century, which resulted in surface flooding and the inundation of several water and wastewater treatment works. This, in turn, resulted in 15 "category 2" pollution incidents alongside an increase in the number of customer contacts, weakening YWS' Service Incentive Mechanism (SIM) score to No. 12 out of 21 companies (No. 5 out of 10 water-and-sewerage companies). Overall, however, we continue to view YWS as solidly positioned within the "excellent" business risk profile category, in part because we consider that recent operational issues were largely related to weather conditions.

Updated Strengths, Concerns, And Mitigating Factors

Strengths

- The generally supportive and transparent regulatory framework for the U.K. water sector. This ensures a high degree of stability and predictability of earnings and cash flow, from which we derive YWS' excellent business risk profile. The regulatory structure is designed to provide companies with high-quality cash flows which are sufficient to finance their operations, provided they meet specified and preagreed operational and financial targets. YWS' tariff review for 2010-2015 is relatively positive for the company, providing an average annual price increase through the period, relatively limited efficiency improvement requirements compared with the industry average, and a higher allowance for capex compared with the previous regulatory period.
- YWS' historically high efficiency in both operating expenditures (opex) and capex. This strong track record resulted in Yorkshire achieving "band A" efficiency rankings in AMP4, which Ofwat used to set relatively favorable efficiency targets for YWS in AMP5.
- A relatively small risk of being negatively affected by the capex incentive scheme (CIS) introduced by Ofwat in AMP5. This is because YWS' CIS ratios (which measure how well the water utility's capex plan compares with Ofwat's view of the utility's capex needs) are close to 100, implying limited penalties if YWS spends more capex than forecast. YWS' CIS baseline ratios are set at 100 and 93 for water and sewerage, respectively, compared with industry-average ratios of 113 and 104.
- Little competitive threat and high barriers to entry in the company's appointed areas. In the absence of genuine competition, Ofwat has established surrogate competition through regulatory comparison.

Concerns

- YWS' aggressive capital structure. The company's aggregate class A and class B net debt to regulated capital value (RCV) is likely to stay in the 80%-83% range, which we consider consistent--albeit at the high end--with similarly rated peers.
- YWS' negative discretionary cash flow. In our assessment, YWS' cash flow after capex and dividends will be negative for most years of AMP5, limiting the company's capacity to reduce leverage and requiring ongoing access to the debt markets.
- Recent areas of operational weakness. In 2010/2011, YWS failed to meet its leakage target and in 2011/2012, the company's SIM ranking fell to No.12 out of 21 companies. In addition, in 2011/2012 YWS had a "marginal" score for underground water serviceability. We continue to assess YWS as falling within the peer average for the range of regulatory measures of operational performance, compared to a position at the high end of the peer group in AMP4. A lowering of our assessment of YWS' operating performance could lead us to revise downward YWS' business risk profile, which might in turn result in us raising our ratio guidance for the ratio.
- What we currently view as weak adjusted ratios for the rating category. In 2011/2012, YWS' ratios weakened slightly, due to negative real price increases, higher operating costs, higher debt indexation, and higher infrastructure renewals expenditure (IRE), which we deduct from FFO. The adjusted FFO-to-debt ratio declined to 4.3% on March 31, 2012, from 5.7% a year earlier, although we forecast a recovery toward 6% in the medium term,

supported by a real increase in tariffs for the rest of AMP5.
- The relatively weak independence of the YWS board, as the three independent directors are outnumbered by seven executive directors and do not benefit from any veto right on matters affecting companies above YWS, such as dividends.
- Limitations on security, as the bulk of YWS' assets are "protected land."
- Regulatory reset risk and sector reforms. Like all water companies, YWS is exposed to reset risk every five years in addition to wider reforms that Ofwat has proposed for the longer term, including increasing competition for nonresidential customers.

Mitigating factors

- YWS is allowed to retain opex or capex outperformance. As the company has ranked highly for operational performance in the past, it is likely that it will outperform regulatory targets in AMP5.
- Protective structural features. These include considerable cash reserves and liquidity facilities, which allow for continued debt servicing under stress; a comprehensive security package (albeit limited by the standard restrictions that apply to the sector); an intercreditor agreement minimizing the rights of junior lenders; and a tight covenant package, which provides the senior bondholders with significant powers to influence the company in times of stress.
- Some flexibility in the revenue-setting regime, provided for example by Ofwat's "interim determination of K" mechanism. The mechanism allows a company to reapply for a revenue increase during a five-year period if its performance is affected by unexpected changes (under specified circumstances). We regard this adjustment to price limits as providing some protection against cash flow-erosion risk during each five-year regulatory period, although the mechanism does not cover all costs and does not cover erosion in RCV due to deflation.

Performance Of The YWS Transaction

Revenue and EBITDA performance

In the year ending March 31, 2012, YWS' operating profit before exceptional items declined slightly by 3.3% to £303 million, because a 3% increase in revenue was more than offset by a 6.6% increase in operating costs. This, in combination with higher interest costs and higher adjustments we make for debt indexation and IRE, contributed to a moderate weakening in Standard & Poor's-adjusted ratios, with FFO to debt and FFO interest cover declining to 4.3% and 1.4x, respectively. We consider these ratios to be weak for the rating category. That said, in our base-case scenario, we forecast that the ratios will improve to about 6% and 2.3x, respectively, by March 2014, supported by a real increase in tariffs and lower adjustments for indexation and IRE. We consider an adjusted FFO-to-debt ratio of about 6% to be commensurate with our current rating.

YWS' interim results for Sept. 30, 2012, support our view that ratios will gradually recover, as operating profit increased by 3.1% to £174 million, partly due to a real increase in tariffs.

Amortization schedule

YWS continues to comply with the debt maturity limitations imposed by the covenants of its structure. YWS' next effective maturity is £450 million of class B debt in 2017, due to a step-up in interest. We do not expect the company to repay any of the debt, although we believe it will increase leverage in line with its growing RCV.

The transaction includes index-linked swaps that have mandatory breaks at regular intervals according to the transaction hedging policy. Swaps with mandatory break clauses in the years 2012 and 2014 have been renegotiated to address the potential negative cash flow effect of breakage costs. We anticipate that YWS will actively manage its swap exposure and potential associated cash outflows at least two years before any breaks.

Key covenants performance

YWS has sufficient headroom under its financial covenants. We believe that headroom should remain adequate during the current regulatory period ending March 31, 2015.

Under our base-case scenario, we do not include any outperformance compared with regulated determinations for opex and capex.

Table 6 shows the financial covenant level requirements and YWS' actual performance as of Sept. 30, 2012; Standard & Poor's base-case forecast for March 2013; and YWS' forecast for March 2013.

Table 6

Key Covenants

Financial covenant	Restricted payment condition*	Actual performance September 2012	Standard & Poor's base-case forecast March 2013	Company forecast performance March 2013	Covenant status
Class A RAR (%)	75.0	71.0	70.7	70.4	Met
Class A + Class B RAR (%)	85.0	80.1	81.0	80.4	Met
Class A ICR (x)	1.6 (default)	--	3.16	3.14	Met
Class A adjusted ICR (x)	1.3	--	1.63	1.62	Met
Class A + Class B adjusted ICR (x)	1.1	--	1.4	1.4	Met
Class A average adjusted ICR (x)	1.4	--	1.56	1.65	Met
Class A + Class B average adjusted ICR (x)	1.2	--	1.34	1.41	Met

ICR--Interest coverage ratio. *For ICR ratios, trigger event covenant is displayed. RAR--Regulatory asset ratio.

We have rerun various stresses as part of our review of YWS. The outcomes do not contradict our rating assessment, in our opinion, as the stresses applied are appropriate for the current rating level. YWS performs adequately under our sensitivities and our forecasted performance continues to show resilience. YWS does not reach distribution lockup events until 2020 under any of our stresses. The average adjusted issuer credit rating comes close to a lockup level in 2020, under our stress that combines lower returns in AMP6, higher capex, and stressed funding costs. However, in all stresses, YWS remains comfortably above its default covenants.

We have applied all our stresses to our base-case scenario for the transaction, which is more conservative than the company's forecasts. Our base case is based on YWS' projections with no outperformance achieved; inflation of 1.8% in both 2013 and 2014 and of 2% from 2015 onward (in line with our forecasts for the U.K.); and an additional 50 basis points (bps) on YWS' cost of debt assumptions.

We have applied the following stresses:

- Standard & Poor's base case plus 1% deflation for the duration of the transaction.

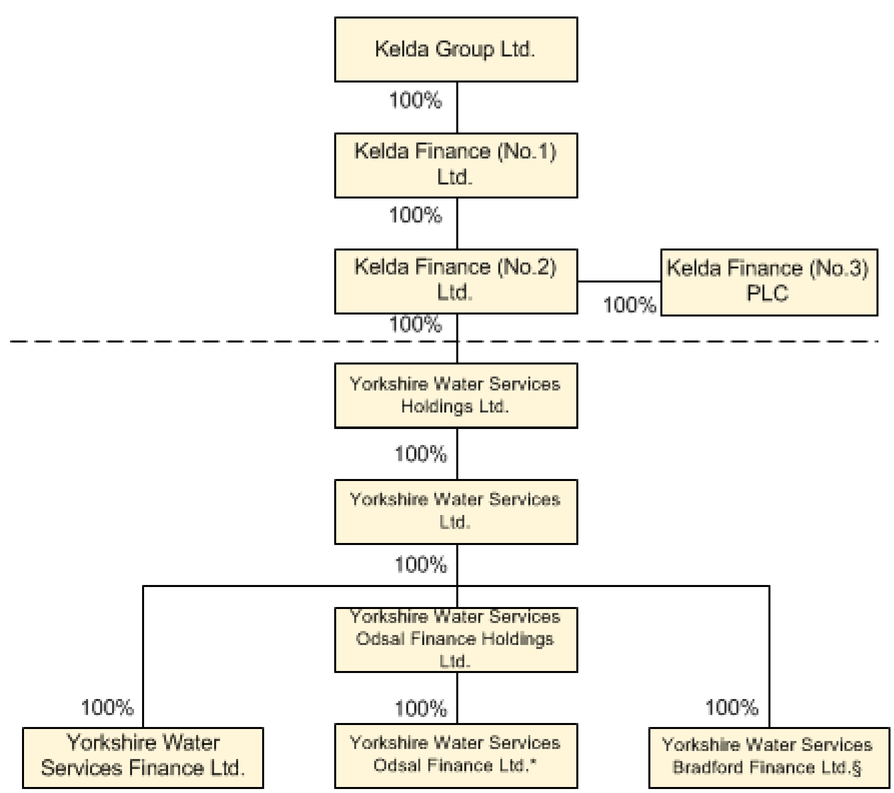
- Standard & Poor's base case plus 1% inflation for the duration of the transaction.
- Standard & Poor's base case with weighted-average cost of capital lowered to 4% in the next regulatory period from April 1, 2015 (AMP6).
- Standard & Poor's base case assuming a 5% increase in operating costs each year.
- Standard & Poor's base case assuming 10% higher capex (not included in RCV) each year.
- Standard & Poor's base case with stressed funding costs (that is, plus 200 bps on YWS' assumptions) applied to all financing and refinancing costs.
- Combination of lower weighted-average cost of capital, 10% capex overspending, and high funding costs.
- Combination of opex and capex overspending.
- Combination of low inflation, lower weighted-average cost of capital, and 5% opex overspending.

Transaction Structure

The structure of the transaction is shown in the following chart.

Chart 1

Yorkshire Water Services Ltd. Transaction Structure



*Exchange issuer. §Program issuer.

Within the corporate securitization structure, we recognize the various structural elements that add to the certainty and stability of cash flow; the financial and corporate structures have been established so that the different debt tranches have different default characteristics. Therefore, an issuer-level corporate credit rating is not meaningful for YWS.

YWS financing group (which comprises YWS and its subsidiaries) is insulated from the rest of the group. YWS is ultimately owned by Kelda Group Ltd., which is itself ultimately owned by a consortium of infrastructure investors comprising Citigroup Alternative Investments LLC, GIC Special Investments Pte Ltd., RREEF Pan-European Infrastructure Fund, L.P., and Infracapital Partners L.P. The basic purpose of the structure is to isolate YWS' low-risk regulated water utility business from the rest of the Kelda group.

We see the quality of YWS' ring-fencing as adequate under our criteria, although it is weaker than some of its peers in the same industry with similar financing arrangements (particularly compared with Thames Water or Anglian Water).

The structural ring-fence is achieved first by having an intermediate special-purpose holding company, Yorkshire Water Services Holdings Ltd. (YWH), within the ring-fence, between YWS and the first of the Kelda Group companies. YWH's sole purpose is to carry out the business of a holding company and to own the shares of YWS, thus providing lenders with a security over those shares.

This corporate structure differs from the one typically seen in other U.K. regulated utilities transactions in that it includes three finance subsidiaries (one of which is held through an intermediary holding company) as opposed to one finance subsidiary, as is more common. This is due to the company's choice to exchange most of its previously outstanding bonds for new ones, as opposed to migrating them into the structure through an amendment of terms. This structure allows for that exchange to be dealt with by a dedicated entity--for simplicity--and to be tax-efficient.

The YWS financing group comprises:

- Yorkshire Water Services Holdings Ltd. (YWH), whose sole purpose by virtue of its constituent documents and the financing documents is to own the shares of YWS and act as the holding company of the companies within the ring-fence.
- The existing debt issuer, Yorkshire Water Services Finance Ltd. (YWSF).
- The two new debt issuers, Yorkshire Water Services Odsal Finance (the exchange issuer) and Yorkshire Water Services Bradford Finance (the program issuer). These subsidiaries are specialized along the lines indicated by their short-hand names: the exchange issuer has issued bonds to replace the outstanding ones that will have been brought to the exchange offer. It will hold on to the outstanding bonds brought to exchange, which will not be cancelled, but may not be sold on. The program issuer will remain the only group entity to issue new bonds going forward. The need for two distinct companies arises from tax considerations: the separation allows the program issuer to qualify as a "securitization company" under the U.K.'s "Taxation of Securitization Companies Regulations 2007," whereas the exchange issuer does not need to qualify for this status. The creation of an intermediary holding between YWS and the exchange issuer is also aimed at achieving the intended tax consideration. Neither YWH nor the issuers have any employees or physical assets. YWS is the license holder and the operating company.

Business Description Update

Yorkshire Water's primary activities are the treatment and distribution of water, as well as the collection and treatment of wastewater in the Yorkshire region.

Business Profile Update

Yorkshire Water's business profile is excellent, stemming from its monopoly wastewater and water activities in the Yorkshire region. The company serves about 4.9 million customers and 130,000 businesses in 2.3 million properties, supplying about 1,300 megaliters of water per day. The company supplies about 1.3 billion liters of drinking water every day and then collects, treats, and returns about 1 billion liters of wastewater safely back into the environment. Nonregulated activities are limited and are linked to Yorkshire Water's regulated activities. They remain outside the ring-fence of the corporate securitization.

Ratings Detail (As Of March 14, 2013)	
Yorkshire Water Services Ltd.	
Corporate Credit Rating	NR/--/--
Corporate Credit Ratings History	
10-Aug-2010	NR/--/--
13-Apr-2010	BBB+/Watch Neg/--
31-Jul-2009	BBB+/Negative/--
01-Jul-2009	BBB/Watch Pos/--
02-Mar-2009	BBB/Watch Neg/--
Related Entities	
Kelda Finance (No. 3) PLC	
Issuer Credit Rating	BB-/Stable/--
Senior Secured	BB-

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com