

## FITCH AFFIRMS KELDA FINANCE'S BOND AT 'BB+'

Fitch Ratings-London-27 February 2014: Fitch Ratings has affirmed Kelda Finance (No.2) Limited's (Kelda) Long-term IDR at 'BB' and senior secured rating at 'BB+'. The Outlook on the Long-term IDR is Stable. A full list of rating actions on Kelda and its subsidiaries is at the end of this commentary.

Kelda is a holding company of Yorkshire Water Services Limited (Yorkshire Water or OpCo; A/BBB+/Negative), the regulated, monopoly provider for water and wastewater services that supplies 4.9 million people in the former county of Yorkshire and North Derbyshire. Kelda Finance (No.3) PLC (FinCo) is the financing vehicle for Kelda, which guarantees the issued bonds together with its parent, Kelda Finance (No.1) Limited.

The affirmation reflects the adequate dividend capacity of the OpCo in comparison with the debt service requirements of Kelda, even though Yorkshire Water faces pressure on credit metrics stemming from Ofwat's (the regulator for the UK water sector) risk and reward guidance for the price review covering April 2015 to March 2020. The rating also takes into account the OpCo's robust financial and regulatory performance.

### KEY RATING DRIVERS

#### Material Reduction of Earnings in the Sector

The regulator has guided towards a cost of capital of 3.85% for the regulated companies, lower than Fitch expected. Companies will be able to earn additional returns from incentives. However, earnings visibility regarding outcome delivery incentives may be limited and their scope to outperform total expenditure will depend on the level at which the regulator sets cost targets and the resulting efficiency challenge for individual companies, relative to their current cost performance.

Ofwat appears to have done a lot of modelling regarding the hypothetically possible return on regulatory equity for the regulated companies, but has put limited emphasis on the timing and visibility of those returns. As the price control process moves forward Fitch will re-assess companies' scope to outperform, consider funding mechanisms associated with incentives and establish forecasts with detailed sensitivities. At present, our view is that not all companies will be able to supplement earnings to an extent that Fitch's guidelines for interest cover ratios for 2015-2020, commensurate with existing ratings, will be met.

#### Dividend Cover at Kelda Remains Adequate

The rating forecast indicates that the Kelda group should be able to maintain credit metrics in line with ratio guidelines, ie dividend cover above 2.5x and consolidated net debt/regulatory asset value below 90%. Post-maintenance and post-tax interest cover is forecasted at around 1.1x.

We note that the GBP265m of incremental debt at the holding level only represents less than 5% of RAV and incurs an annual finance charge of around GBP18m-GBP20m. The significantly reduced dividend stream from Yorkshire Water expected for the next price control will still allow comfortable servicing of the debt. This is based on the assumption that the OpCo will maintain its current financial structure. If management decided to reduce gearing at Yorkshire Water by retaining dividends, this would likely have a negative impact on Kelda's ratings.

#### Robust Regulatory Performance

Over the past two years Fitch assessed Yorkshire Water as a middle ranking company. Outturn reporting for FY13 showed material improvements. The company recorded the lowest ever levels of leakage at 265 megalitres per day and achieved stable asset serviceability for all asset categories. Sewer flooding and pollution incidents related to wastewater assets require further attention, but this

is a common theme across the industry. Reflecting on financial and regulatory reporting for FY13, Fitch would expect the company to be ranked in the second quartile or better as part of the regulator's benchmarking for the price control process.

#### RATING SENSITIVITIES

Negative: Future developments that could lead to negative rating action include:

- A sustainable drop of dividend cover below 2.5x, which could for example be driven by a decision to reduce gearing at OpCo.
- An increase in group gearing above 90%.
- A marked deterioration in operating and regulatory performance of Yorkshire Water or a material change in business risk of the UK water sector.

Positive: The rating currently does not have any upside. For the holding company to have a higher rating, Yorkshire Water would have to have materially lower regulatory gearing.

#### LIQUIDITY AND DEBT STRUCTURE

As of 30 September 2013, the holding company had available a GBP30m undrawn, committed revolving credit facility with maturity in October 2017.

#### FULL LIST OF RATING ACTIONS

Kelda Finance (No.2) Limited

- Long-term IDR affirmed at 'BB', Stable Outlook
- Senior secured rating affirmed at 'BB+'

Kelda Finance (No.3) PLC

- GBP200m bonds, 5.75%, February 2020, guaranteed by Kelda Finance (No. 2) Limited, senior secured rating affirmed at 'BB+'

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com). For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria 'Corporate Rating Methodology', dated 5 August 2013, are available at [www.fitchratings.com](http://www.fitchratings.com).

**Applicable Criteria and Related Research:**

Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=715139](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715139)

UK Water Sector Faces Material Reduction in Earnings

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=737015](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=737015)

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