MOODY'S
INVESTORS SERVICE

Credit Opinion: Yorkshire Water Services Limited

Global Credit Research - 11 Mar 2014

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Baa1
Yorkshire Water Services Bradford Finance Ltd	
Outlook	Stable
Bkd Senior Secured	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

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Key Indicators

[1]**Yorkshire Water Services Limited**

	3/31/2013	3/31/2012	3/31/2011	3/31/2010
Adjusted Interest Coverage	**1.4x**	**1.5x**	**1.5x**	**2.0x**
Net Debt / Regulated Assets Value	**82.6%**	**81.7%**	**74.6%**	**64.7%**
FFO / Net Debt	**7.8%**	**8.3%**	**9.3%**	**12.6%**
RCF / Capex	**0.3x**	**0.7x**	**1.3x**	**0.6x**

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

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

Opinion

Rating Drivers

- Stable cash flows generated from the provision of monopoly water and wastewater services under a well-established, transparent and predictable regulatory regime.

- High financial leverage constrains financial flexibility in light of a challenging environment ahead of the price review.

- Debt structural features, including distribution lock-up covenants, dedicated liquidity, intercreditor and security arrangements reduce event risk and enhance resilience in downside scenarios.

Corporate Profile

Yorkshire Water Services Limited (Yorkshire Water) 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. Yorkshire Water provides drinking water to around 5 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 Yorkshire Water 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.

SUMMARY RATING RATIONALE

Yorkshire Water's corporate family rating (CFR) of Baa1 stable is assigned to Yorkshire Water as if it had a single class of debt and was a single consolidated legal entity, and reflects an opinion on the expected loss associated with the financial obligations within the Yorkshire Water group. The CFR consolidates the legal and financial obligations of Yorkshire Water, its financing subsidiaries Yorkshire Water Services Bradford Finance Limited, Yorkshire Water Odsal Finance Limited and Yorkshire Water Services Finance Limited, and the two intermediate holding companies (Yorkshire Water Services Holdings Limited and Yorkshire Water Services Odsal Finance Holdings Limited) within the ring-fenced group. It also factors in the credit enhancements of the financing structure.

The Baa1 CFR reflects (1) Yorkshire Water's low business risk profile as the monopoly provider of essential water and sewerage services; (2) the high level of gearing; and (3) the creditor protections incorporated within the company's financing structure.

The Baa1 CFR is in line with the corporate family ratings assigned in two of the three comparable transactions in the UK water sector, Anglian Water and Thames Water, and one notch above that for Southern Water (please refer to specific credit opinions for details). Like its peers, Yorkshire Water's credit quality is constrained by the expectation 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 Yorkshire Water from funding its large capex programme or refinancing its debt on reasonable terms.

We note that with the challenges expected from the ongoing regulatory price review, particularly a significant reduction in the allowed return, Yorkshire Water's financial flexibility will reduce over the next regulatory period 2015-20, although we expect ratios to remain broadly in line with our minimum guidance of Net Debt to RCV below 85% and Adjusted Interest Cover Ratio at or above 1.2x. These ratio levels, if breached, would also trigger a distribution lock up.

DETAILED RATING CONSIDERATIONS

STRONG REGULATORY ENVIRONMENT, BUT SOME UNCERTAINTY AROUND 2014 PRICE REVIEW

The UK water industry is in the midst of the 2014 price review (PR14), which will set tariffs for the five-year period commencing 1 April 2015 (AMP6). Ofwat, the economic regulator for the water and sewerage companies in England and Wales, is introducing changes to its framework and methodology of setting price limits for AMP6. Main changes 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, particularly on water trading and abstraction; and (4) a total expenditure (totex) cost assessment. In addition, a Water Bill, which is broadly supportive of Ofwat's proposals will, if approved by parliament, enable retail competition for all non-household customers by April 2017 and - at a later stage - a level of upstream competition. Overall, the Bill is designed to deliver policy in four areas: (1) growth - a water sector that supports a growing economy; (2) resilience - helping to ensure that water is available to supply households and businesses without damaging the environment; (3) choice - offering choice and flexibility to customers; and (4) flood insurance - to help manage the financial risk of flooding.

Whilst we view the changes to the PR14 framework as being largely neutral for the UK water sector as a whole, we believe that the implementation of the wider competition agenda will have negative credit implications beyond AMP6. Both the government and regulator are mindful of the need to preserve investor confidence in the industry but also that credit risk will increase as companies face a tougher operating environment and could be squeezed between potential increases in the cost of capital and a regulator keen to demonstrate that competition has brought customer benefit.

We note increasing political attention on the level of utility bills and their affordability by customers. In that context, Yorkshire Water decided to forego its allowed real price increase for the year 2014/15, so that customer bills would only rise with inflation. This followed letters by the government and the Ofwat chairman to water companies focusing on customers' ability to pay.

Along with its peers, Yorkshire Water published its business plan for the next five-year regulatory period 2015-2020 on 2 December 2013. Yorkshire Water proposed a wholesale weighted average cost of capital of 4.2% (vanilla, real), with retail services adding approximately 20bps of additional return, compared with 5.1% overall return for the current period. Based on the business plan, household customers would also see their bills remain falt (before inflation) over AMP6.

On 27 January 2014, Ofwat announced a significant reduction in the allowed return to around 3.85% (vanilla, real), with potential additional return from competitive non-household retail activities of initially 6bps. This reduction reflects the currently low interest rate environment and was expected, but will nevertheless have negative credit implications. We believe Yorkshire Water will be able to absorb the challenges of a tough price review within current ratings. However, equity returns will fall and the company's future financial flexibility to offset additional cash flow stresses will be reduced. Ofwat will issue further guidance on the price review processfor the non-enhanced companies, including Yorkshire Water, in April 2014, with a draft determination expected in summer.

GOOD OPERATIONAL PERFORMANCE, ALBEIT NOT MUCH AHEAD OF SECTOR AVERAGE

Yorkshire Water has historically been one of the more efficient performers in the sector. The company generally performed well under Ofwat's key performance indicators for 2011/12 and 2012/13, with none of the key performance indicators marked as `Red' on the traffic light reporting matrix. However, performance in certain sewerage services, including pollution incidents and internal sewer flooding, has been below target expectation over the past few years, albeit somewhat affected by negative weather events.

Recent performance under the service incentive mechanism (SIM) also positioned the company more in the mid-field of the sector, with scores in the range of 77-78 (out of 100) over the first three years of AMP5.

PROPOSED CAPEX PROGRAMME WILL RESULT IN FURTHER RCV GROWTH AND ADDITIONAL FUNDING NEEDS

As is the case for its peers, Yorkshire Water faces some risk in the execution of its significant capital programme and the associated financing and refinancing requirements. The company is required to deliver a capital investment programme of around GBP1.9 billion over AMP5 (according to Ofwat's final determination and in 2007/08 prices). Whilst the programme includes a large amount of capital maintenance, it will still increase the RCV by around 11% in real terms over the five-year period to March 2015.

For AMP6, Yorkshire Water Water proposed totex, which included opex and capex, of over GBP3.4 billion (in 2012/13 prices) and expected RCV to grow by around 11% in real terms over AMP6. Given the ongoing large investment requirements, Yorkshire Water will have to maintain good access to capital markets, with net funding requirements expected to be well in excess of GBP1.0 billion over AMP6.

HIGH LEVERAGE CONSTRAINS RATING

Yorkshire Water's Baa1 CFR is constrained by the relatively highly leveraged financial structure adopted by the company. The terms and conditions of its bond programme allow Yorkshire Water 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 (Moody's Funds from Operations, or FFO, less regulatory depreciation divided by net interest) 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 slightly below the dividend lock-up levels at around 80-83% and Adjusted Interest Cover around 1.3x or more. Given the reduced return assumptions for AMP6, financial flexibility going forward will be limited. We could see additional credit pressure developing in a scenario of low inflation or higher than planned expenditure. However, we believe that an adjustment to proposed dividends should ensure that Yorkshire Water maintains a financial profile in line with minimum rating guidance of Net Debt to RCV below 85% and Adjusted Interest Cover at or above 1.2x.

DEBT STRUCTURAL FEATURES PROVIDE RATING UPLIFT FOR ADDITIONAL CREDITOR PROTECTION

Yorkshire Water'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 comparable highly-leveraged financing transactions, and results in uplift of around one notch that is incorporated in the Baa1 CFR.

Additional event risk protection provided by the bond covenant and security package, include, inter alia, restrictions on acquisition and disposals (subject to limited defined exceptions), a dividend lock-up coming into effect if gearing increases above 85% of RCV, and limitation on non-core activities. In addition, we consider creditor step-in rights if certain trigger events occur.

Recovery prospects in a default scenario can be improved by (1) 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 Yorkshire Water, and (2) the agreement by financial creditors to give up their individual rights to petition for insolvency proceedings. We recognise that the benefit of the security provided to bondholders is limited due to the regulated and essential nature of the services provided by Yorkshire Water as governed by its licence and the Water Industry Act 1991.

We also rate the bonds issued by Yorkshire Water's finance subsidiaries under a GBP8.0 billion multicurrency bond programme (the Programme), guaranteed by Yorkshire Water. The bonds are issued either as part of a senior tranche (Class A Debt) or a junior tranche (Class B Debt) and are currently rated A3 or Baa3, respectively.

The A3 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 post any enforcement of security. The rating also, however, factors in the subordinated Class B Debt (Class B Bonds and other pari passu debt) which, whilst it is contractually subordinated, serves to reduce the operator's financial flexibility. Downgrade or default of the Class B Debt could have an impact on the viability of the company's funding model as a whole since the inability to raise additional Class B Debt in the future could undermine the capital structure and affect the credit quality of the senior debt.

The Baa3 rating of the Class B Bonds reflects the same default probability as factored into the Baa1 CFR but also Moody's expectation of a heightened loss severity for the Class B Debt following any default, given its subordinated position.

Other Considerations

Our assessment is based on Moody's global Rating Methodology for Regulated Water Utilities, published in December 2009. The methodology grid results in an indicative factor outcome of Baa1 in line with the assigned CFR.

Whilst we expect financial headroom to reduce following implementation of the new regulatory tariffs from April 2015, we believe that Yorkshire Water's financial profile will remain in line with our minimum ratio guidance, thereby supporting the current ratings.

Liquidity Profile

Yorkshire Water exhibit a solid liquidity profile with its stable and predictable cash flows generated by its regulated activity, cash balances of around GBP19 million at 30 September 2013 and GBP490 million of committed revolving facilities, available until October 2018, of which GBP357 million was available as at 30 September 2013.

In April 2013, Yorkshire Water Services Bradford Finance raised AUD50 million of 10-year Class A debt, and , in June 2013 issued GBP90 million of 20-year Class B debt, with the funds being on-lent to Yorkshire Water. We consider the current funds available to be sufficient to cover Yorkshire Water's ongoing liquidity needs well into the start of AMP6.

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 Yorkshire Water'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 Yorkshire Water 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 (1) unexpected, severe deterioration in operating performance that results in the company remaining persistently in breach of the distribution lock-up triggers; (2) a material change in the regulatory framework for the UK water sector leading to a significant increase in YWS's business risk; or (3) unforeseen funding difficulties.

Rating Factors

Yorkshire Water Services Limited

Regulated Water Utilities [1][2]	**CurrentAs at 3/31/2013**		[3]**Moody's 12-18 months forward viewAs at 3/11/2014**	
			Measure	Score
Factor 1: Regulatory Environment & Asset Ownership Model (40%)				
a) Stability and Predictability of Regulatory Regime		Aaa		Aaa
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery (Ability & Timeliness)		A		A
d) Revenue Risk		A		A
Factor 2: Operational Characteristics & Asset Risk (10%)				
a) Operational Efficiency		Baa		Baa
b) Scale & Complexity of Capital Programme & Asset Condition Risk	8%	A	6-8%	A
Factor 3: Stability of Business Model & Financial Structure (10%)				
a) Ability & Willingness to Pursue Opportunistic Corporate Activity		Aa		Aa
b) Ability & Willingness to Increase Leverage		A		A
c) Targeted Proportion of Revenues Outside Core Water and Wastewater Activities		Aa		Aa
Factor 4: Key Credit Metrics (40%)				
a) Adjusted Interest Coverage (3 year Avg)	1.4x	Ba	1.2-1.4x	Ba
b) Net Debt/ Regulated Asset Value (3 Year Avg)	82.6%	Ba	80-83%	Ba
c) FFO / Net Debt (3 Year Avg)	7.8%	Ba	5-7%	Ba
d) RCF / Capex (3 Year Avg)	0.3x	B	0.4-0.6x	B
Rating:				
a) Indicated Factor-Rating from Grid		Baa2		Baa2
+ Rating Uplift for Additional Creditor Protection		+1		+1

= Final Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned				Baa1

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 3/31/2013; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures