FITCH REVISES YORKSHIRE WATER'S SENIOR SECURED CLASS B DEBT OUTLOOK TO STABLE; AFFIRMS RATINGS

Fitch Ratings-London-25 February 2015: Fitch Ratings has revised the Outlook on Yorkshire Water Services Bradford Finance Limited's (programme issuer) senior secured class B notes to Stable. Its ratings, together with those of Yorkshire Water Services Odsal Finance Limited's (exchange issuer) and Yorkshire Water Services Finance Limited's (YWSF) senior secured ratings, have been affirmed as follows:

Programme issuer:
Class A notes: affirmed at 'A'; Negative Outlook
Class B notes: affirmed at 'BBB+'; Outlook revised to Stable from Negative

Exchange issuer:
Class A notes: affirmed at 'A'; Negative Outlook

YWSF:
Class A notes: affirmed at 'A'; Negative Outlook
Non-participatory bonds: affirmed at 'A-'; Negative Outlook

The programme and exchange issuers and YWSF are debt-raising vehicles of Yorkshire Water Services Limited (Yorkshire Water), the regulated, monopoly provider of water and wastewater services that supplies 4.9 million people in the former county of Yorkshire and part of North Derbyshire.

The rating actions reflect the efficiency challenge embedded in the final determination of tariffs for the period April 2015 to March 2020, positive revenue adjustments related to the 2010-15 period of GBP143m, Fitch's expectation of target gearing being reduced to below 80% net debt / regulatory asset value (RAV) and the high cash cost of its existing debt in comparison to peers' (4.77% before and 4.93% after adjusting for pay as you go index-linked swaps in FY14). The ratings also take account of Yorkshire Water's robust financial and regulatory performance and the covenanted nature of the financing structure.

Forecast interest cover for class A debt remains below our ratio guideline. As a result, the Negative Outlook for class A debt is maintained. Fitch will await first evidence of actual performance during the upcoming price control period to decide, whether the current rating forecast is too conservative or an accurate reflection of the expected financial profile. Our forecast metrics for class B debt are now within rating guidelines, which is reflected in the Outlook revision.

KEY RATING DRIVERS

Top Quartile Cost Position
Yorkshire Water received an uplift of total expenditure (totex) allowances of around GBP70m compared with its business plan and was able to provide robust data to Ofwat (the economic regulator for the UK water sector) to demonstrate input price pressures for the retail unit. This highlights the company's top quartile performance in terms of cost base. For the rating forecast Fitch assumed GBP50m of operating expenditure outperformance (in nominal terms), expecting some scope for outperformance on totex budgets, a broadly neutral position on retail budgets and small penalties on outcome delivery incentives.

Leverage Coming Down

Fitch expects the company to adapt its dividend policy to reduce gearing to below 80% net debt/RAV in the short- to medium-term. As a result, Yorkshire Water will have more financial flexibility within its covenanted and secured financing structure to absorb costs related to exceptional events. Documentation allows for gearing of up to 85% net debt/RAV. Fitch has slightly tightened the guidelines for gearing to 70% from 73% for class A debt and to 80% from 83% for class B debt due to a less supportive position from Ofwat on financeability during the recent price control process.

Interest Cover Remains under Pressure

Under our rating case we calculate forecast post-tax and post-maintenance interest cover (PMICR) of around 1.4x for class A debt, in comparison with a guideline for the existing rating of 1.5-1.6x, and around 1.2x for class B debt, in comparison with a guideline of 1.2-1.3x. Drivers for the low interest cover are Yorkshire Water's high cash cost of embedded debt and the low cost of capital chosen by the regulator at 3.75%.

Fitch's ratios differ from the covenants included in Yorkshire Water's transaction documentation and pay-as-you-go profiling of revenues will have an impact on financial ratios reported in Yorkshire Water's investor report.

Robust Regulatory Performance

In FY14 Yorkshire Water met all its targets related to the customer experience as well as reliability and availability. Some indicators related to environmental impact would benefit from further attention, such as pollution incidents and discharge permit compliance, but this is a common theme across the industry. As part of the tariff settlement the company has given a range of performance commitments that target service and environmental improvements. Management is determined to build on the strong track record from previous years.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- Regulated revenues in line with the final determination of tariffs for April 2015 to March 2020, ie assuming no material over- or under-recoveries
- Operating expenditure outperformance of GBP50m in nominal terms over the five-year period
- Retail costs in line with allowances
- Non-appointed EBITDA of around GBP2.5m per annum
- Retail price inflation of 0.75% for FY15, 1% for FY16, 2% for FY17 and 2.5% thereafter
- Capital expenditure outperformance of GBP100m in nominal terms over the five-year period

RATING SENSITIVITIES

Fitch will look at operating performance and evolution of macro-economic conditions in the first one or two years of the price control period to decide, whether to increase, maintain or decrease the level of outperformance in the rating forecast. Such evidence should assist in the decision to downgrade the class A debt ratings or revise the Outlook to Stable.

Positive: Future developments that may, individually or collectively, lead to positive rating action:

- For class A debt gearing sustainably at or below 70% and PMICR sustainably above 1.5x, which would lead to the Outlook being revised to Stable
- For class B debt positive rating action is unlikely given the highly geared capital structure

Negative: Future developments that may, individually or collectively, lead to a downgrade:
- For class A debt gearing above 70% and PMICR below 1.5x
- For class B debt gearing above 80% and PMICR below 1.2x

- A decline in operational or regulatory performance
- Regulatory decisions such as moving additional parts of the value chain away from RAV-based regulation or swapping RPI indexation for CPI indexation

LIQUIDITY AND DEBT STRUCTURE

At 30 September 2014, Yorkshire Water had available GBP38.5m in cash and GBP336m of undrawn, committed bank facilities maturing in October 2018. This funding position provides sufficient financial resources for operating requirements, debt maturities and dividends beyond March 2016.

The group also has access to GBP231m of debt service reserve liquidity and GBP61.25m of operating and maintenance reserve liquidity, dedicated standby lines that would be available during times of financial distress.

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Additional information is available on 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 28 May 2014, are available at 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=749393