

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

Fitch Ratings-London-25 February 2015: 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 available at the end of this commentary.

Kelda is a holding company of Yorkshire Water Services Limited (Yorkshire Water; class A debt A/Negative, class B debt BBB+/Stable), 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 Yorkshire Water's adequate dividend capacity in comparison with the debt service requirements of Kelda, even though Yorkshire Water faces pressure on credit metrics stemming from Ofwat's final determination of tariffs for the period April 2015 to March 2020 and a recent reduction of retail price inflation. The ratings also take into account of Yorkshire Water's robust financial and regulatory performance.

KEY RATING DRIVERS

Adequate Dividend Cover at Kelda

The rating forecast indicates that the Kelda group should be able to maintain credit metrics in line with our ratio guidelines, ie dividend cover at around 4x (assuming RPI reverts to 2.5% by FY18) and consolidated net debt/regulatory asset value at below 85%. Our post-maintenance and post-tax interest cover forecast is at slightly above 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 GBP16m-GBP19m. Reduced dividend stream from Yorkshire Water expected for the next price control will still allow comfortable servicing of the debt.

However, if retail price inflation remains materially below 1.5% for an extended period of time, dividend stream from Yorkshire Water would be further reduced. This could lead to negative rating action for Kelda's ratings.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for Yorkshire Water 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

In addition, for Kelda Finance we assume:

- Incremental debt at holding company level to remain at around GBP265m
- The annual finance charge at holding company level at around GBP16m-GBP19m

RATING SENSITIVITIES

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

- A sustainable drop of dividend cover below 2.5x
- RPI remaining materially below 1.5% over an extended period of time
- Group gearing sustainably above 85%
- 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 ratings currently do not have any upside. A higher rating for the holding company would be contingent on Yorkshire Water materially reducing its regulatory gearing.

LIQUIDITY AND DEBT STRUCTURE

As of 30 September 2014, 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+'

Contact:

Principal Analyst
Victoria Munarriz
Analyst
+44 20 3530 1419

Supervisory Analyst

Oliver Schuh
Director
+44 20 3530 1263
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson

Josef Pospisil
Senior Director
+44 20 3530 1287

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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.

Related Research

'Fitch Revises Yorkshire Water's Class B debt Outlook to Stable from Negative; Affirms Ratings', dated 25 February 2015

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

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