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Yorkshire Water Services Ltd.

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Yorkshire Water Services Ltd.

Rationale

None

Business Risk	Financial Risk
• Mainly focused on low-risk, U.K.-water regulated monopoly activities. • Transparent, credit-supportive regulatory framework results in financial stability during regulatory periods. • Solid operational performer in terms of the range of measures monitored by the regulator. • Regulatory reset risk every five years.	• Stable and predictable operating cash flows over five-year regulatory periods. • Yorkshire Water Services' (YWS) aggressive capital structure. • Significant and ongoing debt-funded capital expenditure (capex) program resulting in negative discretionary cash flow. • Various structural features designed to increase cash flow certainty for debtholders.

Outlook

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 supported by what Standard & Poor's Ratings Services considers to be stable cash flows--underpinned by the stability of the regulatory framework in which Yorkshire Water Services Ltd. (YWS, or the company) operates and YWS' industry-leading operational performance. The Yorkshire Water financing group consists of YWS and an intermediate holding company Yorkshire Water Services Holdings Ltd. (YWH) that fully owns YWSF, YWSBF, and YWSOF. We do not expect the structure to change during the life of the transaction, so any changes in its credit quality would likely be caused by a change to YWS's credit quality.

Our view of Yorkshire Water's underlying credit quality reflects our expectation that its sole operating subsidiary, YWS, will generate stable cash flows from its regulated activities and maintain adequate operating performance. We also expect Yorkshire Water to maintain adjusted funds from operations (FFO) to debt of at least 6%, which we deem commensurate with the ratings.

Downside scenario

We could lower the ratings on the Yorkshire Water Services group if we see weaker operating performance or reduced profitability, causing credit metrics to fall below our guideline of adjusted FFO to debt of at least 6% for the current rating level. This could happen if the group does not achieve its planned operating efficiencies or exceeds regulatory targets.

Upside scenario

We consider an upgrade unlikely in the near term.

Standard & Poor's Base-Case Scenario

Assumptions

- Retail price index (RPI) of 2.0% in 2015 and 2.4% in 2016 which represents 0.5% uplift to consumer price index (CPI) in 2015 and 0.7% to CPI in 2016.
- Large capex plan, ranging from an annual high of about £430 million in the beginning of the regulatory period to a low of about £385 million in the middle of the period and back up to £410 million at the end of the regulatory period.
- Dividends are expected to be distributed up to a maximum debt/regulatory capital value (RCV) of 80%, as per the company's financial policy.

Key Metrics

	March 2014A	March 2015P	March 2016E
EBITDA margin	59.0%	58%-61%	57%-60%
FFO/total debt	7.4%	6.0%-8.0%	6.0%-8.0%
Debt to EBITDA	7.9x	7.0x-8.0x	8.0x-9.0x

All figures fully adjusted by Standard & Poor's.

A--Actual. E-Estimate. FFO--Funds from operations.

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Company Description

YWS' primary activities are the treatment and distribution of water, as well as the collection and treatment of wastewater in the Yorkshire region. The company 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. Nonregulated activities are limited and are linked to Yorkshire Water's regulated activities. They remain outside the ring-fence of the Yorkshire Water financing group.

Yorkshire Water 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., Infracapital Partners L.P and SAS Trustee Corporation.

Structural Features

Supporting Ratings

Institution	Ratings
The Royal Bank of Scotland PLC as liquidity facility provider	A-/Watch Neg/A-2
Lloyds Bank PLC as liquidity facility provider	A/Watch Neg/A-1
HSBC Bank PLC as liquidity facility provider	AA-/Watch Neg/A-1+
Abbey National Treasury Services PLC (Guaranteed by Santander UK PLC) as liquidity facility provider	A/Watch Neg/A-1
The London branch of BNP Paribas as liquidity facility provider	A+/Negative/A-1
Commonwealth Bank of Australia as liquidity facility provider	AA-/Stable/A-1+
Barclays Bank PLC as liquidity facility provider	A/Watch Neg/A-1

Transaction Key Features

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.

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 before the transaction by YWSF, which migrated to the current structure. We rate at 'BBB' the class B bonds issued by YWSBF. 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.

We see the quality of YWS' ring-fencing as adequate under our criteria. The YWS board is composed predominantly of independent directors (five independent directors versus four executive directors). The independence is further strengthened by the regulatory oversight, which helps to ensure the implementation of the set of covenants included in the documentation.

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 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. The difference arises because the company chose to exchange most of its previously outstanding bonds for new ones, as opposed to migrating them into the structure through an amendment of terms.

The ratings also reflect various structural features designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable YWS to manage temporary cash flow shocks. In particular, debtholders benefit from:

- Ring-fencing of the financing group, which is achieved through the special-purpose status of the entities within the financing group; independent representation on the YWS board; and some business, legal, and regulatory restrictions.
- Liquidity facilities that are irrevocable and available to be drawn at any time, including during a standstill. However, such reserves are only required when the class A debt exceeds 67.5% of RCV. In addition, once drawn, the liquidity facilities can be repaid until the liquidity facilities termination date.
- Liquidity facilities allowing YWS to fund capex to significant levels before needing to access the capital markets. These revolving facilities comprise capex/working capital facilities of £490 million, of which £336 million are undrawn.
- A debt service reserve facility of £231.0 million and an operating and maintenance reserve facility of £61.25 million, each provided by multiple suitably rated counterparties that are sufficient to cover cash interest and finance charges and at least 10% of forecast operating replacement expenditure, and capex for the following 12 months. The facilities remain undrawn and amounts available unchanged.
- A strong covenant package to protect debtholders, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions. There is also a pledge on YWS' and YHW's shares and on all assets in the operating subsidiary, to the extent allowed by legislation.
- Subordination of the class B debt, which cannot create an event of default for the class A debt.
- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control over

YWS at the earliest stage of financial or operational difficulty, or following material changes in business circumstances. The covenants prevent special administration, minimize the borrower's probability of default, and create an additional credit cushion.

- Prudent debt management policies that include a covenanted spread of maturities and interest-rate hedging. We see as a weakness the possibility that super-senior hedging agreements linked to RPI within the class A debt and with a lock-up threshold of 6% of the RCV for accretions, could create a super-senior expense that would rank ahead of the class A notes.

Business Risk

Our assessment of YWS's industry risk as "low" reflects its almost exclusive focus on the U.K. water sector, which we view as having low operating risks. The company's natural monopoly in its service area ensures that it will continue to be regulated by Ofwat, which provides effective regulation to protect end-consumers. We consider the regulatory framework for the water sector in England and Wales to be credit-supportive. Revenues are set prospectively for periods of five years, ensuring transparency and predictability of earnings and cash flows. The strength of the regulator (Ofwat) and its framework is reflected in our assessment of this regulatory framework as offering a "strong" regulatory advantage (see "Why U.K. Utilities' Regulatory Frameworks Merit A 'Strong' Regulatory Advantage Assessment," published Dec. 11, 2013).

Like all U.K. water companies, YWS is exposed to regulatory reset risk every five years, and also to the sector reforms being proposed by the regulator and the government. In December 2014, Ofwat announced its final determination for all water companies in the U.K. and YWS accepted it. In our view, YWS' business risk profile is unchanged following final determination by the regulator. Overall, YWS' final determination is in line with the draft determination published in August 2014. From 2017, YWS will be exposed to competition in the nonresidential retail segment, which will be remunerated under a new regulatory framework based on a default tariff (set as the company cost-to-serve plus a retail margin). We will monitor YWS's consolidated credit quality for any margin compression or cash-flow volatility that might arise from increased competition in the retail segment.

YWS's operational performance measures remain solid. In 2013/2014 YWS once again significantly outperformed leakage targets set by Ofwat. All of YWS' serviceability scores remain stable, and the company's service incentive mechanism (SIM) score has improved to 82 from 78.

S&P Base-Case Operating Scenario

- We assume that revenues will grow at about 2% through 2017, after which we expect a flattening in the growth rate.
- A U.K. GDP growth of 2.7% in 2016 and 2.6% in 2017. However, YWS is relatively resilient to economic conditions, as its earnings under the U.K. regulatory framework are insulated from demand.
- RPI of 2.0% in 2015 and 2.4% in 2016, which represents 0.5% uplift to CPI in 2015 and 0.7% to CPI in 2016.
- Operating expenditure and capex outperformance are factored into our forecast.

Financial Risk

Our rating on YWS is constrained by the group's highly leveraged balance sheet and weak cash flow coverage of debt metrics. The company's aggregate class A and B net debt to regulated capital value (RCV) is likely to stay at about 80%, which we consider consistent--albeit at the high end--with similarly rated peers. We expect discretionary cash flow to be negative for next regulatory period because of the company's large capex program and sizable dividend payments.

Given the group's highly leveraged balance sheet, the lack of incentive for management to reduce debt, and modest cash flow generation, we anticipate that YWS's credit metrics will remain weak, but that the group will maintain headroom within its covenant structure. We also expect that YWS's ratios will remain above our guidance for the rating, that is, adjusted FFO to debt in line with 6% over the next regulatory period.

Index-linked swaps

The YWS transaction includes index-linked swaps that have mandatory breaks at regular intervals according to the transaction hedging policy. The break dates for these swaps are in 2018, 2020, 2023, and 2025. If the swaps are out of the money and cannot be renegotiated or transferred to new swap counterparties, then there is potential for significant cash outflow from the transaction. We anticipate that YWS will actively manage its swap exposure and potential associated cash outflows at least two years before any breaks.

S&P Base-Case Cash Flow And Capital Structure Scenario

- Adjusted FFO to debt above 6% over 2015-2016.
- Increasing debt, but total leverage remaining at about 80% of regulatory asset value.

Financial summary

Table 1

YW Services Ltd. -- Financial Summary

Industry Sector: Water

	--Fiscal year ended Mar. 31--				
(Mil. £)	**2014**	**2013**	**2012**	**2011**	**2010**
Revenues	992.3	940.4	897.5	872.5	872.9
EBITDA	585.7	553.9	519.0	471.5	525.8
Funds from operations (FFO)	341.3	291.1	245.2	248.7	364.0
Net income from continuing operations	203.1	248.5	77.7	117.7	126.1
Cash flow from operations	445.3	432.8	361.4	287.2	345.6
Capital expenditures	363.7	372.6	394.5	167.5	234.1
Free operating cash flow	81.6	60.2	(33.1)	119.7	111.5
Dividends paid	165.5	256.7	63.4	46.9	211.0
Discretionary cash flow	(83.9)	(196.5)	(96.5)	72.8	(99.5)
Debt	4,641.5	4,563.8	4,246.4	3,631.6	3,276.0

Table 1

YW Services Ltd. -- Financial Summary (cont.)					
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	2,489.9	2,386.2	2,441.4	2,472.1	773.5
Debt and equity	7,131.4	6,950.0	6,687.8	6,103.7	4,049.5
Adjusted ratios					
EBITDA margin (%)	59.0	58.9	57.8	54.0	60.2
EBITDA interest coverage (x)	2.3	2.1	1.8	1.8	2.9
FFO cash int. cov. (x)	2.9	2.7	2.6	2.5	2.3
Debt/EBITDA (x)	7.9	8.2	8.2	7.7	6.2
FFO/debt (%)	7.4	6.4	5.8	6.8	11.1
Cash flow from operations/debt (%)	9.6	9.5	8.5	7.9	10.5
Free operating cash flow/debt (%)	1.8	1.3	(0.8)	3.3	3.4
Discretionary cash flow/debt (%)	(1.8)	(4.3)	(2.3)	2.0	(3.0)
Net cash flow/capex (%)	48.3	9.2	46.1	120.5	65.3
Return on capital (%)	5.6	5.9	5.7	6.2	8.7
Return on common equity (%)	8.0	9.9	3.1	7.1	14.6
Common dividend payout ratio (unadjusted) (%)	0.0	31.4	81.6	39.8	167.3

Liquidity

We assess YWS's liquidity position as "strong" under our criteria, supported by our view that YWS's liquidity resources will exceed its funding needs by more than 1.7x in the next 12 months. The credit facility contains covenants, but we estimate that the group has headroom under its trigger and events of default covenants for leverage and interest costs.

Principal Liquidity Sources	Principal Liquidity Uses
• A cash balance of about £38 million as of Sept. 30, 2014; • FFO of about £410 million; and • Committed capex facility of £430 million and working capital facility of £60 million, of which £336 million are undrawn.	• Expected capital spending of approximately £325 million; and • Expected shareholder distributions of approximately £96 million.

Additional reserve accounts

In addition to the above credit facilities, which support its class A and class B debt, YWS must also maintain a debt service reserve (DSR) account or DSR facilities which, combined with the amounts available on the DSR accounts, must cover the next 12 months' forecast cash interest and finance charges on the class A and B debt. The DSR facilities will need to be irrevocable and to be available to be drawn at any time, including during a standstill.

YWS has solid relationships with banks and a generally high standing in the credit market. In our view, all U.K. regulated water companies are well positioned in the credit markets. The company also has a very prudent financial risk management, demonstrated by clear internal guidelines, continual monitoring and reporting of contracts using a framework, and its use of various financial instruments such as swaps.

Debt maturities

Table 2

Debt Maturities	
2016	-
2017	-
2018	28.3
2019	275.0
2020	-
Thereafter	4,285.6

Covenant Analysis

Table 1 shows the financial covenant level requirements, Standard & Poor's base-case scenario for 2014, and YWS's actual performance.

Table 3

Key Covenants

Financial covenant	Restricted payment conditions*	Actual performance September 2014	Company forecast March 2015	Company forecast March 2016
Class A RAR (%)	75.0	68.1	66.8	69.9
Senior RAR (%)	85.0	78.0	76.6	79.6
		'--Year ended March 31--		
		2014	2015f	2016f
Class A ICR (x)	1.6 (default)	3.18	3.18	2.92
Class A adjusted ICR (x)	1.3	1.60	1.55	2.92
Senior adjusted ICR (x)	1.1	1.38	1.33	2.51
Class A average adjusted ICR (x)	1.4	1.60	1.60	1.60
Senior average adjusted ICR (x)	1.2	1.38	1.38	1.38

RAR--Regulated asset ratio.

Compliance Expectations

We consider that YWS has sufficient headroom under its financial covenants and that headroom will remain adequate during the upcoming regulatory period. Our headroom calculations are based on the company's dividend lock-up covenant levels.

YWS continues to perform well under its structural covenants, and has consistently outperformed the forecasts that it provided at the close of the transaction on July 24, 2009. For instance, the class A regulated asset ratio (RAR) and senior RAR were 68.1% and 78.0%, respectively, on Sept. 30, 2014. These figures, as well as the forecast for the next two financial years, are within the distribution lock-up levels of 75% and 85%, respectively, with which YWS has to comply as long as it has index-linked swaps with breaks over the next 10 years.

Reconciliation

Table 4

Reconciliation Of YW Services Ltd. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. £)

	--Fiscal year ended Mar. 31, 2014--									
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
YW Services Ltd. reported amounts	4,588.9	2,561.5	992.3	601.6	330.2	255.5	601.6	461.4	165.5	379.8
Standard & Poor's adjustments										
Interest expense (reported)	--	--	--	--	--	--	(255.5)	--	--	--
Interest income (reported)	--	--	--	--	--	--	--	--	--	--
Current tax expense (reported)	--	--	--	--	--	--	11.3	--	--	--
Operating leases	2.4	--	--	0.2	0.2	0.2	0.0	0.0	--	--
Postretirement benefit obligations/deferred compensation	71.6	(71.6)	--	--	--	--	--	--	--	--
Surplus cash	(21.4)	--	--	--	--	--	--	--	--	--
Infrastructure renewal costs	--	--	--	(16.1)	--	--	(16.1)	(16.1)	--	(16.1)
Nonoperating income (expense)	--	--	--	--	62.2	--	--	--	--	--
Total adjustments	52.6	(71.6)	0.0	(15.9)	62.4	0.2	(260.3)	(16.1)	0.0	(16.1)
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Standard & Poor's adjusted amounts	4,641.5	2,489.9	992.3	585.7	392.6	255.7	341.3	445.3	165.5	363.7

Related Criteria And Research

Related Criteria

- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Methodology For Considering Pre-Insolvency Structural Protections In Europe, Dec. 13, 2012

Related Research

- Why U.K. Utilities' Regulatory Frameworks Merit A 'Strong' Regulatory Advantage Assessment, Dec. 11, 2013
- Exploring The Keys To Success For U.K. Water Corporate Securitizations, Dec. 14, 2006

Ratings Detail (As Of May 21, 2015)	
Yorkshire Water Services Finance Ltd.	
Senior Secured	A-
Senior Secured	BBB
Related Entities	
Kelda Finance (No. 3) PLC	
Issuer Credit Rating	BB-/Stable/--
Senior Secured	BB-
Yorkshire Water Services Odsal Finance Ltd.	
Senior Secured	A-
Senior Secured	BBB
YW Services Ltd.	
Senior Secured	A-
Senior Secured	AA-/Stable
Senior Secured	BBB

*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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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