MOODY'S
INVESTORS SERVICE

Credit Opinion: Yorkshire Water Services Limited

Global Credit Research - 29 Sep 2015

United Kingdom

Ratings

Category	Moody's Rating
Outlook	Stable
Corporate Family Rating	Baa2
Yorkshire Water Services Bradford Finance Ltd	
Outlook	Stable
Bkd Senior Secured	Baa1
Bkd Subordinate -Dom Curr	(P)Ba1
Yorkshire Water Services Odsal Finance Ltd	
Outlook	Stable
Bkd Senior Secured -Dom Curr	Baa1
Yorkshire Water Services Finance Limited	
Outlook	Stable
Bkd Senior Secured -Dom Curr	Baa1

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Key Indicators

[1]**Yorkshire Water Services Limited**

	3/31/2015	3/31/2014	3/31/2013	3/31/2012	3/31/2011
Adjusted Interest Coverage	1.5x	1.4x	1.4x	1.5x	1.5x
Net Debt / Regulated Assets Value [2]	83.1%	80.8%	82.7%	81.7%	74.6%
FFO / Net Debt	9.0%	8.1%	7.7%	8.3%	9.3%
RCF / Capex	1.5x	0.8x	0.5x	0.6x	1.5x

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM [2] March 2015 RAV reflects Ofwat's midnight adjustment at 1 April 2015

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.

- Derivatives portfolio increases risks in current low-interest rate environment.

- 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 Baa2 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 Baa2 CFR reflects, as positives (1) Yorkshire Water's low business risk profile as the monopoly provider of essential water and sewerage services; and (2) the stable cash flows generated under a transparent and well-established regulatory regime. The rating is constrained by (1) the high level of gearing around 80% of Net Debt to RCV; and (2) the risk embedded within the company's derivative portfolio that included around GBP1.3 billion (notional) of inflation-linked swaps as at 31 March 2015. The Baa2 CFR also incorporates rating uplift from the additional creditor protections incorporated within the company's financing structure.

We note that Yorkshire Water is rated one notch lower than comparable transactions, such as Anglian Water or Thames Water due to the risks embedded in the company's derivatives portfolio. In that context, Yorkshire Water's credit quality is more closely linked to Southern Water, which also holds a Baa2 CFR.

Yorkshire Water holds a portfolio of inflation-linked derivatives with a notional amount of approximately GBP1.3 billion, equivalent to approximately 23% of the company's regulatory capital value (RCV). The company's derivatives portfolio is very sensitive to movements in interest rates, and a fall (or rise) of rates can see the MTM of the portfolio increase (or reduce) significantly. In the continuing low interest rate environment, the MTM value of these inflation-linked swaps stood at around GBP2.1 billion as at March 2015.

Moody's believes that this negative MTM has become a persistent feature within the company's capital structure. This high level of negative MTM is relevant also in the context of certain swaps that include an option for the bank counterparties to break the swap before its final maturity, thereby increasing the likelihood of a payout of the MTM under these swaps. In June 2015, Yorkshire Water concluded a restructuring that removed the 2018 break dates from swaps with a notional amount of around GBP160 million. The company still holds swaps with a notional amount of around GBP290 million that have breaks in the years 2020-2025. While the restructuring removed the immediate liquidity risk, it also increased the overall interest rate paid by Yorkshire Water. This in turn further increased the MTM value following the restructuring, albeit modestly in the context of the overall swap portfolio and also mitigated by paydown of inflation accretion for these swaps. The large negative MTM is primarily a reflection of the the long tenor of a number of the swaps and the overall comparably high rates locked in by Yorkshire Water over such an extended period of time. We believe that this puts the company at a disadvantage in relation to its average funding costs when compared with its peers in the UK water sector.

We do not expect the company to face significant pressures from its operations, taking into account that (1) Yorkshire Water's final price determination has been largely in line with the company's business plan submission;

(2) the company has a solid operational performance track record; and (3) management took a prudent approach to financial policy, with gearing reduced to 80% of net debt to RCV. However, we believe that these positive aspects are not sufficient to fully offset the risk embedded within the company's derivatives portfolio, particularly considering the very long tenor of a number of the inflation-linked swaps.

DETAILED RATING CONSIDERATIONS

STRONG REGULATORY ENVIRONMENT, AND CERTAINTY OF CASH FLOWS AFTER FINAL PRICE DETERMINATION

The UK water sector benefits from a very transparent, stable and predictable regulatory regime, which is based on clearly defined risk allocation principles and their consistent application in setting water tariffs by an independent regulatory body, the Water Services Regulation Authority (Ofwat).

Ofwat published the final price determination for the sector in December 2014, and Yorkshire Water accepted its final determination in February 2015. As part of the determination, Ofwat changed the way it sets tariffs for the water companies in England and Wales. For the five-year period that commenced on 1 April 2015 (AMP6), tariffs have been set to reflect (1) separate price controls for retail and wholesale activities; (2) increased customer involvement in companies' business planning and focus on long-term outcomes rather than short-term outputs; (3) more tailored outcome delivery incentives; and (4) a total expenditure (totex) cost assessment. The introduction of separate price controls for retail and wholesale services is in part to facilitate retail competition for non-household (NHH) customers. Competition, which the regulator expects to start in 2017, was enabled by new legislation - the Water Act 2014. The Act also provides for further upstream reform by enabling changes to the Water Supply Licensing regime to allow new entrants to supply water and wastewater services to NHH customers.

We view the changes introduced for AMP6 as being largely neutral for the UK water sector as a whole. Following the final determination, we expect Ofwat to continue developing its upstream reform agenda and will assess the wider implications for the credit quality of the sector, as and when more details become available. Overall, we view the introduction of any form of competition into a previously fully regulated monopoly sector as credit negative.

Along with its peers, Yorkshire Water's final determination includes (1) an allowed return of 3.6% per annum on the wholesale RCV; (2) a net retail margin of 1% for household retail activities; and (3) a net retail margin of 2.5% for non-household retail activities. The overall allowed return, which for a notional company is around 3.74% per annum (vanilla, real), is significantly lower than both the 5.1% p.a. return allowed in the current period and the 4.2% p.a. proposed by the company in its initial business plan submitted in December 2013. However, Yorkshire Water managed to secure additional revenues to allow smoothing of customer bills over the next two periods, which will provide additional liquidity and partly offsets the reduction in allowed return.

GOOD OPERATIONAL PERFORMANCE TRACK RECORD SUPPORTS RATINGS

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 over the 2010-15 regulatory period, with none of the key performance indicators marked as `Red' on the traffic light reporting matrix.

Recent performance under the service incentive mechanism (SIM) positioned the company the upper mid-field of the sector, with scores improving from 76 to around 85 (out of 100) over the AMP5 regulatory period.

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. For AMP6, Yorkshire Water has been allowed total expenditure (totex), which included opex and capex, of around GBP3.5 billion (in 2012/13 prices) for the wholesale part of the business. Under the final determination, RCV will grow by around 9% 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, (including refinancing needs) expected to be around GBP1.5 billion over the next five years.

HIGH LEVERAGE AND DERIVATIVES EXPOSURE CONSTRAIN RATING

Yorkshire Water's Baa2 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.

Furthermore, the company's credit quality is impacted negatively by the additional risk that the inflation-linked derivatives portfolio poses for Yorkshire Water. Its GBP1.3 billion of inflation-linked swaps carried a MTM loss of around GBP2.1 billion as at March 2015. The persistently high MTM value of the overall swap portfolio is a function of primarily the current low interest rate environment. While an increase in interest rates could markedly reduce the company's MTM, the structure of Yorkshire Water's swaps mean that the MTM value will remain highly volatile with interest rate fluctuations, and the long tenor of a number of its swaps continue to expose the company to such volatility over the very long term. The long tenor also means that its interest rate structure has been locked in over a long period, which puts the company at a disadvantage compared with peers in the UK water sector.

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 a level of rating uplift incorporated in the Baa2 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.

The highly-leveraged UK water companies, including Yorkshire Water, introduced a new supplementary interest cover covenant, designed to reflect regulatory changes in the revenue building block approach for tariff setting purposes. The definition of Yorkshire Water's supplementary covenant is slightly different than that for its highly-leveraged peers. Whereas Anglian Water' or Thames Water's supplementary covenant replaces the previous regulatory capital charges (infrastructure renewals charge and current cost depreciation) with the new RCV depreciation under Ofwat's totex approach, Yorkshire Water also deducts the funded portion of infrastructure renewal expenditure not included in opex in its statutory financial statements, as well as a `fast/slow adjustment' that would reverse excess revenue allowances compared with expected cost assumptions at the final determination. We believe that Yorkshire Water's supplementary covenant most closely resembles the creditor protection that was intended with the original interest cover covenant. As has been the case in the past, Moody's calculation of the Adjusted Interest Cover Ratio (Adjusted ICR) will likely differ from the covenant definition, subject to additional disclosure provided in regulatory accounts and investor reports. Overall, we expect Yorkshire Water to continue to exhibit an Adjusted ICR, based on Moody's calculation, in line with the minimum guidance for its current ratings.

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 Baa1 or Ba1, respectively.

The Baa1 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 Ba1 rating of the Class B Bonds reflects the same default probability as factored into the Baa2 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, one notch higher than the assigned CFR, because the grid does not reflect the risk associated with Yorkshire Water's derivative portfolio.

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, including management's strategy of slightly reduced gearing below 80%, will provide some additional flexibility.

Liquidity Profile

Yorkshire Water exhibits a solid liquidity profile with its stable and predictable cash flows generated by its regulated activity, cash balances of around GBP35 million at 31 March 2015 and access to GBP490 million committed bank facilities to cover capex and working capital needs, available until October 2018, of which remained undrawn. In addition, under its financing structure, Yorkshire Water has access to debt service and operation & maintenance reserve liquidity facilities of altogether GBP305 million, renewed annually in April.

In April 2017, GBP450 million of Class B debt due 2025 is callable. The next significant debt maturity is in October 2018 when GBP490 million of committed revolving facilities expire.

Rating Outlook

The rating outlook is stable, reflecting Moody's view that Yorkshire Water's management will be able to manage the risks associated with its derivatives portfolio at the Baa2 CFR rating level. This view takes into account the company's strategy to (1) reduce the risk of potential MTM payments by removing breaks from the derivative contracts; and (2) maintain additional financial flexibility to offset comparably higher cost of debt than its peers through lower gearing that will not exceed 80% of net debt to RCV. The stable outlook also reflects Moody's view that the current low interest rate environment is unlikely to persist over the medium term.

What Could Change the Rating - Up

The ratings could be upgraded if (1) the risk exposure of Yorkshire Water's derivatives portfolio reduces over time, such that it no longer affects the company's financial flexibility in comparison with its peers, or (2) the company managed to create additional financial flexibility by reducing leverage below 75% of net debt to RCV. However, before considering any upgrade, Moody's will also assess the company's remaining derivatives exposure and ongoing risk in light of the then present market conditions.

What Could Change the Rating - Down

The ratings could be downgraded in the event of unexpected, severe deterioration in operating performance that results in the company exhibiting financial metrics of net debt to RCV persistently above 80% and/or an Adjusted Interest Cover Ratio consistently below 1.2-1.3x. Further downward pressure could develop in case of (1) a material change in the regulatory framework for the UK water sector leading to a significant increase in Yorkshire Water's business risk; or (2) unfavourable market conditions that would affect the company's ability to refinance debt maturities when due, also in the context of future breaks under its existing swaps arrangements.

Rating Factors

Yorkshire Water Services Limited

Regulated Water Utilities [1][2]	**CurrentAs at 3/31/2015**			[3]**Moody's 12-18 months forward viewAs at September 2015**	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)	Measure	Score		Measure	Score
a) Stability and Predictability of Regulatory		Aaa			Aaa

Regime				
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	6-8%	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	1.3-1.4x	Ba
b) Net Debt/ Regulated Asset Value (3 Year Avg)	82.2%	Ba	78-82%	Ba
c) FFO / Net Debt (3 Year Avg)	8.3%	Ba	6-8%	Ba
d) RCF / Capex (3 Year Avg)	0.8x	Ba	0.5-1.0x	Ba
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		Baa2		Baa2

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 3/31/2015; 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

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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