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

Fitch Ratings-London-23 February 2016: Fitch Ratings has affirmed Yorkshire Water Services Limited's (Yorkshire Water) debt-raising vehicles' senior secured debt at 'A'/'BBB+'. At the same time, Fitch has revised the Outlook on the class A debt to Stable from Negative. A full list of rating actions is available at the end of this commentary.

The affirmation reflects our expectation that Yorkshire Water will maintain adequate financial metrics for the ratings, despite a material reduction of earnings for the current regulatory period from April 2015 to March 2020 (asset management plan 6; AMP6). It also reflects Fitch's expectation that its target gearing remains below 70% net debt/regulatory asset value (RAV) for its class A debt and below 80% for its class B debt, and the high cash cost of its existing debt in comparison to peers' (4.77% before and 4.87% after adjusting for pay-as-you-go index-linked swaps in the financial year to March 2015).

The Stable Outlook for the class A debt reflects our expectation that the company will meet our net debt/RAV guidelines for the rating, despite interest cover being slightly weak for the rating in the near term.

The ratings also take into account Yorkshire Water's solid financial and regulatory performance, and the secured nature of the group's financing structure, which benefits from structural enhancements, including trigger mechanisms (such as dividend lock-up provisions tied to financial, positive and negative covenants) and debt service reserve liquidity.

The vehicles are programme issuer Yorkshire Water Services Bradford Finance Limited, exchange issuer Yorkshire Water Services Odsal Finance Limited and Yorkshire Water Services Finance Limited's (YWSF).

Yorkshire Water is 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.

KEY RATING DRIVERS
Class A Interest Cover Weak
Fitch expects post-tax and post-maintenance interest cover (PMICR) for AMP6 to be weak for the class A debt. Fitch forecasts an average of 1.44x PMICR for class A debt, compared with a rating guideline of 1.5x-1.6x, and an average of 1.3x PMICR for class B debt, versus a rating guideline of 1.2x-1.3x. The low interest coverage is driven by Yorkshire Water's high cost of embedded debt and the low regulatory cost of capital for the current price control.

Operational Outperformance Expected
Fitch expects the company to outperform capex and opex targets over AMP6 given its track record, new processes and the implementation of identified efficiencies for this period. We expect the company to start outperforming in capex early in the price control period. Fitch's forecasts include operating cost outperformance of GBP50m and capex outperformance of GBP130m, in nominal terms over the five-year period.

Expected Deleveraging
Fitch expects the company to reduce gearing to below 70% net debt/RAV for its class A debt and 80% for its class B debt over AMP6, which is commensurate with the agency's rating guidelines

for the current ratings. As a result, Yorkshire Water will have more financial flexibility within its covenanted and secured financing structure to absorb costs related to exceptional events.

Solid Regulatory Performance

Yorkshire Water improved its regulatory performance over the last four years of AMP5. For FY15, the company reported stable asset serviceability for all asset categories for its networks, met most of its regulatory targets, including leakage, and continues to improve pollution incident measures. The company has also improved its Service Incentive Mechanism score, which reflects customer satisfaction, to 85 from 76 over AMP5. As other water companies have also been improving their performance, Yorkshire Water is still viewed as a middle-ranking performer in the sector.

RCV Reduction in March 2020

Ofwat will make a one-off midnight adjustment to UK water companies' regulated capital values (RCVs) at March 2020 as a result of the price review 2014 (PR14) rulebook reconciliation.

The adjustment will not affect the companies' cash flows over AMP6 as companies will retain the run-off revenues and the return earned through AMP6. However, it will result in a reduction in RCV of around 2% for the water companies, although the reduction for each company will depend on its capex. For Yorkshire Water the RCV will be reduced by GBP103m (in 2013 prices). This represents an increase in leverage of around 1.5% based on Fitch's forecast RCV for 2020.

In our view the RCV reduction could be put pressure on companies' credit metrics for AMP7 especially those with high gearing. The increase in gearing following the RCV adjustment could decrease the companies' financial flexibility as a result of reduced liquidity and increased refinancing risk as it may limit the ability of some companies to take on more debt. However, we believe the companies have sufficient time to adapt their strategies over AMP6 to protect their ratings either by reducing dividends or through equity injections.

Index-linked Swaps

Yorkshie Water has a portfolio of index-linked swaps with a notional amount of GBP1,289m embedded in its capital structure. In June 2015, Yorkshire Water completed a restructuring that resulted in the removal of the 2018 mandatory breaks. As a result, the notional value of Yorkshire Water's portfolio of index-linked swaps with mandatory breaks in 2020-2025 has been reduced to GBP292m, in turn lowering the company's liquidity and refinancing risks. We expect management to actively manage the liquidity exposure associated with the breaks in the swaps at least 24 months in advance.

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
- Cumulative operating expenditure outperformance of GBP50m in nominal terms over the five-year period
- Retail costs in line with allowances
- Non-regulated EBITDA of around GBP2.5m per annum
- Retail price inflation of 1.3% for FY16, 2% for FY17 and 2.5% thereafter
- Capex outperformance of GBP130m in nominal terms over the five-year period

RATING SENSITIVITIES

Positive:

- Positive rating action is unlikely for both classes of debt, given the highly geared capital structure.

Negative: Future developments that may, individually or collectively, lead to a downgrade:

- Class A debt gearing above 70% and PMICR substantially below 1.5x
- Class B debt gearing above 80% and PMICR substantially below 1.2x
- Deterioration 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
At 30 September 2015, Yorkshire Water had available GBP32.5m in cash and GBP440m 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 2017.

The group also has access to GBP239.8m of debt service reserve liquidity and GBP65.6m of operating and maintenance reserve liquidity, and dedicated standby lines that would be available during times of financial distress.

FULL LIST OF RATING ACTIONS
Yorkshire Water Services Bradford Finance Limited (programme issuer):
Class A notes: affirmed at 'A'; Outlook revised to Stable from Negative
Class B notes: affirmed at 'BBB+'; Stable Outlook

Yorkshire Water Services Odsal Finance Limited's (exchange issuer):
Class A notes: affirmed at 'A'; Outlook revised to Stable from Negative

Yorkshire Water Services Finance Limited's (YWSF):
Class A notes: affirmed at 'A'; Outlook revised to Stable from Negative
Non-participatory bonds: affirmed at 'A-'; Outlook revised to Stable from Negative

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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 - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362