

Rating Action: Moody's changes outlook to negative on Yorkshire Water, affirms Baa2 CFR

Global Credit Research - 30 Sep 2016

London, 30 September 2016 -- Moody's Investors Service (Moody's) has today affirmed the Baa2 corporate family rating of the fifth-largest UK water company, Yorkshire Water Services Limited (Yorkshire Water). The rating agency also affirmed the Baa1 senior secured and Ba1 subordinated debt ratings of the Class A and Class B notes issued by Yorkshire Water Services Bradford Finance Ltd, the Baa1 senior secured debt ratings of Yorkshire Water Services Finance Limited, and the Baa1 senior secured debt ratings of Yorkshire Water Services Odsal Finance Limited (all issuance guaranteed by Yorkshire Water) were also affirmed. At the same time, Moody's changed the outlook for the ratings to negative from stable.

The outlook change primarily reflects the company's exposure to risks associated with a potentially prolonged low-yield environment, which could significantly curtail future allowed regulatory returns and create particular challenges for companies, such as Yorkshire Water, with expensive, longer-term debt profiles.

A full list of affected ratings is provided towards the end of this press release.

RATINGS RATIONALE

RATIONALE FOR OUTLOOK CHANGE

Today's rating action reflects Yorkshire Water's exposure to a persistently low interest rate environment given the company's leveraged capital structure and funding arrangements. A 'lower-for-longer' interest rate scenario could result in a significant reduction in allowed returns for the UK water sector from 2020 and poses particular risks for companies, including Yorkshire Water, with more expensive and longer-term debt relative to likely regulatory assumptions.

Yorkshire Water's net debt was close to 80% of its regulatory capital value (RCV) as at 31 March 2016. This level of gearing is above both the sector average of around 70% and the gearing assumed by the economic regulator at previous price controls (62.5% at PR14). Consequently, the company is relatively exposed to any divergence between its borrowings costs and those allowed by the regulator.

In addition to its outright borrowings, Yorkshire Water holds a portfolio of inflation-linked derivatives with a notional amount of approximately GBP1.3 billion, which had a negative mark-to-market (MTM) value of around GBP2.6 billion, equivalent to approximately 40% of the RCV, as at March 2016. This sizeable MTM loss reflects the company's locked-in funding costs, which are significantly above current market rates over the long term. Overall, taking into account debt and derivatives, Yorkshire Water reported effective average interest rates of 2.4% and 6.0% for index-linked and nominal fixed-rate debt, respectively, in the year to March 2016.

UK economic regulators base their allowed return calculations on a notional company, that is to say a hypothetical entity with a set gearing (trending towards the average sector gearing, but currently lower) and a defined capital structure. For example, in the water sector the notional gearing is 62.5%, and the notional company would have around 33% of index-linked debt within its capital structure. The Water Services Regulation Authority (Ofwat), the economic regulator for the water and sewerage companies in England and Wales, also assumes a split between embedded and new debt, when setting the cost of debt allowance. Historically, Ofwat has been guided by historical average rates over a 10-year horizon when setting the cost of embedded debt. Continuing with this approach during an extended period of low interest rates, future cost of debt as well as cost of equity (driven by reducing risk-free rates) allowances will invariably decline. Current gilt curves could, for example, support, an overall reduction in the allowed wholesale return from 3.6% in the current period by at least 100 basis points from April 2020.

Companies will benefit from the low interest rate environment over time as they raise new debt. However, companies such as Yorkshire Water with debt tenors beyond that assumed by the regulator, will underperform as allowed returns will converge to market rates more quickly than their embedded cost of debt. A cut in allowed returns will pressure interest cover ratios and companies may need to reduce gearing if they are to maintain credit quality in a lower-for-longer scenario.

Moody's further notes that the low-yield environment may have eroded equity buffers. Taking into account the fair value of existing borrowings and derivatives, Yorkshire Water had gearing (as calculated by Moody's) of around 130% as at March 2016. A visible erosion of the equity value could weaken incentives for shareholders to provide further funding. In addition, while Yorkshire Water has enjoyed ready access to the capital markets, lenders may in future be less supportive of companies with high embedded debt costs and potentially limited equity value.

The rating agency does not expect Yorkshire Water to face significant pressures from its operations, taking into account that (1) its final price determination has been largely in line with the company's business plan submission; and (2) it has a solid operational performance track record. Management's approach to reducing gearing below 80% of the RCV also shows consideration of pressures presented by the current capital structure in a low-yield environment.

However, these positive aspects may not be sufficient to fully offset the risk embedded within the company's capital structure, particularly considering its high-cost and long-dated debt.

RATIONALE FOR RATING AFFIRMATION

In affirming Yorkshire Water's Baa2 rating, Moody's reflects that the company has visibility over allowed revenues for the remainder of the regulatory period to 2020, providing for a financial profile in line with current ratings. The rating agency also takes into account that future interest rates are uncertain and the regulator's duty to ensure that an efficient company is financeable, while noting that this duty may be of limited value to companies, such as Yorkshire Water, with a financing structure that is not aligned with the sector average or that of the regulator's notional company.

Moody's further anticipates that the time available until the next price review allows management and shareholders to consider possible changes in financial and operational policy, which may support cash flow generation and a reduction in gearing over time, thereby creating additional flexibility to mitigate lower future returns.

More broadly, Yorkshire Water's Baa2 CFR reflects, as positives (1) the company'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. As discussed above, the rating is constrained by (1) the high level of gearing; and (2) the risk embedded within the company's derivative portfolio. The Baa1 rating of the Class A Bonds reflects the strength of the debt protection measures for this class of bonds and other pari passu indebtedness, the senior position in the cash waterfall and post any enforcement of security. 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 within the financing structure.

WHAT COULD CHANGE THE RATING UP/DOWN

Given the current negative outlook, there is currently limited upgrade potential. The outlook could be stabilised if Moody's concludes that the risk exposure of Yorkshire Water's capital structure remains manageable and does not adversely affect the company's financial flexibility in comparison with its industry peers, taking into account any additional measures management or shareholders may be willing to implement to mitigate the company's exposure and the timing of those. The rating agency will also consider incentives for shareholders to provide additional financing given the impact of the low yield environment on the debt fair value and derivative valuations.

Conversely, the rating could be downgraded if the above risks are not offset by mitigating measures that would address the high sensitivity to market-rate movements, or create additional financial headroom.

Furthermore, negative rating pressure could derive from (1) unexpected, severe deterioration in operating performance that results in the company remaining persistently in breach of its distribution lock-up triggers; (2) a material change in the regulatory framework for the UK water sector leading to a significant increase in Yorkshire Water's business risk; or (3) unforeseen funding difficulties.

The principal methodology used in these ratings was Regulated Water Utilities published in December 2015. Please see the Ratings Methodologies page on www.moody's.com for a copy of this methodology.

LIST OF AFFECTED RATINGS

Affirmations:

..Issuer: Yorkshire Water Services Bradford Finance Ltd
...BACKED Subordinate MTN Program , Affirmed (P)Ba1
...BACKED Subordinate Regular Bond/Debenture, Affirmed (P)Ba1
...BACKED Subordinate Regular Bond/Debenture, Affirmed Ba1
...BACKED Senior Secured MTN Program, Affirmed (P)Baa1
...BACKED Senior Secured Regular Bond/Debenture, Affirmed Baa1
..Issuer: Yorkshire Water Services Finance Limited
...BACKED Senior Secured Regular Bond/Debenture, Affirmed Baa1
...Underlying Senior Secured Regular Bond/Debenture, Affirmed Baa1
..Issuer: Yorkshire Water Services Limited
...LT Corporate Family Rating , Affirmed Baa2
..Issuer: Yorkshire Water Services Odsal Finance Limited
...BACKED Senior Secured MTN Program, Affirmed (P)Baa1
...BACKED Senior Secured Regular Bond/Debenture, Affirmed Baa1

Outlook Actions:

..Issuer: Yorkshire Water Services Bradford Finance Ltd
...Outlook, Changed To Negative From Stable
..Issuer: Yorkshire Water Services Finance Limited
...Outlook, Changed To Negative From Stable
..Issuer: Yorkshire Water Services Limited
...Outlook, Changed To Negative From Stable
..Issuer: Yorkshire Water Services Odsal Finance Limited
...Outlook, Changed To Negative From Stable

Yorkshire Water Services Limited is the fifth largest of the 10 water and sewerage companies in England and Wales by both 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.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the

rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Stefanie Voelz
VP - Senior Credit Officer
Infrastructure Finance Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Neil Griffiths-Lambeth
Associate Managing Director
Infrastructure Finance Group
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

MOODY'S
INVESTORS SERVICE

© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S

PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE. MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third- party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody's.com under the heading "Investor Relations — Corporate

Governance — Director and Shareholder Affiliation Policy.”

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY’S affiliate, Moody’s Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody’s Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to “wholesale clients” within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY’S that you are, or are accessing the document as a representative of, a “wholesale client” and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to “retail clients” within the meaning of section 761G of the Corporations Act 2001. MOODY’S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY’S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody’s Japan K.K. (“MJKK”) is a wholly-owned credit rating agency subsidiary of Moody’s Group Japan G.K., which is wholly-owned by Moody’s Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody’s SF Japan K.K. (“MSFJ”) is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization (“NRSRO”). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000. MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.