MOODY'S
INVESTORS SERVICE

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.moodys.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.

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