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Summary:

Yorkshire Water Services Ltd.

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Summary:

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Rationale

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. • Aggressive capital structure. • Significant and ongoing debt-funded capital expenditure (capex) program resulting in negative discretionary cash flow (DCF). • Various structural features designed to increase cash flow certainty for debtholders.

Outlook

Our view of the Yorkshire Water Services financing group's underlying credit quality reflects our expectation that its sole U.K. water operating subsidiary, Yorkshire Water Services (YWS), will generate stable cash flows from its regulated activities and maintain adequate operating performance. We also expect YWS financing group to maintain adjusted funds from operations (FFO) to total debt of at least 6% and adjusted FFO to senior debt of at least 7%, which we deem commensurate with the current ratings. YWS group includes Yorkshire Water Services Ltd., Yorkshire Water Services Bradford Finance Ltd., Yorkshire Water Services Finance Ltd., and Yorkshire Water Services Odsal Finance Ltd.

Downside scenario

We could lower the ratings on the debt issued by YWS financing 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 subordinated class B debt and at least 7% for the class A debt. This could happen if the group does not achieve its planned operating efficiencies or exceeds regulatory allowances for expenditure and costs.

Upside scenario

We consider an upgrade unlikely in the near term as we expect limited headroom under YWS financing group's financial metrics and possible increased pressure from the newly introduced competition.

Our Base-Case Scenario

We rate at 'A-' the senior secured class A bonds issued by YWS financing group which reflects our assessment of the financing group's 'bbb+' stand-alone credit profile (SACP) plus one notch of uplift for structural enhancements. We rate at 'BBB' the subordinated class B bonds issued by Yorkshire Water Services Bradford Finance Ltd., which reflects the group's subordinated SACP of 'bbb'. The financial and legal 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. The higher SACP for senior debt reflects our view of the relatively strong cash flow coverage ratios for senior debt compared only to consolidated metrics due to the cushion of subordinated debt and the better positioning of senior creditors in terms of security enforcement and decision-making power.

The regulatory performance of YWS has been strong during the first two years of AMP6 (2015-2020). As per the water regulator Ofwat's assessment, YWS is meeting or exceeding 24 of its 26 operational, service, and environmental performance commitments.

Our base case assumes:

- Retail price index (RPI) of 1.7% in 2017, 3.2% in 2017, 3.10% in 2019, and 2.8% in 2020.
- Revenue growth between 2%-3% for 2017 and 2018 and close to 4% in 2019 and 2020.
- Large capex plan, ranging from an annual high of about £480 million to a low of about £350 million over the remainder of the AMP6 regulatory period.
- Dividend distributions of £90 million-£100 million annually.
- Operating expenditure and capex outperformance are factored into our forecast.

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' credit metrics will remain weak, but that the group will maintain headroom within its covenant structure. We also expect YWS' ratios to remain above our guidance for the rating, that is, adjusted total FFO to debt in line with 6% over the next regulatory period. Based on our assumptions, we arrive at the following metrics:

- EBITDA margin of 56%-57% in 2017 and 2018, progressively improving toward 60% over 2019 and 2020.
- Group total FFO to debt between 6.1%-6.3% in 2017 and 2018 but improving to 6.5%-7.0% over 2019 and 2020.
- FFO to Class A debt between 7.5%-8.0% in 2017 and 2018, improving to 8.0-8.5% in 2019 and 8.5%-9.0% in 2020.
- Debt to EBITDA of about 8.5x in 2017 and 2018, progressively improving to 8.0x–8.5x in 2019 and 7.5x–8.0x in 2020.

Business Risk

Our assessment of YWS' industry risk continues to be supported by 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 Ofwat and its framework is reflected in our assessment of this regulatory framework offering a strong regulatory advantage (see "Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment," published on Dec. 11, 2013, on RatingsDirect).

From April this year, YWS has been exposed to competition in the non-household 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). In order to prepare the company for the transition, YWS has implemented an internal transformation program from the shadow business retail market (opened in October 2016) to full market.

Additionally, the U.K. Government has also requested Ofwat's opinion on the possible benefits of extending retail competition to household water customers in England. Ofwat's opinion, published in July 2016, indicated that household retail competition could be beneficial for customers thanks to better customer service, innovations in the water companies' offering while allowing for some savings, as well as for enhanced environmental benefits. A transition toward household retail competition can therefore be feasible by the end of the current AMP in 2020--subject to the government's final decision on whether retail competition should be extended to household customers. We will monitor YWS' consolidated credit quality for any margin compression or cash-flow volatility that might arise from increased competition in the retail segment.

Financial Risk

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

Liquidity

We assess YWS's liquidity position as strong, supported by our view that YWS' liquidity resources will exceed its funding needs by more than 1.5x in the next 12 months, starting from March 31, 2017. 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 £205 million as of March 31, 2017; • FFO of £350 million-£360 million; and • Undrawn committed facilities of £465 million.	• Expected capex of approximately £415 million; • Expected shareholder distributions of approximately £95 million; and • Expected ongoing refinancing of debt maturities.

Additional facilities

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 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 very prudent financial risk management, demonstrated by clear internal guidelines, continuous monitoring and reporting of contracts using a framework, and its use of various financial instruments such as swaps.

Covenant analysis:

At the YWS level, the creditors benefit from two levels of covenants:

- A trigger event, including if the YWS senior debt to RCV ratio reaches 85%, or if the rating falls below 'BBB' on the class A bonds (currently rated 'A-') or below investment grade for the class B bonds. The primary consequence of a trigger event is that there can be no distribution of any kind toward affiliated companies outside the financing group.
- An event of default, including if the operating company's senior debt to RCV ratio reaches 95%. Once an event of default has occurred, an automatic standstill of claims takes effect, and no enforcement action can be taken by creditors for a period of 18 months.

We expect that YWS will remain compliant with its financial covenants. The covenant requirements and covenant compliance expectations are summarized below.

Financial covenants (as of March 31):

- Class A RAR (%): 67.4 (September 2016A), 67.9 (2017F), 70.8 (2018F), 71.7 (2019F), and 71.2 (2020F)
- Senior RAR (%): 77.3 (September 2016A), 77.6 (2017F), 80.1 (2018F), 80.7 (2019F), and 79.9 (2020F)
- Class A ICR (x): 2.79 (2017F), 2.76 (2018F), 3.04 (2019F), and 3.13 (2020F)
- Class A adjusted ICR (x): 2.79 (2017F), 2.76 (2018F), 3.04 (2019F), and 3.13 (2020F)
- Senior adjusted ICR (x): 2.45 (2017F), 2.38 (2018F), 2.81 (2019F), and 2.90 (2020F)
- Class A average adjusted ICR (x): 2.86 (2017F), 2.98 (2018F), 2.98 (2019F), and 3.26 (2020F)
- Senior average adjusted ICR (x): 2.55 (2017F), 2.70 (2018F), 2.70 (2019F), and 2.97 (2020F)

A--Actual. F--Forecast.

Restricted payment conditions:

- Class A RAR (%): 75.0
- Senior RAR (%): 85.0
- Class A ICR (x): 1.6 (default)
- Class A adjusted ICR (x): 1.3
- Senior adjusted ICR (x): 1.1
- Class A average adjusted ICR (x): 1.4
- Senior average adjusted ICR (x): 1.2

Index-linked swaps

The YWS transaction includes index-linked swaps (notional value of £1.289 million as of year-end (YE) 2016) that have mandatory breaks at regular intervals according to the transaction hedging policy. The break dates for these swaps are summarized in the below. The fair value liability associated with those swaps as of YE2016 stood at £1,734.3 million. If the swaps are out of money and cannot be renegotiated or transferred to new swap counterparties, then there is potential for significant cash outflow from the transaction. We understand from management that YWS is actively managing its swap exposure and will resolve the mandatory swap breaks and associated cash outflows at least two years before any breaks date.

Mandatory swap breaks (Mil. £):

- February 2020: 117.5
- February 2023: 151.5
- February 2025: 23.4

Structural Enhancements

The ratings on the senior notes reflect various structural enhancement that should, in aggregate, help YWS manage temporary cash flow shocks. These include:

- 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.
- 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 capital markets. These revolving facilities comprise capex and working capital facilities of £490 million, of which £336 million are undrawn.
- A DSR facility of £239.8 million and an operating and maintenance reserve facility of £80.0 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' shares and on all assets in the operating subsidiary, to the extent allowed by legislation.
- 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.

- Subordination of the class B debt, which cannot create an event of default for the class A debt.

Related Criteria And Research

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions - June 25, 2013
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses - February 24, 2016
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology - September 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Transaction Structure Methodology - September 16, 2014
- General criteria: Guarantee Criteria – October 21, 2016

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