FITCH AFFIRMS YORKSHIRE WATER'S SENIOR SECURED DEBT AT 'A/BBB+'; OUTLOOK STABLE

Fitch Ratings-London-04 July 2017: Fitch Ratings has affirmed Yorkshire Water Services Limited's (Yorkshire Water) debt-raising vehicles' senior secured debt at 'A/BBB+'. The Outlooks for both classes of debt are Stable. A full list of rating actions is available at the end of this commentary.

The affirmations and Stable Outlooks reflect adequate financial metrics and Fitch's expectation that Yorkshire Water's economic gearing will reduce to around 69% net debt/regulatory asset value (RAV) for its class A debt and to around 77% for its class B debt by the end of the price control from April 2015 to March 2020 (AMP6).The ratings also take into account Yorkshire Water's solid financial and regulatory performance, and the secured nature of the group's financing structure and the high cost of its existing debt compared to peers.

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. 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).

KEY RATING DRIVERS
Operational and Financial Restructuring
Fitch views management's structured reassessment of the Yorkshire Water group's financing and operations as positive. The changes will result in the company's capital structure retaining more flexibility by reducing leverage and financing costs, which should place the company in a better position to affront challenges arising from the price control starting in April 2020 (AMP7), including a potential lower cost of capital and subsequent erosion of cash flow generation.

Yorkshire Water has recently carried out a swap restructuring of index-linked swaps already embedded in its capital structure, which will result in financing cost savings and a reduction of around GBP270 million in the swaps' mark-to-market liability. This is positive, as it will help to improve the company's interest cover. In addition, proceeds of GBP195 million from the drawdown of a bank loan at Kelda Finance No.2 (HoldCo) have been injected into Yorkshire Water (as a reduction of HoldCo's liability to Yorkshire Water). The company is also in the process of selling its non-regulated business, Kelda Water Services; we expect the proceeds from the sale to be injected into Yorkshire Water.

Deleveraging Expected
Fitch expects the company to reduce gearing to around 69% net debt/RAV for its class A debt and 77% for its class B debt over AMP6 to levels comfortable for the current ratings (our forecast gearing differs from the company's forecast as we calculate economic gearing which takes into account adjustments for total expenditure (totex) outperformance). We expect the company to achieve this through the board-approved steps mentioned above, retention of dividends upstreamed to HoldCo (as well as to ultimate shareholders) and the use of totex outperformance generated over the course of AMP6.

Improved Interest Cover
For FY17 (ending 31 March 2017), Fitch forecasts post-tax and post-maintenance interest cover (PMICR) of 1.3x for class A debt and 1.2x for senior debt for AMP6, both of which are below our

guidelines of 1.5-1.6x for class A and of 1.2-1.3x for senior debt. However, we expect PMICR to be comfortably within our guidelines for the remainder of AMP6 as a result of the positive effect on financing costs from the swap restructuring.

Totex Outperformance Anticipated

In our view, Yorkshire Water is well positioned to achieve totex outperformance over AMP6, given its track record in regulatory and operational performance. Two years into the current price control, efficiency initiatives and newly implemented processes have enabled the company to secure a high proportion of targeted operational cost savings while the capital programme is on track to deliver the capex outperformance also targeted by the company. Fitch's forecasts include operating cost outperformance of GBP50 million and capex and infrastructure renewals expenditure outperformance of GBP140 million, in nominal terms over AMP6.

Regulatory Performance as Expected

Yorkshire Water has continued to improve its regulatory performance in FY16 and we expect it to continue improving in FY17. Stability and reliability measures were stable across all four of the company's key asset categories. The company met its leakage target and the Service Incentive Mechanism (SIM) score, which reflects customer satisfaction, slightly improved from 82 to 82.6. However, drinking water compliance was slightly below target, and pollution and sewer flooding performance measures, although within targets, have also deteriorated slightly. Overall, compared to its peers, we view Yorkshire Water as a middle ranking performer in the sector.

Sale of Non-Household Retail Business

Yorkshire Water is to sell its non-household retail business (Three Sixty), which represents around 15% of its total retail revenues and around 1% of company's total revenues, with completion likely in September 2017. In our view, the sale is likely to be neutral for the ratings and should enable the company to focus on improving services for its household customers. We currently consider counterparty risk as low, given the arrangements stipulated in the market code for non-household retail supply, which should mitigate counterparty risk. Yorkshire Water will continue to look after its household customers, which represent around 90% of its customer base.

DERIVATION SUMMARY

Yorkshire Water Services Limited is one the regulated monopoly providers of water and wastewater services in England and Wales. The company's senior secured ratings and credit metrics reflect the highly geared nature of the company's secured covenanted structure versus peers such as United Utilities Water Limited (senior unsecured: A-/Stable) and Wessex Water Services Limited (senior unsecured: A-/Stable), which have lower leverage and are not covenanted secured structures. Yorkshire Water's financing structure 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 company's higher ratings compared to similar peers with covenanted structures, such as Southern Water (A-/BBB/Stable), reflects stronger credit metrics and a more robust financial and regulatory performance. No Country Ceiling constraints affect the rating. Parent/Subsidiary Linkage is applicable but given the regulatory, structural and contractual ring-fenced structure of the group it does not impact the ratings.

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 GBP56 million in nominal terms over the five-year period.
- Retail costs in line with allowances.
- Non-regulated EBITDA of around GBP2.5 million per annum.
- Retail price inflation of 3.1% for FY17, and 3% thereafter up to 2020.

- Capex and Infrastructure renewal expenditure outperformance of GBP140 million in nominal terms over the five-year period.
-Around GBP2 million of EBITDA reduction per annum from FY18 as a result of the sale of the non-household retail business.
-No outperformance related to Outcome Delivery Incentives as the company has deferred them to AMP7.

RATING SENSITIVITIES
Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Positive rating action is unlikely for both classes of debt, given the highly geared capital structure.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Class A debt gearing above 70% and/or PMICR materially below 1.5x on a sustained basis.
- Class B debt gearing above 80% and/or PMICR materially below 1.2x on a sustained basis.
- Deterioration in operational or regulatory performance.
- Regulatory decisions that may materially impact cash flow generation such as moving additional parts of the value chain away from RAV-based regulation or swapping RPI indexation for CPI indexation.

LIQUIDITY
Adequate Liquidity: As of 31 March 2017, the company had GBP178.3 million in cash and cash equivalents and GBP465 million in available undrawn committed bank facilities maturing in October 2018. This funding position provides sufficient financial resources for operating requirements, debt maturities and dividends beyond March 2018.The group also has access to GBP239.8 million of debt service reserve liquidity and GBP80 million of operating and maintenance reserve liquidity, 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 Stable
-- Class B notes: affirmed at 'BBB+'; Stable Outlook
Yorkshire Water Services Odsal Finance Limited's (exchange issuer;
-- Class A notes: affirmed at 'A'; Outlook Stable
Yorkshire Water Services Services Finance Limited's (YWSF):
-- Class A notes: affirmed at 'A'; Outlook Stable
-- Non-participatory bonds: affirmed at 'A-'; Outlook Stable

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Summary of Financial Statement Adjustments
- EBITDA excludes exceptional operating costs relating to flooding event
- Cash interest is adjusted to reflect pay-down provisions on some index-linked swaps
- Debt and interest cost as published in the statutory accounts are adjusted to reconcile with the amounts published in the company's investor report

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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
Criteria for Rating Non-Financial Corporates (pub. 10 Mar 2017)
https://www.fitchratings.com/site/re/895493
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557