CREDIT OPINION
27 November 2024

Update

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RATINGS

Yorkshire Water Services Finance Limited

Domicile	United Kingdom
Long Term Rating	Baa2
Type	Senior Secured - Underlying - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Stefanie Voelz +44.20.7772.5555
VP-Sr Credit Officer
stefanie.voelz@moodys.com

Jonathan Dolbear +44.20.7772.1099
Lead Ratings Associate
jonathan.dolbear@moodys.com

Paul Marty +33.1.5330.3371
Associate Managing Director
paul.marty@moodys.com

Yorkshire Water Services Finance Limited / Yorkshire Water Finance plc

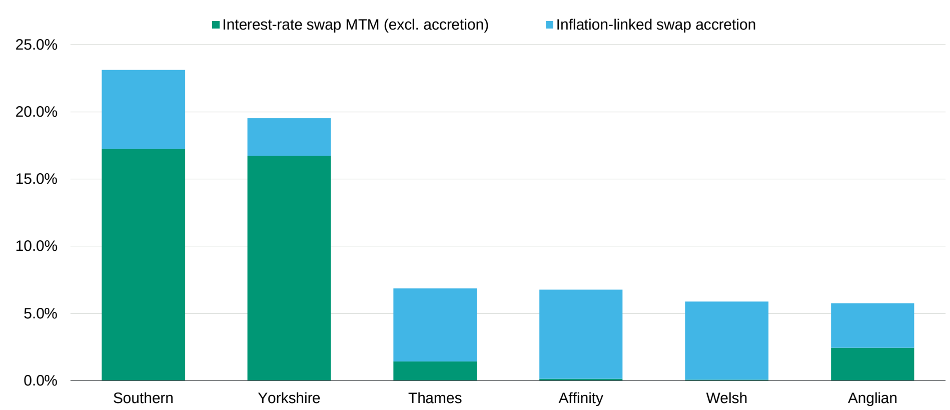
Update following negative outlook

Summary

Yorkshire Water Services Finance Limited (Baa2 negative) and Yorkshire Water Finance plc (Baa2/Ba1 negative for senior and junior debt issuance, respectively) are the financing subsidiaries of Yorkshire Water Services Limited (Yorkshire Water), which guarantees all issuance. Yorkshire Water's credit quality is supported by the company's low business risk as a monopoly provider of essential water and sewerage services. However, credit quality is constrained by a deterioration of the UK water sector's business risk amid a continuing trend of negative public perception resulting in more regulatory powers, an increased focus on enforcement action, demanding targets, greater penalties for operational underperformance and growing regulatory complexity that, in turn, result in higher cash flow volatility and leaner returns.

Credit quality is further constrained by Yorkshire Water's long-dated derivatives portfolio. The company remains exposed to sizeable mark-to-market losses (MTM), which would rank ahead of principal and interest on senior debt in a default scenario, if creditors demanded payment acceleration. At March 2024, the company reported overall MTM liabilities of £1.8 billion (or £1.3 billion credit value-adjusted), equivalent to just under 20% (around 14%) of the company's Regulatory Capital Value (RCV). This is a significant reduction compared with a high of £3.0 billion (39%) in March 2022.

Exhibit 1
MTM liability for interest-rate derivatives, including inflation-linked swaps, as percentage of RCV
As at March 2024



Most interest rate derivatives rank super-senior, although pari passu ranking is possible. Companies may report their overall MTM value as adjusted for credit risk, which reduces the reported obligation.
Source: Companies' annual performance reports 2023/24, Moody's Ratings

In October 2022, Yorkshire Water announced that one of its holding companies would repay £941 million of intercompany loans to the operating company. Although part of this will be reinvested to reduce pollution from storm overflows, the company has committed to start the next regulatory period (AMP8) with regulatory gearing no higher than 72%, subject to certain caveats, compared to 78% based on management's previous plans. In light of Ofwat's draft determination proposals, which indicate a long-term maximum gearing threshold of 70%, we expect the company to target gearing at or just below this level over the next regulatory period.

Credit strengths

» Monopoly position for the provision of water and wastewater services in Yorkshire

» Well-established and transparent regulatory regime

» Debt structural features, including distribution lock-up covenants, dedicated liquidity, intercreditor agreement and security arrangements, which provide some creditor protection for event risk

Credit challenges

» Increasingly challenging regulatory targets, leading to performance penalties in the current regulatory period and the risk of this to continue into the next regulatory period

» Large mark-to-market liability under long-dated derivatives portfolio that would rank ahead of senior creditors in an event of default, if creditors demand payment acceleration

» Swap re-profiling means interest cover covenant protects a weaker Moody's Adjusted Interest Coverage Ratio (AICR)

Rating outlook

The outlook is negative, reflecting a deterioration in the UK water sector's business risk profile and associated tightening of our ratio guidance. While we believe that the company could achieve these tighter metrics in our base case scenario, there is risk to the downside associated with performance penalties, particularly for storm overflows, which may be exacerbated by cost cuts in this area in the draft determination. The negative outlook, therefore, reflects the uncertainty around any potential improvement to cost allowances and performance requirements in the final determination, expected in December 2024. The outlook could be stabilised if Yorkshire Water were to exhibit an AICR of at least around 1.4x on average over AMP8 and gearing, measured by net debt to RCV, no higher than 75%.

Factors that could lead to an upgrade

Given our revised view of the sector's business risk and the current negative outlook, a rating upgrade is currently considered unlikely. Nevertheless, we could consider an upgrade, if Yorkshire Water appeared likely to achieve an AICR consistently above 1.6x and net debt/RCV sustainably below 68%. This would have to be coupled with a financial policy that underpins maintaining such lower gearing despite a financial structure that allows leverage at much higher levels as well as a level of holding company debt and derivative exposure that has not increased compared with current levels.

Factors that could lead to a downgrade

The ratings could be downgraded if Yorkshire Water appeared unlikely to achieve an AICR of at least around 1.4x on average over AMP8 or exhibited gearing, measured by net debt to RCV, in excess of 75%. In addition, downward rating pressure could result from (1) material increases in mark-to-mark valuation of Yorkshire Water's swaps, (2) the adoption of a more aggressive financial policy, including from an increase in holding company debt, which carried sizeable refinancing risk and could impede future shareholder support, (3) a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a further reduction in the stability and predictability of regulatory earnings, which in each case are not offset by other credit-strengthening measures, or (4) unforeseen funding difficulties, including failure to maintain a sustained forward-looking liquidity runway of at least 12 months.

Key indicators

Exhibit 2
Yorkshire Water Services Limited

	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25 Forecast	AMP8 average Forecast
Adjusted Interest Coverage Ratio	0.9x	1.0x	0.7x	0.7x	0.7x-0.9x	1.4x-1.7x
Net Debt / Regulated Asset Base	78.7%	73.7%	72.0%	69.3%	72%-74%	68%-70%
FFO / Net Debt	6.2%	6.4%	5.8%	6.2%	6% - 8%	7%-8%
RCF / Net Debt	6.2%	6.1%	5.2%	5.3%	5%-7%	6%-7%

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. For definitions of Moody's most common ratio terms, please see the accompanying User's Guide. Although the CMA's redetermination has affected cash flow starting only in the 2022-23 financial year, Moody's AICR adjusts for reprofiling and reflects the benefit of the redetermination from the 2020-21 financial year. Moody's Forecast reflects our view and not the view of the issuer. Forecast ratios remain highly uncertain at this point, because cost allowances, performance incentives and allowed returns will likely change at the final determination stage.
Source: Moody's Financial Metrics™ and Moody's Ratings' forecast

Profile

With an RCV of £9.1 billion as of March 2024, Yorkshire Water is the fifth largest of the 10 water and sewerage companies in England and Wales. Yorkshire Water provides drinking water to over 5 million people and 140,000 local businesses over an area of around 14,294 square kilometres encompassing the former county of Yorkshire and part of North Derbyshire in Northern England.

Exhibit 3
Yorkshire Water's service area

Source: Moody's Ratings

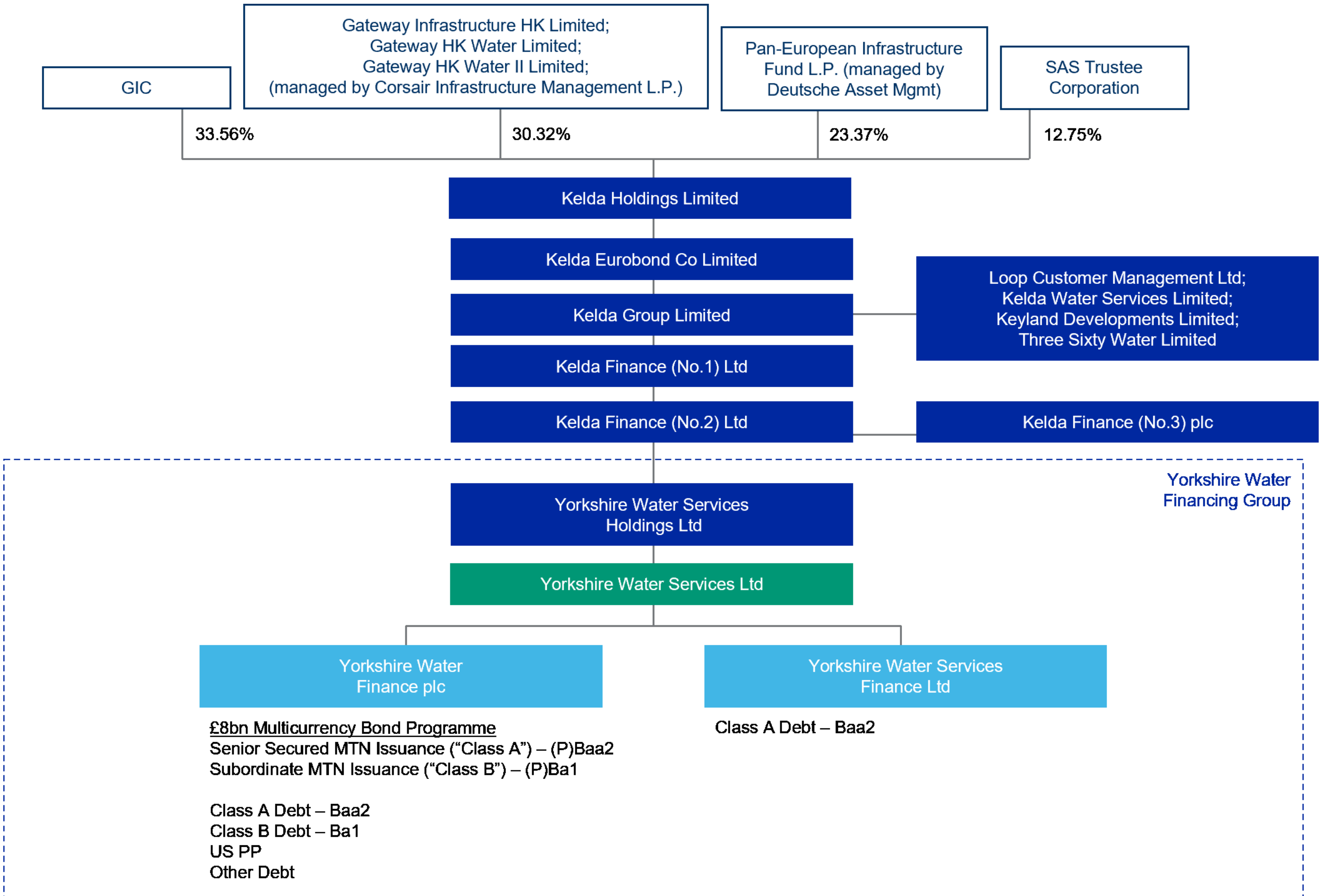
Exhibit 4
Price control summary

	GB Water
Regulator/Price Control	Ofwat / AMP7
Term of price control	April 2020 - March 2025
Allowed return (appointee, vanilla CPIH-real)	3.20%
Regulatory Capital Value	£9.1 billion (March 2024)

Source: Ofwat

Kelda Group Limited, the parent company of the Yorkshire Water group, is ultimately owned by GIC Special Investments Pte Limited, the private equity investment arm of the Government of Singapore; Corsair Infrastructure Partners, as a custodian for a number of infrastructure investment funds; Deutsche Asset Management's infrastructure investment arm; and SAS Trustee Corporation, the trustee of certain New South Wales public-sector superannuation schemes.

Exhibit 5
Simplified organisational structure



Source: Company reports, Moody's Ratings

Detailed credit considerations

Deterioration in the sector's business risk profile amid growing public, political and regulatory scrutiny

There has been a material and sustained weakening of credit quality for nearly all UK water companies amid continued public scrutiny and heightened political and regulatory focus. Across the sector, previous decisions, such as prioritising affordability and shareholder distributions, have contributed to underinvestment and exacerbated the sector's exposure to changing weather patterns, population growth and shifting expectations. Regulatory targets have become more demanding and penalties for those that fall short have continued to rise. With widespread investigations ongoing, fines for UK water companies breaching environmental legislation are likely to increase further.

In addition, the perception that the water sector is "broken" has prompted a government-initiated strategic review, which aims to improve the regulatory environment and create a stable backdrop to attract investment. However, the review results in greater short-term uncertainty for the sector until it is completed and any potentially credit positive recommendations are successfully implemented.

Given the above considerations, we have changed our assessment of the stability and predictability of the regulatory environment for the UK water sector under our rating methodology to A from Aa.

We believe that the predictability and supportiveness of the regime has reduced regardless of whether the final determination for the next regulatory period (1 April 2025 to 31 March 2030, known as AMP8), expected on 19 December 2024, ultimately results in a more positive outcome for the sector than the draft determination. This assessment reflects a continuing trend of negative public perception resulting in more regulatory powers, an increased focus on enforcement action, demanding targets, greater penalties for operational underperformance and growing regulatory complexity that, in turn, result in higher cash flow volatility and leaner returns. All of these factors are leading to an environment that is less supportive of the water utilities' operations and, therefore, credit negative.

Challenging draft determination

On 11 July 2024, Ofwat published its draft determination for AMP8. On balance, Yorkshire Water appears to face a lower totex challenge than during PR19, when the company appealed its determination, which was then referred to the Competitions and Markets Authority (CMA). However, the draft determination still includes relatively challenging performance targets, which – if implemented without change – are likely to expose the company to net penalties over AMP8.

The draft determination also includes an allowed return of 3.66% (CPIH-deflated) for the wholesale activities, which is above Ofwat's early view (3.23%) and current allowed returns (3.12% for Yorkshire) but slightly above the company's business plan assumptions of 3.60%, on the same basis. However, in its representations to Ofwat's draft determination, Yorkshire Water proposed an estimated range for the allowed return of 4.15-4.85%.

Exhibit 6
Evolution of allowed returns

	Ofwat PR04	Ofwat PR09	Ofwat PR14	Ofwat PR19	CMA PR19	Ofwat PR24 Methodology	Ofwat PR24 DD
					WaSCs	September 2022 cut off	March 2024 cut-off
	RPI-based	RPI-based	RPI-based	CPIH-based	CPIH-based	CPIH-based	CPIH-based
Notional gearing	**55.0%**	**57.5%**	**62.5%**	**60.0%**	**60.0%**	**55.0%**	**55.0%**
Existing debt		3.40%	2.65%	2.42%	2.47%	2.34%	2.46%
New debt		4.20%	2.00%	0.53%	0.19%	3.28%	3.36%
Existing: new debt ratio		75%	75%	80%	83%	83%	74%
Explicit debt issuance cost			0.10%	0.10%	0.10%	0.10%	0.15%
Cost of debt (pre-tax)	**4.3%**	**3.60%**	**2.59%**	**2.14%**	**2.18%**	**2.60%**	**2.84%**
Risk-free rate	2.5-3.0%	2.0%	1.25%	-1.39%	-1.34%	0.47%	1.43%
Equity risk premium	4.0-5.0%	5.4%	5.50%	7.89%	8.15%	5.99%	5.15%
Total market return	6.5-8.0%	7.4%	6.75%	6.50%	6.81%	6.46%	6.58%
Equity beta	1.00	0.90	0.80	0.71	0.71	0.61	0.60
Point estimate above mid-point					0.25%		0.26%
Cost of equity (post-tax)	**7.7%**	**7.1%**	**5.65%**	**4.19%**	**4.73%**	**4.14%**	**4.80%**
Vanilla WACC (appointee)	**5.8%**	**5.1%**	**3.74%**	**2.96%**	**3.20%**	**3.29%**	**3.72%**
Retail Margin	n/a	n/a	0.14%	0.04%	0.08%	0.06%	0.06%
Wholesale WACC	**n/a**	**n/a**	**3.60%**	**2.92%**	**3.12%**	**3.23%**	**3.66%**
Wholesale WACC Differential CPIH - Ofwat PR19						0.30%	0.74%
Wholesale WACC Differential CPIH - CMA PR19						0.10%	0.54%

Source: Ofwat, CMA

Yorkshire Water's business plan was assessed as standard with no intervention, which would provide a small reward of 5 basis points on the equity return or £11 million overall (in 2022/23 prices). The reward would be added to its opening RCV or AMP8 revenue allowance.

As previously announced by Ofwat, with effect from 1 April 2025, the rating trigger resulting in a cash lock-up under the licence will be raised to Baa2/BBB negative from Baa3/BBB- negative currently. The definition of "issuer credit rating" that Ofwat considers relevant for the rating trigger includes Moody's Class A rating, currently at Baa2 negative.

Additional licence changes, which apply from 17 May 2023, will allow the regulator to also take enforcement action where companies do not link their dividend payments to operational performance or fail to be transparent about their dividend policy.

In addition to these, the draft determination considers the introduction of a further dividend limitation if gearing exceeds 70%, but this may not apply before PR29.

Operational performance below regulatory expectations in AMP7 and risk of penalties during AMP8 if draft determination remains unchanged

Yorkshire Water has historically been a relatively strong operating performer, earning material rewards under outcome delivery incentives (ODIs) in AMP6. In AMP7, however, Yorkshire Water's operational performance – in line with many of its peers – has fallen increasingly short of regulatory expectations, which have become more demanding. The company incurred aggregate net penalties of £37 million (in 2017/18 prices) over the first three years, which are cash effective in this period.

In addition, Yorkshire Water reported £35 million (in 2017/18 prices) of ODI penalties in FY2023/24, excluding customer service, for which it tended to earn a small penalty of £2.5-3.5 million per year historically. Penalties are concentrated in areas of internal sewer flooding, water quality and supply interruptions. ODI penalties incurred in the last two financial years of AMP7 will carry over into AMP8 with a two-year lag.

Ofwat's draft determination for AMP8 includes 24 common performance commitments, which apply to all companies. Performance targets have generally been set more stretching than companies' proposals and incentive rates have been widened, particularly for common environmental and asset health performance commitments and customer service.

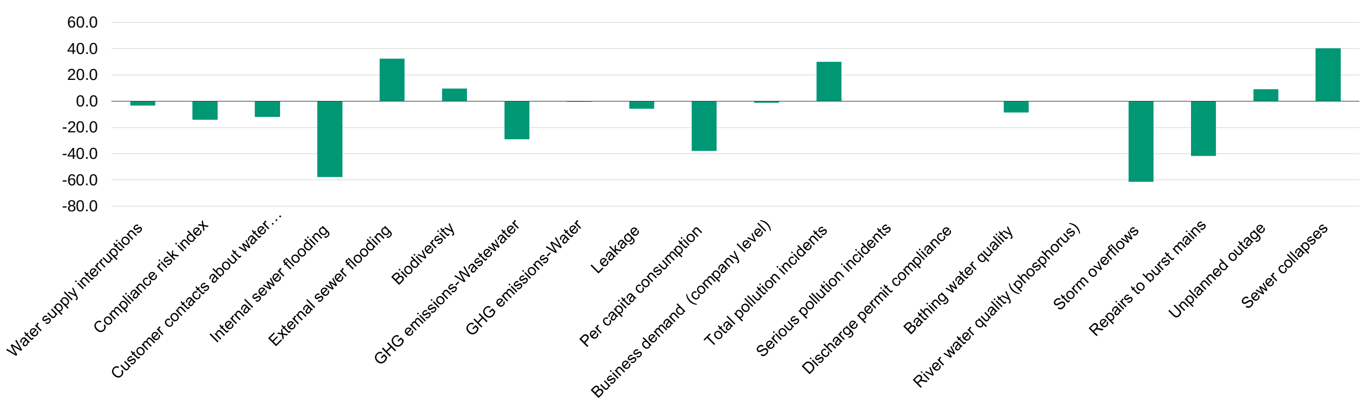
For Yorkshire Water, we expect this to lead to annual average net penalties of just over £30 million (in 2022/23 prices) over AMP8, if targets remain unchanged and the company performs in line with its original business plan assumptions. The associated proportional reduction on expected regulatory return on equity would be below sector average (please see our August 2024 sector comment on the draft determinations for wider comparison). Main areas of penalties are linked to storm overflows, internal sewer flooding, mains repairs and per capita consumption. On storm overflows, in particular, the performance commitment requires a material step-change to current performance, the trajectory of which was agreed with Ofwat under a separate undertaking, and expected future improvements.[1] Performance under this incentive may also be influenced by the amount of funding allowed, with requested storm overflow expenditure receiving a sizeable cut from the regulator (further discussed below).

Penalties could increase significantly, if the company's performance remained in line with current levels or in the context of severe weather events.

Exhibit 7

Expected total forecast ODI penalties over AMP8, if draft determination is confirmed and company performs in line with original business plan assumptions

Amounts in £ millions (in 2022/23 prices)



Common ODIs, but excluding customer, developer and business/retail service measures. There is an aggregate sharing mechanism, whereby incentive impact of more than +/-3 percentage points on RORE is shared 50% with customers and more than 5 percentage points is shared 90%.

Source: Ofwat draft determination, company's business plan and representations, Moody's Ratings

In its representations to Ofwat's draft determination, the company – in line with many of its peers – highlighted the negative skew of performance commitments, citing an increased level of stretch, while funding allowances were reduced from the company's request, and an unrealistic starting level of performance for many.

Catch-up of capital investment in AMP7 will prepare for step-up in AMP8

Over the first three years of the current regulatory period, Yorkshire Water invested significantly less than its totex allowance, particularly with respect to its enhancement expenditure, which aims to improve service for customers. The company attributes this to the time required to plan and implement its relatively large investment programme under the Water Industry National Environment Plan (WINEP), which includes the requirement to remove phosphorous from wastewater. Ofwat's final determination included a £772 million allowance for WINEP, significantly less than the company's request of £941 million.

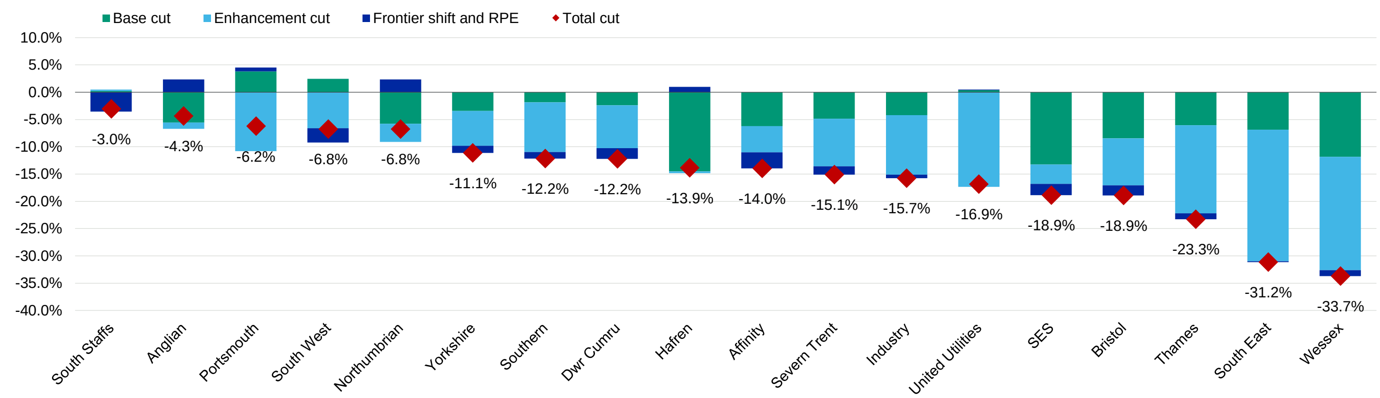
Capital investment has stepped up significantly during FY2023/24 and further scaling up is planned for FY2024/25 in order to ensure that all WINEP requirements can be met by the end of AMP7 in line with regulatory requirements.

Yorkshire Water's draft determination allowed £7.5 billion overall total expenditure (totex) compared with £8.3 billion that the company requested in its updated plan (including cost adjustment claims of almost £750 million). Of this, base operating cost and maintenance is £5 billion, a 5% reduction to the company's ask, while enhancement is set at £2.5 billion, around 17% lower than the company's proposal. After adjustments for frontier shift efficiency (proposed at 1% p.a.) and costs that will be subject to real price effects true-up (such as energy as part of base costs and plant and equipment as part of enhancement costs), the overall cut is 11% compared with the company's ask and below the sector average. The proposed cut is also smaller than at PR19, when at draft determination stage the overall totex cut was almost 16% (just under 10% on base costs).

Exhibit 8

Yorkshire Water's cost challenge under Ofwat's draft determination is below the sector average

Proposed cost reduction as % of requested amount



Efficiency challenge calculated as cost difference between draft determination and company's plan divided by company's plan costs.
Source: Ofwat's draft determinations

The main base cost challenge is in relation to the water activities and cost adjustment claims for mains replacement and water non-infrastructure capital maintenance, which were only partially accepted or completely rejected, respectively. In addition, the upfront cost allowances for business rates are £64 million below the company's request, which may need to be pre-funded before a true up at the start of the next regulatory period.

On enhancement expenditure, the most sizeable adjustments relate to storm overflows, environmental investigations and water resilience. In most instances, Ofwat cited higher costs, overlap with base expenditure (both of which we would consider a possible cost efficiency challenge rather than scope) or lack of need for complex studies (which may be considered scope).

Exhibit 9

Totex allowance per Ofwat's draft determination (DD) compared with company's business plan (BP) suggests 5-10% efficiency challenge

	Challenge	BP	PR24 DD	Difference	%
Base					
Modelled	Efficiency	4828	4615	-213	-4%
Unmodelled	Efficiency	503	437	-66	-13%
Total base		**5331**	**5053**	**-278**	**-5%**
Water enhancement					
Supply-demand	Efficiency	99	71	-28	-28%
Metering	Efficiency	141	153	12	9%
Drinking water quality	Efficiency	97	77	-20	-21%
Resilience	Efficiency	193	97	-96	-50%
Water WINEP	Undefined	75	64	-11	-15%
Other	Undefined	11	0	-11	-100%
Total		**616**	**463**	**-153**	**-25%**
Wastewater enhancment					
Nutrients	Undefined	369	367	-2	-1%
Storm overflows	Efficiency	1532	1297	-236	-15%
Other WINEP	Scope	243	231	-11	-5%
Resilience	Efficiency	0	15	15	n/a
Other	Scope	225	90	-135	-60%
Total		**2369**	**1999**	**-369**	**-16%**
Total enhancement		**2984**	**2462**	**-522**	**-17%**
Overall totex challenge		**8315**	**7515**	**-800**	**-10%**
Estimated efficiency challenge				-632	-8%
Additional challenge subject to evidence/scope				-168	-2%
Frontier shift and RPE		-152	-262	-110	-1%
Overall totex challenge post frontier shift		**8163**	**7253**	**-910**	**-11%**

Source: Ofwat's draft determination, Moody's Ratings

In its representation to Ofwat's draft determination, Yorkshire Water increased its request for total expenditure by around £100 million to £8.4 billion (including cost adjustment claims and pre-frontier shift) compared with its business plan. Main adjustments relate to additional cost items for resilience, new statutory requirements and storm overflows that did not meet the DPC requirements; however, these additions have been mitigated by other cost reductions where there has been higher certainty on scope or unit costs.

We understand that Yorkshire Water is at an advanced stage of preparing its supply chain capabilities, and we expect the company to be able to manage the step up in AMP8 capital investment, also in the context of the ramp-up in the investment programme over the final years of this regulatory period. Capital investment for FY 2024/25 is expected around £800-850 million, compared with average annual capital spend of £900 million (in outturn prices) forecast for AMP8 under the draft determination.

Ongoing pollution investigations pose risk of material fines

In November 2021, the UK government's Environment Agency (EA) and Ofwat launched parallel investigations into more than 2,000 sewage treatment works across all wastewater companies in England, “after new checks led to water companies admitting that they could be releasing unpermitted sewage discharges into rivers and watercourses.” In November 2022, Ofwat confirmed that it had opened enforcement cases against six companies, including Yorkshire Water. This was subsequently extended to all wastewater companies.

In December 2023, the regulator notified Yorkshire Water and two of its peers of its provisional findings and, on 6 August 2028, published its draft conclusions to impose financial penalties of around 7% of wastewater turnover or ca. £47 million on Yorkshire Water.[2]

If confirmed as fines, the amount will have to be paid into HM Treasury's Consolidated Fund and would either have to be funded from shareholder equity or will otherwise eat into the companies' cash reserves and increase net debt. The regulator may consider a company-proposed alternative regulatory settlement instead of a financial penalty payment, including compensation to customers (via bill reductions) or remediation of failure, if appropriate. Given that the investigation has been widely trailed, our forecast assumptions have already included the likelihood of such a penalty occurring. Nevertheless, the penalties are a reflection of heightened regulatory scrutiny, which increases the risk of cash flow volatility for the sector.

In addition to Ofwat's investigation, all wastewater companies operating in England are also subject to a parallel investigation by the Environment Agency (EA). We do not expect the EA to conclude its investigation before 2025, but its fines follow sentencing guidelines[3] and are unlimited, particularly for repeat or deliberate offenders.

Following changes to the definition of serious pollution incidents, Yorkshire Water's environmental performance assessment dropped to 2 stars in 2021 (from 4 stars in 2020), was assessed 3 stars in 2022 and fell back to 2 stars in 2023, which is defined as requiring improvement.[4] The company reported 5 serious pollution incidents (this is classified as red; prior year was 3 incidents and classified as amber) out of 26 total pollution incidents and has among the lowest self-reporting rates.

Deleveraging under regulatory pressure

The phasing of AMP7 spending contributed to a reduction in leverage from 77.8% in March 2020 to 69% in March 2024. We had previously expected that leverage would rise again toward 78% by the end of AMP7 as investment accelerated. However, in October 2022, Yorkshire Water announced that one of its holding companies, Kelda Eurobond Co Limited, would downstream £941 million to Yorkshire Water in repayment of intercompany loans dating from the group's acquisition in 2008. This resolved a previously undisclosed investigation by Ofwat into whether the loans were in breach of Yorkshire Water's licence conditions (see Yorkshire Water Services Limited – Deleveraging under regulatory pressure, 14 October 2022).

Under “undertakings” given by Yorkshire Water to Ofwat, £300 million of the intercompany loans must be repaid by June 2023, a further £200 million by March 2025 and the remainder, approximately £440 million, by March 2027. In June 2023, Yorkshire Water received £400 million via partial repayment of the intercompany loan, followed by £100 million in May 2024, with the remaining receivable balance now reduced to £437 million and required to be received by March 2027.

Taking into account these measures, Yorkshire Water must reduce is net debt/RCV, calculated on a regulatory basis, to no higher than 72% by April 2025, subject to certain caveats. Specifically, Yorkshire has undertaken to “Achieve a gearing level on the regulatory basis of no higher than 72% by 1 April 2025 (subject to external factors beyond the control of YWS and beyond the existing regulatory expectation that all water companies manage their financial resilience to ensure they can withstand economic and cost shocks, excluding any agreed early start investment for AMP8 and also to exclude any accelerated investment in AMP7 as a result of the request by the Secretary of State and Defra in October 2022).” As at March 2024, Moody's-adjusted gearing was 69%, and we forecast gearing of just under 72% for March 2025, post-midnight adjustment for regulatory true-ups.

Yorkshire Water has also undertaken to complete a financial structure review by April 2025, at which point it must provide Ofwat with an update on findings and recommendations and “an update on the gearing level and an overview of likely gearing post 2025.”

Swaps could reduce recovery for senior creditors, but MTM has fallen materially since 2022

Yorkshire Water's borrowing costs are relatively high because of inflation swaps entered into at the time of the acquisition in 2008, many of which extend to the mid-2040s or beyond. Under these swaps, Yorkshire Water receives an amount linked to SONIA and pays a fixed coupon, while accruing an amount linked to RPI that must be paid to the counterparty at fixed intervals or at maturity of the swap, depending on the instrument.

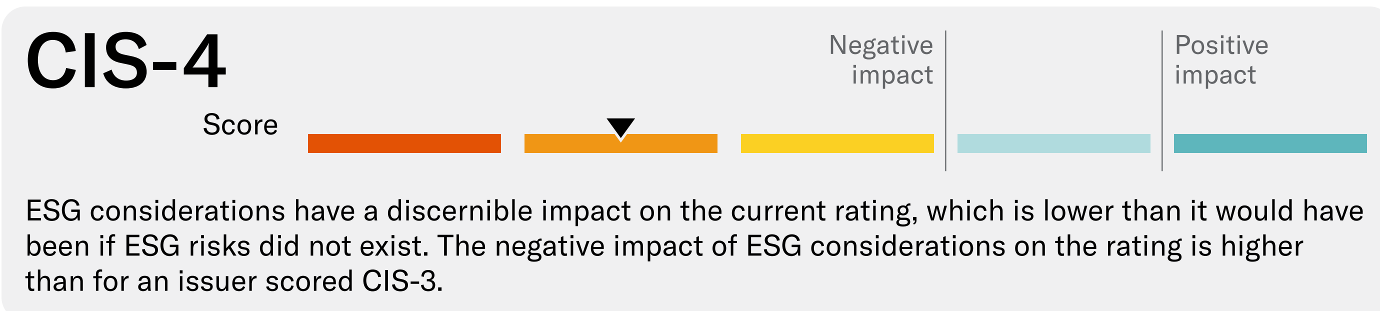
As interest rates fell from 2008 to 2022, receipts under these swaps declined while payments remained constant. As a result, net financing costs rose and the discounted value of expected future cash flow became increasingly negative. As of March 2022 the MTM on these swaps had reached approximately £3.0 billion, 39% of RCV. This is important to the credit quality of the company's senior debt because, in a default scenario, if creditors demand payment acceleration, Yorkshire Water would be required to make a termination payment based on swap counterparties' assessment of their total losses, which is likely to be close to the MTM at that time. Under the company's finance documents, this payment would rank ahead of principal and interest on senior debt and would materially reduce senior debt recovery.[5]

However, the rise in market interest rates since March 2022 as well as the company terminating early a number of RPI-linked swaps with original maturity in 2026 and a notional amount of £177 million have reduced the MTM significantly. As at March 2024 the overall MTM was £1.8 billion or just under 20% of RCV (including £256 million of inflation accretion). In its annual financial statements the company reports this as adjusted for credit value at £1.3 billion (~14% of RCV). Although it remains material, the reduction in the MTM is positive for senior creditors.

ESG considerations

Yorkshire Water Services Finance Limited's ESG credit impact score is CIS-4

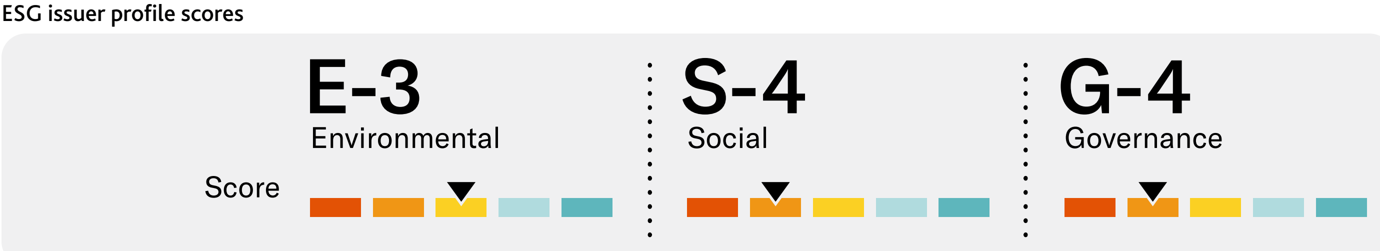
Exhibit 10
ESG credit impact score



Source: Moody's Ratings

The **CIS-4** ESG Credit Impact Score for Yorkshire Water indicates that ESG considerations have a negative impact on current credit quality and that the rating is lower than it would have been if these risks did not exist. The **CIS-4** score largely reflects high social and governance as well as moderate environmental risks. The overall credit impact score also recognises mitigating factors, in particular the regulated nature of water companies' activities and their investment requirements, including a forward-looking allowance for efficient cost. However, as investment needs grow to tackle climate change and population growth, the resulting increase in regulated assets and their remuneration will have to continue to be supported by the regulatory tariff framework in order to avoid negative credit implications in the future.

Exhibit 11
ESG issuer profile scores



Source: Moody's Ratings

Environmental

Yorkshire Water's **E-3** score is largely associated with the company's sewerage operations. Treatment of sewage carries environmental risk, and failures can result in fines and reputational damage. In particular, discharges from combined sewers can affect beaches and bathing waters. In November 2021, Ofwat and the Environment Agency announced a "major investigation" into sewage treatment works, and in March 2022 enforcement cases were opened against Yorkshire Water and four other companies, albeit recently extended to all wastewater companies in England and Wales. In December 2023, three companies, including Yorkshire Water, were notified of provisional findings and, in August 2024, Ofwat published its provisional decision to potentially fine the company for 7% of wastewater turnover or around £47 million. On the drinking water side, shortages are likely to grow more acute with climate change, increasing investment needs for UK water companies. However, these pressures are likely to be lower in the north of England than in other regions.

Social

Yorkshire Water's **S-4** score reflects elevated risk that public concern over environmental, social or affordability issues could lead to adverse regulatory or political intervention. While the risk is common to all regulated utilities, it is particularly acute for UK water companies, with public perception at an all-time low and heightened scrutiny over operational performance and dividend payments. Materially growing investment requirements to improve environmental performance and increase drought resilience will require bills to rise, exacerbating affordability concerns.

Governance

Yorkshire Water's **G-4** score reflects the company's highly leveraged financial structure and extensive use of derivatives, including restructurings and amendments, which reflects a greater tolerance for financial risk than many investment-grade utilities. The Kelda Holdings group that owns Yorkshire Water has additional debt, equivalent to around 5% of Yorkshire Water's RCV, which must be serviced by distributions from Yorkshire Water. Financial covenants do, however, limit the ability of the holding company to extract cash in downside scenarios, although these protections have been somewhat eroded by the use of derivatives. Yorkshire Water's credit quality is also protected by regulatory mechanisms designed to preserve the independence of the operating companies, including the requirement that independent directors represent the largest single group on the board. In addition, the company's licence prescribes maintenance of a minimum credit profile. The ongoing EA investigation into sewage treatment works raises moderate risks associated with compliance and reporting.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Liquidity analysis

Yorkshire Water has an excellent liquidity profile, underpinned by (1) revolving credit facilities totalling £630 million maturing in November 2028 (with an option to upsize by a further £30 million and extend by another year, if exercised by November 2024), of which £80 million was drawn at March 2024; (2) a further £80 million bilateral facility, which remains undrawn and matures in July 2027 (with two one-year extensions available); and (3) just under £50 million of unrestricted cash and cash equivalents as of March 2024. These are sufficient to cover the company's operating, investment and refinancing needs for a period of at least 24 months from March 2024. There are also no major near term debt maturities, with the next major repayment linked to a £300 million bond due in November 2026.

Liquidity is further supported by a £182 million rolling five-year evergreen debt service reserve guarantee issued by Assured Guaranty UK Limited (A1 stable) and a £120 million O&M reserve. These would be available to the company to service debt in the event of a standstill being declared following a breach of covenants.

Structural considerations

Debt structural features provide additional creditor protection…

Yorkshire Water's creditors benefit from a covenant and security package that is designed to insulate the company's creditworthiness from that of its shareholders and improve creditors' protection in a default scenario. The overall covenant and security package is similar to that of comparable highly leveraged financing transactions.

Additional event risk protection provided by the bond covenant and security package includes, inter alia, restrictions on acquisitions and disposals (subject to limited defined exceptions), a dividend lock-up coming into effect if senior gearing increases above 85% of RCV or senior adjusted interest coverage falls persistently below 1.2x (both calculated under the company's covenant definitions), and limitations on non-core activities. In addition, creditors have step-in rights if certain trigger events occur.

The transaction documents also include (1) a first-ranking fixed charge over the shares in the company, plus first-ranking fixed and floating charges over all the assets, rights and undertakings of Yorkshire Water; and (2) the agreement by financial creditors to give up their individual rights to petition for insolvency proceedings. We recognise that the benefit of the security provided to bondholders is limited because of the regulated and essential nature of the services provided by Yorkshire Water as governed by its licence and the Water Industry Act 1991.

In 2015, the highly leveraged UK water companies, including Yorkshire Water, introduced a new supplementary interest cover covenant, designed to reflect regulatory changes in the revenue building block approach for tariff-setting purposes. The definition of Yorkshire Water's supplementary covenant is slightly different from that of its highly leveraged peers. Whereas Anglian Water's or Thames Water's supplementary covenant replaces the previous regulatory capital charges (infrastructure renewals charge and current cost depreciation) with the new RCV depreciation under Ofwat's totex approach, Yorkshire Water also deducts the funded portion of infrastructure renewal expenditure not included in operating expenditures in its statutory financial statements, as well as a “fast/slow adjustment” that would reverse excess revenue allowances compared with expected cost assumptions at the final determination. We believe that Yorkshire Water's supplementary covenant most closely resembles the creditor protection that was intended with the original interest cover covenant.

...but benefit weakened by swap arrangements

Between 2017 and 2020, Yorkshire Water executed several swap amendments and restructurings through which it will increase its swap receipts by £160 million over AMP7 and £127 million over AMP8.[6] In exchange, the maturity of these out-of-the-money swaps was extended so that Yorkshire will make additional cash payments in the 2030s and 2040s equivalent to the amount received plus an implied funding cost.[7]

Under Yorkshire Water's financing structure, the swap re-profiling reduces interest costs by around £30-35 million until March 2028 and £20-25 million between March 2029-30.

In our view this undermines creditor protection. Financial ratio trigger events and events of default are intended to protect the position of creditors, including when the company's financial profile weakens for reasons outside of its control. Bringing forward cash flow using swaps does not improve the credit quality of the company, but by bolstering covenant financial metrics may prevent a trigger event when one might otherwise have occurred. Without the benefit of the restructurings and amendments, Yorkshire Water would have had very limited headroom to its trigger event threshold during AMP7.

The amendments and restructurings also reduce net debt, because cash is received and the corresponding liability is not included in common definitions of debt. We estimate that Yorkshire Water will have received a cumulative £210 million from swap restructurings by the end of AMP7, growing to ca. £360 million by the end of AMP8 (equivalent to around 2.2-2.8% of RCV, respectively).

Moody's AICR excludes cash flow associated with the swap restructurings and amendments. Although we regard the probable future payments resulting from swap restructurings as debt-like, we do not include them in Moody's-adjusted net debt because the company does not disclose them separately from the contingent mark-to-market liabilities on its other swaps.

The senior secured bonds and subordinated debt are rated Baa2 and Ba1 respectively

The Baa2 rating of the senior secured (Class A) bonds reflects the strength of the debt protection measures for this class of debt and other pari passu indebtedness, and their senior position relative to the Class B bonds in the cash waterfall and post any enforcement of security.

The Ba1 rating of the subordinated (Class B) bonds of Yorkshire Water Finance plc reflect the same default probability in addition to our expectation of a heightened loss severity for the Class B debt following any default, given its subordinated position within the financing structure.

However, in a default scenario, if creditors demand payment acceleration, Yorkshire Water would be required to make a termination payment based on swap counterparties' assessment of their total losses, which is likely to be close to the MTM at that time. This payment would rank ahead of principal and interest on senior debt and would reduce Class A and Class B debt recovery. The ratings, therefore, also factor in the sizeable super-senior obligations, which limit the benefit applied to Class A debt, in particular, in the context of its ranking within the capital structure.

Rating methodology and scorecard factors

Yorkshire Water's Baa2 rating reflects the application of our Regulated Water Utilities rating methodology. The scorecard-indicated outcome is currently depressed by weak cash flow based metrics, but credit quality remains underpinned by solid liquidity and shareholder support, and we expect an improvement in AMP8.

Exhibit 12

Rating methodology scorecard

Yorkshire Water Services Limited

Regulated Water Utilities Industry [1][2]	Current FY 3/31/2024		AMP8 Forward View As November 2024 [3]	
Factor 1 : Business Profile(50%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Environment	Aa	Aa	A	A
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Sufficiency & Timeliness)	A	A	A	A
d) Revenue Risk	Aa	Aa	Aa	Aa
e) Scale and Complexity of Capital Programme & Asset Condition Risk	Aa	Aa	Baa	Baa
Factor 2 : Financial Policy (10%)				
a) Financial Policy	B	B	B	B
Factor 3 : Leverage and Coverage (40%)				
a) Adjusted Interest Coverage Ratio (3 Year Avg)	0.8x	Caa	1.4x - 1.7x	Baa
b) Net Debt / Regulated Asset Base (3 Year Avg)	71.6%	Ba	68% - 70%	Baa
c) FFO / Net Debt (3 Year Avg)	6.1%	Ba	7% - 8%	Ba
d) RCF / Net Debt (3 Year Avg)	5.5%	Ba	6% - 7%	Baa
Rating:				
Scorecard-Indicated Outcome Before Notch Lift		Ba2		Baa3
Notch Lift		1		0.5
a) Scorecard-Indicated Outcome		Ba1		Baa2
b) Actual Rating Assigned				Baa2

(1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) As at 31/03/2024. (3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate any significant acquisitions or divestitures.

Source: Moody's Financial Metrics™

Ratings

Exhibit 13

Category	Moody's Rating
YORKSHIRE WATER SERVICES FINANCE LIMITED	
Outlook	Negative
Bkd Senior Secured -Dom Curr	Baa2
Underlying Senior Secured -Dom Curr	Baa2

Source: Moody's Ratings

Appendix

Exhibit 14
Yorkshire Water Services Limited
Selected peer comparison

	Yorkshire Water Services Limited Baa2/Ba1 Negative*			Anglian Water Services Ltd. A3 RUR-DNG			Thames Water Utilities Ltd. Caa1 Negative			Southern Water Services Limited Ba1 RUR-DNG*		
(in GBP million)	FYE Mar-22	FYE Mar-23	FYE Mar-24	FYE Mar-22	FYE Mar-23	FYE Mar-24	FYE Mar-22	FYE Mar-23	FYE Mar-24	FYE Mar-22	FYE Mar-23	FYE Mar-24
Revenue	1,119	1,145	1,227	1,400	1,495	1,627	2,092	2,181	2,401	845	816	887
EBITDA	606	611	649	790	819	862	1,062	1,065	1,287	452	592	371
Total Assets	10,853	11,007	10,869	12,229	12,470	13,539	20,563	22,870	23,748	7,568	7,645	8,596
Regulated Asset Base (RAB)	7,746	8,715	9,132	8,780	9,959	10,676	16,664	18,945	19,947	5,665	6,455	6,798
Total Debt	5,738	6,571	6,379	6,534	7,254	8,366	14,201	16,809	17,803	4,127	4,622	5,382
Net Debt	5,709	6,278	6,329	5,663	6,621	7,361	13,781	14,979	16,528	3,677	4,476	4,766
Net Debt / Regulated Asset Base	73.7%	72.0%	69.3%	64.5%	66.5%	69.0%	82.7%	79.1%	82.9%	64.9%	69.3%	70.1%
Adjusted Interest Coverage Ratio	1.0x	0.7x	0.7x	1.4x	1.4x	1.1x	0.7x	0.5x	0.6x	-0.1x	-0.1x	-0.6x
FFO / Net Debt	6.4%	5.8%	6.2%	8.4%	7.9%	7.5%	4.6%	3.8%	4.3%	1.4%	-2.3%	1.9%
RCF / Net Debt	6.1%	5.2%	5.3%	6.7%	5.4%	6.4%	4.3%	3.5%	3.1%	1.5%	-2.3%	1.9%

All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months. RUR* = Ratings under Review, where UPG = for upgrade and DNG = for downgrade. Rating for Yorkshire Water and Southern Water are assigned at the level of the relevant finance subsidiaries.
Source: Moody's Financial Metrics™

Exhibit 15
Yorkshire Water Services Limited
Moody's adjusted debt breakdown

(in GBP million)	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-24
As Reported Total Debt	5,598	5,514	5,457	6,070	5,906
Pensions	0	0	0	0	0
Leases	9	0	0	0	0
Non-Standard Adjustments	58	213	281	502	473
Moody's Adjusted Total Debt	5,665	5,727	5,738	6,571	6,379
Cash & Cash Equivalents	(250)	(198)	(29)	(294)	(50)
Moody's Adjusted Net Debt	5,416	5,529	5,709	6,278	6,329

All figures are calculated using Moody's estimates and standard adjustments. Non-standard adjustments add cumulative swap accretion to debt.
Source: Moody's Financial Metrics™

Exhibit 16
Yorkshire Water Services Limited
Moody's adjusted FFO breakdown

(in GBP million)	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-24
As Reported Funds from Operations (FFO)	414	480	470	445	548
Leases	3	0	0	0	0
Capitalized Interest	(17)	0	0	0	0
Alignment FFO	(69)	(96)	(214)	(367)	(298)
Unusual Items - Cash Flow	(50)	(28)	0	0	0
Non-Standard Adjustments	33	(12)	109	286	143
Moody's Adjusted Funds from Operations (FFO)	314	344	365	364	393

All figures are calculated using Moody's estimates and standard adjustments. Non-standard adjustment primarily comprise interest payments associated with swaps and adding back annual inflation accretion on index-linked debt to FFO.
Source: Moody's Financial Metrics™

Exhibit 17

Yorkshire Water Services Limited

Selected historical financial data, Moody's-adjusted

(in GBP million)	FYE Mar-20	FYE Mar-21	FYE Mar-22	FYE Mar-23	FYE Mar-24
INCOME STATEMENT					
Revenue	1,063	1,101	1,119	1,145	1,227
EBITDA	564	636	606	611	649
EBITDA margin %	53.0%	57.7%	54.2%	53.4%	52.9%
EBIT	235	313	273	270	274
EBIT margin %	22.1%	28.4%	24.4%	23.6%	22.3%
Interest Expense	259	257	411	583	404
Net income	(49)	34	(195)	(295)	(105)
BALANCE SHEET					
Net Property Plant and Equipment	7,838	8,197	9,222	8,954	9,320
Total Assets	9,661	10,010	10,853	11,007	10,869
Total Debt	5,665	5,727	5,738	6,571	6,379
Cash & Cash Equivalents	250	198	29	294	50
Net Debt	5,416	5,529	5,709	6,278	6,329
Total Liabilities	8,982	9,180	9,756	9,834	9,701
Total Equity	679	830	1,097	1,173	1,169
CASH FLOW					
Funds from Operations (FFO)	314	344	365	364	393
Cash Flow From Operations (CFO)	339	450	403	390	436
Dividends	62	1	15	40	56
Retained Cash Flow (RCF)	251	343	350	324	337
Capital Expenditures	(486)	(437)	(371)	(507)	(631)
Free Cash Flow (FCF)	(209)	12	17	(157)	(250)
INTEREST COVERAGE					
(FFO + Interest Expense) / Interest Expense	2.2x	2.3x	1.9x	1.6x	2.0x
Adjusted Interest Coverage Ratio	1.3x	0.9x	1.0x	0.7x	0.7x
LEVERAGE					
FFO / Net Debt	5.8%	6.2%	6.4%	5.8%	6.2%
RCF / Net Debt	4.6%	6.2%	6.1%	5.2%	5.3%
Regulated Asset Base (RAB)	6,960	7,024	7,746	8,715	9,132
Net Debt / Regulated Asset Base	77.8%	78.7%	73.7%	72.0%	69.3%

All figures are calculated using Moody's estimates and standard adjustments.
Source: Moody's Financial Metrics™

Endnotes

1 Yorkshire Water committed to invest £180 million, in addition to the company's existing investment plan, to reduce pollution from storm overflows. Under existing cost-sharing mechanisms, 45% of this expenditure will be recovered from customers over time, with around £100 million ultimately absorbed by Yorkshire Water. The company will provide annual updates to Ofwat on the plan during the rest of AMP7. See also Ofwat: Undertakings for the purpose of Section 19 of the Water Industry Act 1991

2 https://www.moodys.com/research/Northumbrian-Water-LtdThames-Water-Utilities-LtdYorkshire-Water-Services-Ltd-Ofwats-proposed-Issuer-Comment--PBC_1417752#290612199861c31d1036b185b4e69b75

3 Please see the sentencing council's guidelines for environmental offences effective from 1 July 2014: https://www.sentencingcouncil.org.uk/offences/magistrates-court/item/organisations-illegal-discharges-to-air-land-and-water-unauthorised-or-harmful-deposit-treatment-or-disposal-etc-of-waste/

4 https://www.gov.uk/government/publications/water-and-sewerage-companies-in-england-environmental-performance-report-2023/water-and-sewerage-companies-in-england-environmental-performance-report-2023

5 Yorkshire Water's intercreditor arrangements contain provisions intended to reduce the likelihood of an event of default and, if one were to occur, to allow resolution before enforcement action. In particular, an automatic standstill of up to 18 months follows the occurrence of an event of default (resulting

from, for example, non-payment of scheduled payments, maintaining forward-looking liquidity of less than six months, violation of licence terms, rating downgrades from multiple agencies or breach of default financial ratios). The standstill is designed to allow time for secured creditors to pursue options that could include a sale of the regulated business. During the standstill period, no other enforcement of creditor's rights is allowed, including payment acceleration that would trigger termination payments to swap counterparties.

6 https://www.moodys.com/research/docid--PBC_1236790

7 £11.6 million received in August 2020, as part of a package to mitigate the effect of the coronavirus outbreak on Yorkshire Water's financial covenants, will be effectively repaid over the following seven years.

REPORT NUMBER 1429826