FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Yorkshire Water's Class A Debt to 'BBB+'; Outlook Stable

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Fitch Ratings - London - 06 Feb 2025: Fitch Ratings has downgraded Yorkshire Water Services Finance Limited's (YWSF) and Yorkshire Water Finance Plc's (YWF) senior secured class A debt to 'BBB+' from 'A-' and affirmed their subordinated class B debt at 'BBB-'. The Outlooks are Stable.

The downgrade of class A debt reflects the significant derivatives liabilities of Yorkshire Water Services Limited (YWS). We believe that these partially offset the strong recovery expectations embedded in the class A debt rating, while the class B debt was already downgraded in 2021 for the same reason.

The Stable Outlook reflects our expectation that YWS will gradually deleverage towards 70% by the end of the five-year price control period ending March 2030 (AMP8), after a peak in FY26. Moreover, we see YWS's financial policy as consistent with the current rating and believe that management is committed to maintaining the rating. We have revised the negative rating sensitivity for YWS to 70% net debt/regulated capital value (RCV) in AMP8 from 72%.

KEY RATING DRIVERS

Downgrade Related to MtM Liabilities: Fitch has removed the one-notch uplift for sector-specific recovery for our UK water portfolio when mark-to-market (MtM) liabilities related to super senior derivatives exceed 10% of the RCV. This follows our revised view of the sector, reflecting its increased risk profile.

The derivative liabilities for YWS were GBP1.8 billion, 19% of RCV at financial year end-March 2024. This is the key driver of the class A debt rating downgrade. Fitch expects to reinstate the one-notch uplift if MtM liabilities consistently reduce towards this threshold in the future.

Rising Sector Risk: Fitch believes that the final determination has provided a reasonable outcome for most UK water companies, especially compared with the draft determination, and is in line with our expectations. However, we still see moderately higher business risk in AMP8, mainly driven by heightened exposure to environmental risk, increasing public scrutiny, and higher clawback risk, which is linked to the price control deliverables (PCDs) mechanism. Further uncertainties may arise from the Cunliffe review, the most significant regulatory reform since privatisation.

The sector also faces a heightened risk of fines related to operational and environmental under-performance, and a pressing need to rebuild trust with the public, government, and regulatory bodies. At the same time, we would expect the sector to enhance its assets to accommodate population growth and extreme weather conditions.

Tightened Debt Capacity: Fitch has revised the sector's debt capacity for AMP8, leading to a 2% reduction in net debt/RCV and a 0.1x increase in cash and nominal post-maintenance interest coverage ratios (PMICRs) for YWS.

Forecast Gearing Headroom: Fitch forecasts tight net debt/RCV rating headroom for YWS in AMP8. We anticipate net debt/RCV to peak at 77% in FY26, before declining to about 70% by end-AMP8. The fall is due to the shareholders' commitment to repay a legacy inter-company loan to YWS in FY27 of around GBP600 million with accrued interest. Fitch has tightened the net debt/RCV sensitivities in AMP8 after accounting for all debt at YWS, instead of just class A debt previously. As a result, we would allow a 2.5% breach of net debt/RCV within AMP8, provided the PMICRs remain well within their rating sensitivities.

Adequate PMICRs Headroom Expected: We forecast cash PMICR of 1.9x for AMP8, which is comfortably above our negative rating sensitivity of 1.5x, and a nominal PMICR of 1.9x, which is above our negative rating sensitivity of 1.8x. The cash PMICR has greater headroom than the nominal PMICR, due to around 60% of YWS's total debt being inflation-linked (IL), partly through swaps in FY24. This is above our sector average of about 52%. Our ratios assume an average cost of new debt at 5.8%, broadly in line with the sector average.

Neutral Total Expenditure Performance: Total expenditure (totex) for AMP8 stands at GBP8.5 billion in real terms, excluding Ofwat's adjustments, representing a material increase from GBP4.1 billion in AMP7. Totex allowances are in line with those requested by YWS, but enhancement totex for AMP8 is nearly 3.5x higher than in AMP7. Investments under PCDs need to achieve the Ofwat benchmarks of allowance and timeline to mitigate the risk of a clawback. Under this mechanism, investment funding is ringfenced, ensuring that any unspent allowances are returned to customers.

Net ODI Penalties Assumed: We forecast net in-period ODI penalties of GBP67 million cumulatively for AMP8. Since the cash impact of these penalties materialises with a two-year lag, we are projecting cash ODI penalties of GBP148 million in AMP8 to include the amount related to the last two years of AMP7. In AMP8, we expect that YWS will incur penalties mainly in internal sewer flooding, storm overflows, and compliance risk index.

Regulatory Fines Forecast: Fitch forecasts about GBP75 million in total fines from the Environment Agency and Ofwat as baseline cash outflows, due to heightened regulatory scrutiny and stricter controls on wastewater networks. This includes the GBP47 million Ofwat fine currently under investigation. We have assumed fines across all companies operating wastewater networks and will adjust this assumption to reflect actual fines or a perceived reduction in risk, accordingly.

Subordinated Debt Rating: The non-participatory notes issued by YWSF are rated one notch lower than the class A debt rating at 'BBB'. This reflects the absence of a share pledge by YWS but also the benefit from other creditor protections and structural features of the overall covenant package at YWS and YWSF. YWF's class B debt is subordinated to class A debt and sizeable super-senior IL swap liabilities, and we rate class B debt two notches below class A debt.

Standalone Assessment under PSL: Fitch rates YWS on a standalone basis using the stronger subsidiary/weaker parent approach under its Parent and Subsidiary Linkage (PSL) Rating Criteria. This assessment reflects 'insulated' legal ring-fencing, highlighted by a well-defined contractual framework, and tight financial controls imposed by Ofwat, which are designed to support YWS's financial profile. We view access and control as overall 'porous' as YWS operates with separate cash management and uses a mixture of external and intercompany funding.

DERIVATION SUMMARY

The senior secured class A rating for YWS at 'BBB+'/Stable is lower than Anglian Water Services Financing Plc's class A debt rating of 'A-'/Stable. This is due to YWS's class A rating no longer benefitting from a one-notch uplift for sector-specific recovery, as a result of its large super senior MtM liabilities. However, YWS's class A rating is two notches higher than SW (Finance) I PLC's (Southern Water) class A rating of 'BBB-'/Rating Watch Negative. Similar to YWS, Southern Water also has substantial super senior MtM liabilities, to which we have applied the same treatment.

KEY ASSUMPTIONS

- Ofwat's final determination financial model used as the principal source of information

- Neutral totex performance

- Net cash ODI penalties of GBP148 million in FY26-FY30

- Fines totalling about GBP75 million from the Environmental Agency or Ofwat

- Nominal cost of new debt averaging 5.8%

- CPIH averaging 2.8% (starting at 3.3% in FY26 and decreasing to 2.5% by 2030). RPI averaging 3% (starting at 3.5% in FY26 and trending down to 2.5% by 2030)

- Equity injection of approximately GBP600 million in FY27, which will be used to repay GBP440 million of a legacy inter-company loan and accrued interest

-No cash tax payments or pension-deficit recovery payments

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Adjusted total net debt/RCV above 70%, combined with cash PMICR below 1.5x and nominal PMICR below 1.8x

- Deterioration in operational and environmental performance, resulting in financial penalties and fines that exceed Fitch's rating case

- Lower-than-expected equity injection or a more aggressive financial policy

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Adjusted total net debt/RCV below 65%, combined with cash PMICR above 1.7x and nominal PMICR above 1.9x

- MtM of super senior derivatives liabilities trending towards 10% of RCV, assuming that the capital structure aligns with our expectations

LIQUIDITY AND DEBT STRUCTURE

As of end-September 2024, YWS held about GBP172.4 million of unrestricted cash and cash equivalents and an undrawn committed revolving credit facility (RCF) of GBP710 million. The company has extended its GBP610 million RCF maturity by one year to November 2029. The remaining GBP80 million of the RCF expires in July 2027 and has two one-year extension options. Its next debt maturity is GBP300 million due in November 2026.

In addition, YWS benefits from a committed undrawn debt service reserve liquidity facility of GBP182 million, sized to cover 12 months of interest payments (including hedge payments), together with a committed undrawn operating and maintenance reserve facility of GBP120 million - both only available on trigger events.

ISSUER PROFILE

YWS is an Ofwat-regulated regional monopoly providing water and wastewater services in England and Wales with an RCV of about GBP9.1 billion at FYE24. We forecast this to increase to about GBP13.5 billion by FYE30. YWSF and YWF are financing companies of operating company YWS.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest reconciled with investor reports

- Statutory total debt reconciled with investor reports

- Capex and EBITDA net of grants and contributions

- Cash PMICRs adjusted to include 50% of the accretion charge on IL swaps with five-year pay-downs, and 100% of the accretion charge on IL swaps with less than five-year pay-downs

- Debt adjusted for borrowing through swaps

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

ESG CONSIDERATIONS

For more information on Fitch's ESG Relevance Scores, visit

https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Yorkshire Water Finance Plc				
senior secured	LT	BBB+	Downgrade	A-
subordinated	LT	BBB-	Affirmed	BBB-
Yorkshire Water Services Finance Limited				
senior secured	LT	BBB+	Downgrade	A-
senior secured	LT	BBB	Downgrade	BBB+

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer’s available public disclosure.

APPLICABLE CRITERIA

Corporate Hybrids Treatment and Notching Criteria (pub. 12 Nov 2020)

Sukuk Rating Criteria (pub. 13 Jun 2022)

Country-Specific Treatment of Recovery Ratings Criteria (pub. 03 Mar 2023)

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Government-Related Entities Rating Criteria (pub. 09 Jul 2024)

Corporate Recovery Ratings and Instrument Ratings Criteria (pub. 02 Aug 2024) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 06 Dec 2024) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 06 Dec 2024)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Yorkshire Water Finance Plc	UK Issued, EU Endorsed
Yorkshire Water Services Finance Limited	UK Issued, EU Endorsed

DISCLAIMER & DISCLOSURES

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

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