FitchRatings

Fitch Revises Outlook on Yorkshire Water's Senior Secured Debt to Negative

Fitch Ratings-London-11 February 2019: Fitch Ratings has revised the Outlook on Yorkshire Water Services Limited's (YW) class A and class B debt to Negative from Stable, while affirming their ratings at 'A' and 'BBB+', respectively. Fitch has also affirmed the holding company Kelda Finance (No.2) Limited's (Kelda) Long-Term Issuer Default Rating (IDR) at 'BB' with Negative Outlook. A full list of rating actions is available at the end of this commentary.

The revision of the Outlook reflects our expectations that YW's financial profile and, in particular, gearing in the next regulatory period, AMP7, could be weak for the current ratings. Fitch's preliminary forecast suggests net senior adjusted debt-to-regulatory capital value (RCV) of around 81% at FYE25 (financial year ending March) versus our negative rating sensitivity of 77%.

The Outlook could be revised to Stable if the company's final business plan demonstrates balance sheet strengthening and a potential to earn meaningful financial rewards for operational performance in AMP7. We expect to revisit the Outlook after the regulator publishes its AMP7 price determinations.

The affirmation of Kelda's rating with a Negative Outlook reflects our expectation of weak forecast dividend cover and high level of uncertainty over the financial profile of the underlying operating company, YW. Kelda's cash flows and debt service are entirely reliant on dividends from YW.

KEY RATING DRIVERS

Weaker Returns After 2020: In December 2017 the UK water industry regulator, Ofwat, announced a significant step down of the allowed return on capital for AMP7. Real, RPI-linked weighted average cost of capital (WACC) of 3.6% (excluding retail margin) is set to decline to 2.3%. This will create a significant decline in YW's EBITDA and post- maintenance cash flow. The regulator also plans to introduce more challenging cost and performance targets, with higher penalties for inefficiency. Additionally, pressure on the gearing ratio will come from a midnight inflation correction adjustment to RCV (GBP103 million in 12/13 prices), which could add around 1.5% to debt/RCV at the beginning of AMP7.

Increased Business Risk: Fitch tightened its ratio guidelines for all rated UK water holding and operating companies in July 2018 to reflect an increase in business risk from the next price control. This is because the tougher proposed regulatory package offers lower cash flow visibility, as more revenue will be at risk with a higher proportion of the allowed return linked to performance. We have tightened our gearing rating sensitivity by 3% and increased the post-maintenance interest cover (PMICR) sensitivity by 0.1x for Fitch-rated entities for the upcoming price control.

Stretched Gearing in AMP7: Our preliminary analysis of YW's business plan submitted to Ofwat in September 2018 suggests that the company may struggle to maintain gearing in line with our revised rating sensitivities during the next price control. Under Fitch's rating case, we expect class A and total senior swap-adjusted net debt/RCV to be substantially over our negative rating sensitivities of 67% and 77% and average PMICRs at our negative rating sensitivities of 1.6x and 1.3x, assuming approximately 2% total expenditure (totex) outperformance and GBP32 million of outcome delivery incentives (ODI) rewards (in nominal terms).

Given the company's middle-ranking regulatory performance in AMP6, the total wholesale cost challenge of 18% recently announced by Ofwat and more demanding cost and incentive targets for AMP7, the extent of potential out/(under)performance is highly uncertain at this point in the regulatory price-setting process.

Regulatory Performance Stable: In FY18, the company achieved 22 out of 26 commitment performance targets, resulting in a net positive reward of GBP12.66 million (in 12/13 prices), with the main rewards coming from water supply interruptions and internal flooding incidents. Reliability measures were stable across all four of the company's key asset categories. The company met its service incentive mechanism (SIM) score, which slightly improved to 84.3 from 83.4, reflecting higher customer satisfaction.

However, In FY18 the company missed its drinking water quality contacts target (leading to a penalty of GBP6.6 million in 2012/13 prices) and it expects to continue missing its performance targets on this measure for the rest of the AMP, leading to an estimated overall penalty of GBP14.4 million (in 12/13 prices). Severe weather conditions negatively impacted YW's leakage performance, which resulted in the company just missing its leakage target. This did not result in financial penalties. Overall, YW is a middle-ranking performer and forecasts a net cumulative reward of GBP68 million in AMP6 (in 2012/13 prices).

AMP6's Totex Outperformance Reinvested: In early 2018 YW decided to increase its capex and reinvest around GBP230 million of totex outperformance achieved in FY16-FY17 in service improvements within the last two years of the AMP6 period. Key areas of reinvestment are reduction of leakage, water supply interruptions, pollution incidents and sewer flooding incidents. The company expects these investments to deliver dramatic service enhancements including a 40% reduction in leakage and a 70% reduction in internal sewer flooding by the end of AMP7. As a result of larger capex, we now expect higher closing gearing at FYE20, at around 78.4% versus 77% previously. At FYE18, the company reported net debt-to-shadow RCV of 76.6%.

Swap Restructuring Lowers Cash Interest: In 2017-2018 the company completed a number of swap restructurings. As a result of these, YW extended mandatory breaks on some of its swaps and arranged for a temporary step-up in the cash interest received from the swaps in FY18-FY32 of around GBP45 million p.a. on average. A forecast reduction in the net cash interest paid results in improved class A and total senior PMICR metrics, which had previously been under pressure.

Swap-Related Adjustment: We view YW's proactive approach in managing the breaks and the super-senior accretion pay-downs on its swap portfolio positively. However, since a substantial part of the fixed cash interest savings was funded through extending the tenor on out-of-money swaps, the cash flow benefit received in FY18-FY30 could be paid back by YW to swap counterparties in the price controls following AMP8. We view this as a way to borrow through swaps, although the amount payable in the future will depend on the real interest rates.

To reflect potential cash outflow after FY30, we add the re-couponing benefit to the reported net debt in each respective year, on a cumulative basis, excluding funding other than tenor extensions. This reflects a general approach we have developed for similar swap re-couponing transactions funded through swap tenor extensions. The adjustment starts accruing in FY19 and reaches a peak by FY30, with a gradual decrease thereafter.

Base Dividends Planned for AMP7: YW's shareholders demonstrated their flexibility over cash dividends in AMP5 and AMP6. In particular, during 2017, shareholders agreed to waive dividends for the rest of AMP6, resulting in dividends being significantly below the level assumed at the price determination. The AMP6's dividends primarily cover operating costs and external interest costs at Kelda. For AMP7, YW followed Ofwat's proposal for setting base dividend at a 5% equity yield, noting that this plan will be subject to financial resilience testing prior to deciding on actual distributions. Overall, total external dividends in AMP7 amount to GBP236 million versus only GBP45 million in AMP6, which contributes to a higher forecast gearing.

Index-linked Swaps: YW has a portfolio of index-linked swaps with a notional amount of GBP1,289 million and a negative money-to-market (MtM) value of GBP2,399 million at 31 March 2018. Although we do not adjust the gearing ratio for these contingent liabilities unless the swaps crystallise, we factor them in our overall rating assessment as they could substantially increase the company's senior debt. The company paid down around GBP130 million of RPI accretion on these swaps in November 2018, actively managing its super-senior trigger event covenant of 6% RCV. We expect management to continue managing YW's liquidity exposure associated with the breaks and accretion pay-downs in the swaps at least 24 months in advance.

Weak Dividend Cover at Kelda: Based on the submitted business plan and dividend forecast by YW, we estimate average dividend cover of 2.8x in FY21-FY25. Given that YW is no longer an outlier among its rated peers in low expected senior gearing, Fitch has decided to align Kelda's dividend cover sensitivity with the rest of the rated UK water holding companies. This resulted in a negative sensitivity of 3.0x versus 2.5x previously. We will have more clarity around any changes in the dividend cover forecast after the draft and final determinations are published by Ofwat.

DERIVATION SUMMARY

Kelda is a holding company of YW (class A debt A/Negative, class B debt BBB+/Negative), one of the regulated monopoly providers for water and wastewater services in England and Wales. Its higher rating than that of peers such as Greensands UK Limited (B-/Negative) and Kemble Water Finance Limited (BB-/Negative) reflects YW's stronger regulatory performance and lower gearing. No Country Ceiling, constraints affect the rating. Parent/subsidiary Linkage is applicable but given the structural and contractual ring-fence structure of the group it does not impact the ratings.

The senior secured ratings and credit metrics reflect the highly geared nature of YW's secured covenanted structure versus that of peers such as United Utilities Water Limited (IDR: BBB+/Stable, senior unsecured A-) and Wessex Water Services Limited (IDR: BBB+/Negative, senior unsecured: A-), which have lower leverage and are not covenanted secured structures. YW's debt financing 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 (class A: BBB+/ class B: BBB-/Stable) reflects stronger credit metrics and more robust 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
-Long-term RPI at 3%, long-term CPIH at 2%
-Allowed WACC in AMP7 declines to 2.3% (RPI based) and 3.3% (CPIH based) in real terms, excluding retail margins
-50% of the RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, starting from FY21
- AMP7 totex of GBP5.5 billion in nominal terms
- Pay-as-you-go (PAYG) ratio of 53.4%, run-off rate at 3.8%
- Net AMP6-related ODI rewards of GBP105 million (nominal) are included in AMP7's revenue adjustments
- 2% totex outperformance, GBP32 million ODI-related rewards in AMP7 (nominal)

- Retail EBITDA of GBP12 million p.a. on average during AMP7
- EBITDA from unregulated businesses of GBP20 million in total over AMP7
- Average YW's cash cost of debt of 3.2% (including the benefit from swap-re-couponing), total cost of debt of 4.9% in AMP7
- Average Kelda's cost of debt of 5.9% and annual corporate costs of around GBP9 million
- Pension deficit recovery payments of around GBP14 million p.a. in FY19-FY22
- YW's AMP7 total dividend of GBP417 million and Kelda's AMP7 dividend of GBP326 million

RATING SENSITIVITIES

YW
Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
-An upgrade is unlikely for both classes of debt, given the pressure on the gearing
-The Outlooks could be revised to Stable if we expect class A debt gearing below 67% and net senior gearing below 77% in AMP7, through a combination of expected operational outperformance and changes to planned distributions.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
-Class A debt gearing above 67% and/or PMICR materially below 1.6x on a sustained basis
-Net senior gearing above 77% and/or PMICR materially below 1.3x on a sustained basis
-Deterioration in operational or regulatory performance
-Regulatory decisions that may materially impact cash flow generation such as opening up additional parts of the value chain to competition

Kelda
Developments That May, Individually or Collectively, Lead to Positive Rating Action
-Upside is limited given the Negative Outlook. We may revise the Outlook to Stable if YW and Kelda materially reduce regulatory gearing and expected dividend cover improves materially to above 3.0x throughout the AMP6 and AMP7 price controls

Developments That May, Individually or Collectively, Lead to Negative Rating Action
-A dividend cover below 3.0x on a sustained basis while YW continues to retain dividends, rather than upstreaming them to Kelda to aid deleveraging
-Group gearing above 82% and consolidated PMICR below 1.2x on a sustained basis
-A marked reduction in RPI on a sustained basis that may further reduce the dividend being up-streamed from YW
-Marked deterioration in operating and regulatory performance of YW or a material change in the business risk of the UK water sector

LIQUIDITY

YW
As of 30 September 2018, the company had GBP23.3 million in cash and cash equivalents and GBP684.0 million in available undrawn committed bank facilities. Of the available liquidity facilities, GBP405 million (recently extended to Oct 2023) can be used without restriction while the remaining GBP279 million of operational and maintenance and debt service reserve facilities can only be utilised by YW during a standstill period. This funding position provides sufficient financial resources for operating requirements and debt maturities for the next 18 months. YW's senior net indebtedness was GBP5 billion at end-September 2018 and GBP4.9 billion at FYE18.

Kelda

As of 30 September 2018, the holding company had available a GBP30 million undrawn, committed revolving credit facility with maturity in October 2022 and GBP2.3 million readily available cash. The next debt maturity is a GBP200 million bond in February 2020. Kelda had senior net indebtedness of GBP460 million at end-September 2018, unchanged from FYE18.

FULL LIST OF RATING ACTIONS

YW
Yorkshire Water Services Bradford Finance Limited (programme issuer)
-- Class A notes: Outlook revised to Negative from Stable; senior secured rating affirmed at 'A'
-- Class B notes: Outlook revised to Negative from Stable; senior secured rating affirmed at 'BBB+'
Yorkshire Water Services Odsal Finance Limited's (exchange issuer)
-- Class A notes: Outlook revised to Negative from Stable; senior secured rating affirmed at 'A';
Yorkshire Water Services Services Finance Limited's (YWSF)
-- Class A notes: Outlook revised to Negative from Stable; senior secured rating affirmed at 'A'
-- Non-participatory bonds: Outlook revised to Negative from Stable; senior secured rating affirmed at 'A-'

Kelda
Kelda Finance (No.2) Limited
--Long-Term IDR affirmed at 'BB', Outlook Negative
--Senior secured rating affirmed at 'BB+'
Kelda Finance (No.3) PLC
--Senior secured bonds issued by Kelda Finance (No.3) PLC affirmed at 'BB+'. The bonds are guaranteed by Kelda.
Kelda Finance (No.3) PLC (FinCo) is the financing vehicle for Kelda, which guarantees the issued bonds together with its parent, Kelda Finance (No.1) Limited

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Summary of Financial Statement Adjustments
- Statutory cash interest and statutory total debt reconciled to match YW's and Kelda's FY18 compliance

certificates
- Cash interest is adjusted to reflect pay-down provisions on some index-linked swaps

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
Corporate Rating Criteria (pub. 23 Mar 2018)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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