Research Update:

Yorkshire Water Services Outlook Revised To Stable On Favorable Competition And Markets Authority Redetermination

April 14, 2021

Rating Action Overview

- We consider the publication of the redetermination by the Competition and Markets Authority (CMA) will improve Yorkshire Water Services' (YWS) operating conditions for the last three years of the current AMP7 regulatory period.
- As a result, we believe that the group will, on average, be able to post credit metrics stronger than previously anticipated over the current regulatory period AMP7 and in line with our thresholds for current issue-level ratings on YWS.
- We therefore revised the outlook on our issue-level ratings on YWS to stable from negative and affirmed the ratings on the debt.
- The stable outlook reflects our view that YWS' credit metrics should remain commensurate with our current thresholds for the current rating level over the rest of AMP7 on the back of more favorable operating conditions following the CMA redetermination.

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Rating Action Rationale

The positive CMA redetermination will ensure that YWS' credit metrics remain above existing targets during AMP7. We consider the outcome of the redetermination of YWS' business plan for AMP7 (April 2020 to March 2025) by the CMA published on March 17 as a positive development for appealing water companies. YWS, alongside three other water companies, had asked its regulator (Ofwat) to refer its final determination (FD) of the 2019 price review to the CMA in February 2020. The redetermination from the CMA supersedes the FD from Ofwat and its impact will be gradually reflected over the last three years of the current regulatory period that is from April 2022 to March 2025.

Under the terms of the redetermination, YWS will see revenue increasing by £148 million (in 2017/2018 prices) over AMP7, a 3% increase compared with Ofwat's FD. The higher revenue results from a 24-basis-point increase in allowed return (3.20% real Consumer Prices Index

including owner occupiers' housing costs) on its regulatory capital value (RCV) and a £112 million increase in base cost allowance compared with Ofwat's FD (net increase in total expenditures of £158 million). While the allowed return after the CMA redetermination remains higher than that under Ofwat's FD, we nonetheless observe a 30-basis-point reduction against the CMA's preliminary findings published in September 2020 (See: U.K. Water Utilities: Was Appealing Ofwat's Determination Worth It?, published Oct. 1, 2020)

As a result, we now project our funds from operations (FFO) to debt metrics ratio to remain commensurate with the current ratings level over AMP7, averaging about 6%-6.5% on a consolidated debt basis (class A and B) and 7%-7.5% on a class A debt only. We also expect the group to maintain its adjusted debt to EBITDA below 10x and 9x on a consolidated and class A debt only, respectively. We nonetheless consider YWS' gearing as measured by reported net debt to RCV as high at 78% for fiscal 2020 and its capital structure as relatively aggressive and consider that the gearing level is unlikely to decrease markedly by the end of AMP7 compared with its level at the end of AMP6.

Despite the increased allowance, the current regulatory period remains challenging for YWS from an operational standpoint. For instance, we consider that YWS will face an efficiency challenge over AMP7, with total expenditures (totex) remaining underfunded by about £195 million between the CMA redetermination and its submitted business plan in August 2019. YWS is, in our view, an average performer compared with its water sector peers, having spent about 3% more than its regulatory allowance over AMP6, which Ofwat considered as some of the least-efficient incurred costs in its Service Delivery Report (2019-2020), while leading the sector in achieving the highest level of Outcome Delivery Incentives ODI return on regulated equity. Despite the favorable redetermination and greater totex allowance, YWS' room for outperformance appears limited, in our view. Similarly, the more stringent ODI targets over AMP7, broadly unaffected by the redetermination, will likely reduce significantly YWS' ability to generate any significant ODI rewards by the end of AMP7.

YWS continues to be resilient to the fallout of COVID-19. We consider YWS as relatively hardy against the effects of the pandemic, given the essential service the company provides and the regulated nature of its activities. We expect a significant reduction in water consumption for non-household customers of about 15% and lower-than-anticipated revenue coupled with rising bad debts as a result, although this will be offset by an increase in residential consumption of about 10%. We do not expect any significant reduction in YWS' capital expenditures program, despite a reduction of approximately 15% against initial targets over the first half of 2020. The regulatory framework for the sector includes mechanisms enabling water companies to compare actual revenue in any specific year with the amount allowed under the FD. There is a two-year lag between any over- orunder-collection and the subsequent true-up, so any under-collection in 2020/2021 should be offset by an increase in allowed revenue in 2022/2023.

The company's derivatives portfolio is sizable, but with limited risks over AMP7. YWS has a relatively large exposure to derivatives, with a portfolio of index-linked swaps with a notional amount of about £1.3 billion (about 18% of its RCV). This portfolio includes mandatory early termination dates (mandatory breaks) of about £290 million spread between 2025 and 2033, and we therefore consider as critical for the group to maintain a proactive approach in addressing mandatory breaks at least 24 months ahead of due dates to avoid any pressure on its liquidity. We note that recent restructurings indicate that YWS has so far been successful in doing so, including the completion on March 4, 2021, of the successful extension of mandatory breaks on £72.4 million notional of seven inflation-linked swaps with mandatory breaks extended individually from

February 2023 to February 2028, February 2033, or February 2040. Nevertheless, this extension comes at a cost, with a permanent adjustment on real coupon and interest cost.

Outlook

The stable outlook reflects our expectation that YWS will be able to post an adjusted FFO-to-debt ratio averaging above 6% and 7% on a sustainable basis on its consolidated debt and class A debt, respectively, over the rest of AMP7, which we view as commensurate with both issue-level ratings while demonstrating solid operating performance.

Downside scenario

We could lower the ratings on YWS' class A debt and class B debt by one notch if YWS' credit quality deteriorated over AMP7, with FFO to debt on both consolidated and class A debt being consistently below 6% and 7%, respectively. This could happen if YWS were to face any significant challenges to the execution of its business plan, significantly overspending against its regulatory allowances or being in a large net penalty position on its outcome delivery incentives or if it implemented a financial policy more aggressive than currently assumed.

Upside scenario

At this stage, higher issue-level ratings are unlikely, in our view. This could nonetheless occur if credit metrics were to remain sustainably and significantly above 7% and 8% on both consolidated and class A debt, respectively, in conjunction with what we would consider an industry-leading operational performance over the current regulatory period.

Liquidity

Over the 12 months started Dec. 31, 2020, we expect:

Principal liquidity sources:

- A cash balance of about £186 million,
- Cash FFO of about £330 million, and
- Committed RCF, of which the unused portion is £240 million.

Principal liquidity uses:

- Expected cash capital spending of approximately £470 million,
- Contractual debt repayment of £100 million, and
- Dividends of £45 million to service debt and external costs at Kelda Financing Group.

Ratings Score Snapshot

Senior Secured (class A)

Issue-level Rating: A-/Negative

Business risk: Excellent

- Country risk: Low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

Various structural enhancements (+1 notch)

Subordinated (class B)

Issue-level Rating: BBB/Negative

Business risk: Excellent

- Country risk: Low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

U.K. Water Utilities: Was Appealing Ofwat's Determination Worth It?, Oct. 1, 2020

Ratings List

Ratings Affirmed; Outlook Revised

	To	From
Yorkshire Water Finance Plc		
Senior Secured (Class A)	A-/Stable	A-/Negative
Subordinated (Class B)	BBB/Stable	BBB/Negative

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