FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Yorkshire Water's Class A and B Debt at 'A-' and 'BBB-'; Outlook Stable

Wed 09 Jun, 2021 - 3:24 PM ET

Fitch Ratings - London - 09 Jun 2021: Fitch Ratings has affirmed Yorkshire Water Service Finance's(YW) and Yorkshire Water Finance plc's senior secured class A debt rating at 'A-' and subordinated class B debt rating at 'BBB-', with Stable Outlooks.

The affirmations reflect the favourable outcomes of the CMA final determination, which have resulted an increase in the weighted average cost of capital (WACC), an increase of GBP158 million in totex allowances and expected improvements in ODI performance over the upcoming AMP7 regulatory period. This leads to a marginally stronger financial profile with leverage metrics that are within our rating guidelines, however, nominal post maintenance interest coverage ratios (PMICRs) are still slightly beyond our negative sensitivities.

Feedback

KEY RATING DRIVERS

Challenging Price Control Ahead: Ofwat announced a significant cut to the allowed WACC to 1.96% (real, long-term RPI of 3%) from 3.7% (2.8%) for AMP7. Following YW's appeal to the CMA, they will receive a 20bps increase to the WACC following the CMAs ruling on the final determinations (FD). Lower return will put pressure on YW's cash flow and interest cover metrics. YW's second quartile ranking regulatory performance and challenging performance commitments are likely to lead to meaningful outcome delivery incentive (ODI) penalties in AMP7.

CMA Final Determination Positive: The CMA released their final determination on YW's appeal against Ofwat's AMP7 FD in April 2021 with changes supporting YW's credit metrics. For our rating case, we apply a 20bps uplift to the weighted average cost of capital and an increase in totex allowances of GBP158 million, all based on the decisions and consultations published by the CMA. These assumptions result in slightly improved gearing and PMICR forecast metrics compared to our previous rating case.

Improved Financial Profile: We expect YW's Fitch adjusted net debt-to-regulated capital value (RCV) to be around 78.9% at FYE25 compared to our negative sensitivity of 82%, providing some headroom. This is driven by the increases in the allowed return and totex allowances. We expect this to benefit YW's net ODIs, however, we still forecast cash penalties of around GBP28 million during AMP7.

We estimate average class A cash and nominal PMICRs at 1.5x and 1.6x, respectively, for AMP7, versus the negative rating sensitivities of 1.4x and 1.7x. We also estimate average senior cash and nominal PMICRs at 1.3x and 1.5x, respectively, for AMP7, versus the negative rating sensitivities of 1.2x and 1.5x. This is an improvement from our previous forecasts which reflects the improved WACC and higher totex allowance.

Neutral Totex Assumed: YW's AMP7 wholesale totex allowance of GBP4,120 million (in 2017/2018 prices, excluding pensions and third-party cost) increased by GBP158 million as a result of the CMA appeal. Overall, this is slightly under 4% below the totex requested by YW in its representations to the CMA. This differential could be reduced to neutral totex spend as a result of YW's cost optimisation. In AMP6, the company has overspent around 1% against its totex allowance (after adjustments for insurance and reinvestment).

Feedback

ODI Penalties Expected: We forecast around GBP50 million in net ODI penalties for YW's operational delivery in AMP7, of which GBP28 million impact AMP7's cash flows. This is lower than in our previous rating case due to the increase in totex allowance. YW also reported better than expected operational performance including improvements in drinking water contacts. The penalties are driven by the challenging commitment targets, which are now set to holistically measure the company's operational performance.

While in AMP6, the company benefitted from a few well-selected and structured financially rewarded ODIs and only incurred modest penalties, in AMP7, the situation will change. We expect most of AMP7's penalties to come from internal sewer flooding, main repairs and leakage. Internal sewer flooding penalties are expected to be offset by external sewer flooding rewards. Our assumptions on performance include a one in five years severe weather event.

Mid-Ranking Performer: Based on Ofwat's 2019-20 service delivery report, YW demonstrated average operational performance compared with the sector with considerable improvement in the final year of AMP6. Although it received substantial net ODI rewards over AMP6, its performance on leakage, internal sewer flooding, pollutions and customer service was below sector-average. YW performed better than the sector on per capita consumption and in line with the sector on supply interruptions and water-quality contacts. Of the GBP64 million net ODI rewards (in 2012/13 prices) for AMP6, it received GBP30 million from supply interruptions, GBP25 million from internal sewer flooding and GBP22 million from pollution incidents, while drinking water contacts performance resulted in a GBP13.5 million penalty.

Subordinated Class B Debt: We carried out a sector-wide review of large derivative liabilities across Fitch-rated UK regulated networks in February 2021 resulting in the downgrade of YW's class B debt by one notch. The class B debt is subordinated to the super-senior index-linked (IL) swap liabilities and class A debt, therefore we do not expect the recovery of YW's class B debt to be above average in an event of default scenario.

Borrowing Through Swaps: YW executed three swap restructuring transactions in FY18-FY19. They resulted in additional cash inflows from certain index-linked swaps in FY18-FY32, which significantly reduce the company's net cash interest from FY19 and improve headroom under the interest-cover covenants. These cash inflows were funded by GBP250 million of new class A debt, savings generated via swap bifurcation and tenor extensions on out-of-money swaps. Fitch treats the re-couponing benefit funded through tenor extensions on out-of-money swaps as borrowing through swaps and adjusts its forecast net debt by the cumulative amount of the benefits received. Total debt adjustment amounts to 2.3% RCV at FYE25.

Index-linked Swaps: YW had index-linked swaps with a notional amount of GBP1.3 billion and a negative marked-to-market value of GBP2.79 billion at 31 March 2021. Fitch does not adjust the gearing ratio for these contingent liabilities unless the swaps crystallise but we factor them in our rating assessment as they could substantially increase senior debt in the future. YW voluntarily paid down GBP130 million RPI accretion on these swaps in November 2018 and an additional GBP15 million in accretion in August 2020, actively managing its super-senior trigger event covenant of 6% RCV.

Fitch expects YW to continue managing its liquidity associated with the breaks and accretion pay-downs in the swaps at least 24 months in advance. In March 2021, the extension of GBP151 million (notional) RPI swaps which had breaks in 2023 were extended to 2028 and beyond. The breaks were paid through an increase in the real coupon payable by YW from 2023 to coincide with the original break dates.

DERIVATION SUMMARY

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/Stable, senior unsecured: BBB+), which have lower adjusted leverage and no 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. It is rated higher than similar peers with covenanted structures such as Southern Water (class A: BBB+/RWN), reflecting stronger class A credit metrics and more robust regulatory performance.

KEY ASSUMPTIONS

- Ofwat's FD financial model used as a main information source;

- Allowed wholesale WACC of 2.12% (RPI-based) and 3.12% (CPIH-based) in real terms including a 0.2% uplift (for both) due to the CMA final determinations, excluding retail margins;

- 50% of RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, starting from FY21;

- RPI 1.4% in FY21, gradually increasing to 2.7% by FY25; CPI 0.9% in FY21, gradually increasing to 2.0% by FY25;

- Allowed net totex of GBP4.4 billion in nominal terms (net of grants and contributions), including an additional GBP158 million in totex due to CMA appeal outcome;

- EBITDA shortfall of 35.4 million in FY20, recovered between FY23 and FY25;

- COVID-19 and CMA appeal legal costs of around GBP21 million in FY21 of which GBP2.5 million is recovered in FY22;

- Neutral totex spend over AMP7;

- Net ODI penalties of c. GBP28 million in AMP7;

- Weighted average PAYG rate of 62%, with a 98m reduction in PAYG totex and equal increase in non-PAYG totex;

- Weighted average run-off rate of 3.9%;

- Unregulated EBITDA of GBP25 million over AMP7 including other operating income;

- Retail EBITDA around GBP8 million per year;

- Average dividends to Kelda of GBP58 million per year; total of GBP8 million external dividends over AMP7;

- Pension deficit recovery payments in line with Ofwat's allowance of GBP14 million in FY21-FY22;

- Average nominal and real cost of debt at around 4.3% and 2%, respectively;

- Average nominal cost of new debt at around 2.4% at YW;

- Proportion of index-linked debt increases to around 70% in FY25 from around 60% in FY20.

RATING SENSITIVITIES

Factors That May, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Rating upgrade is unlikely in the medium term. In the longer term, an upgrade could be considered if the company maintains:

- Class A adjusted debt gearing below 67%, class A cash and nominal PMICRs above 1.6x and 1.8x, respectively;

- Total senior adjusted debt gearing below 77%, total senior cash and nominal PMICRs above 1.3x and 1.6x, respectively.

These could be achieved due to a combination of significant outperformance versus Fitch's current totex and ODI assumptions, and substantial balance-sheet strengthening.

Factors That May, Individually or Collectively, Lead to Negative Rating Action/Downgrade

We could downgrade the ratings if YWS's financial profile falls deteriorates beyond:

- Class A adjusted debt gearing above 72%, class A cash and nominal PMICRs below 1.4x and 1.7x, respectively;

- Total senior adjusted debt gearing above 82%, total senior cash and nominal PMICRs below 1.2x and 1.5x, respectively.

This could happen due to deterioration in the company's operational performance, substantial and prolonged impact of coronavirus on revenue recovery.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Strong Liquidity: As at 31 March 2021, YW had unrestricted cash and cash equivalents balances of GBP185 million and an undrawn revolving credit facility of GBP240 million maturing in October 2023, which was increased to GBP560 million in end-April 2021. The company's liquidity position comfortably covers Fitch's forecast 24-months negative free cash flow of GBP278 million and FY21 debt maturities of GBP41million. YW also has a debt service reserve liquidity facility of GBP146 million, an operating and maintenance reserve facility of GBP75 million and GBP37 million of restricted cash, which can only be utilised by YW during a standstill period.

ISSUER PROFILE

Yorkshire Water is a regulated water and waste water company whose core operations are the collection, treatment and delivery of water, and the collection, treatment and recycling of waste water. The company operates in the regions of Yorkshire, part of North Lincolnshire, and part of Derbyshire, all in England. The company is one of the ten regional water authorities. Yorkshire water is part of the Kelda Group.

SUMMARY OF FINANCIAL ADJUSTMENTS

-Cash interest for cash PMICR adjusted for 50% annual inflation accretion from RPI swaps with five-year pay-down provisions;

-Statutory cash interest reconciled with investor reports;

-Statutory total debt reconciled with investor reports.

Feedback

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.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

ENTITY/DEBT	RATING			PRIOR
Yorkshire Water Finance Plc				
• senior secured	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
• subordinated	LT	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
Yorkshire Water Services Finance Limited				

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 26 Aug 2020)

Corporate Rating Criteria (pub. 21 Dec 2020) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

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

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Corporate Finance Utilities and Power Europe United Kingdom

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