

Rating Action: Moody's affirms Yorkshire Water's ratings and changes outlook to stable

10 Sep 2021

London, 10 September 2021 -- Moody's Investors Service (Moody's) has today affirmed the Baa2 underlying senior secured and backed senior secured ratings of Yorkshire Water Services Finance Limited, and has affirmed Yorkshire Water Finance plc's Ba1 backed subordinated and Baa2 backed senior secured ratings. Concurrently, Moody's has affirmed Yorkshire Water Finance plc's (P)Ba1 backed subordinate MTN program and (P)Baa2 backed senior secured MTN program ratings. Moody's has changed the outlooks to stable from negative. The companies are financing vehicles for Yorkshire Water Services Limited (Yorkshire Water) which guarantees issuance.

The A2 ratings of those bonds that are subject to a financial guarantee of timely payments of scheduled interest and principal by Assured Guaranty UK Limited (A2 stable) will continue to reflect the insurance financial strength rating of the guarantor and are unaffected by this action.

RATINGS RATIONALE

The rating action reflects Yorkshire Water's performance in the first year of the 2021-25 regulatory period (AMP7) and the final determination of the Competition and Markets Authority (CMA), announced in March 2021, under which Yorkshire Water will generate stronger cash flow from April 2023 than initially allowed by Ofwat, the economic regulator for water companies in England and Wales.[1] Specifically, the ratings and stable outlooks reflect Moody's view that Yorkshire Water will be able to maintain an Adjusted Interest Coverage Ratio (AICR) of around 1.3x and net debt around 77% of Regulatory Capital Value (RCV) over AMP7, in line with guidance for the current rating.

Moody's base case assumes that Yorkshire Water will accrue modest financial penalties for operational performance over the period. However, Yorkshire Water has a solid track record of operational performance that resulted in GBP64 million rewards over AMP6, and penalties of GBP1.1 million in the first year of AMP7 represent strong performance against more challenging operational targets. If Yorkshire Water is able to achieve net rewards over AMP7, this would improve the company's position in the current rating category.

The ratings also take into account the company's low business risk as a monopoly provider of essential water and sewerage services, comparatively strong operational and environmental performance, relatively stable cash flow generated under a well-established and transparent regulatory regime, and creditor protections incorporated within the company's financing structure.

However, the senior debt ratings are constrained by high borrowing costs under the company's long-dated derivatives portfolio, which results in interest coverage that is likely to remain weak for the assigned rating and a persistently high mark-to-market loss (MTM) of around GBP2.8 billion (39% of RCV) as of March 2021. In a default scenario, if creditors demand payment acceleration, the company 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, at current levels, materially reduce senior debt recovery.

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 prior to enforcement action. In particular, an automatic standstill of up to 18 months follows the occurrence of an event of default, which 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.

However, the company has executed several swap amendments and re-structurings which in Moody's opinion weaken the value of these creditor protections by reducing the likelihood that trigger events will occur. Under these transactions, the company will receive over GBP290 million from swap counterparties over AMP7 and AMP8, reducing net interest for covenant purposes but increasing the MTM and probable future outflows. Because Moody's regards these transactions as economically equivalent to new super-senior borrowings

rather than interest received, the AICR under Yorkshire Water's covenant definition will be approximately 0.2x higher than Moody's calculation.

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 reflects the same default probability but also Moody's expectation of a heightened loss severity for the Class B bonds following any default given its subordinated position within the financing structure.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Moody's currently does not envisage any upward rating pressure because metrics are likely to remain weakly positioned for the assigned rating for the foreseeable future, given the high cost of the company's long-dated portfolio of swaps.

The ratings could be downgraded if Yorkshire Water appears unlikely to achieve an AICR of around 1.3x with gearing, measured by net debt to RCV, not materially above 80%. In addition, downward rating pressure could result from (1) material increases in the mark-to-market valuation of Yorkshire Water's swaps, which would reduce recoveries by senior creditors in a default scenario, (2) adoption of a more aggressive financial policy, (3) a significant increase in business risk for the sector as a result of legal and/or regulatory changes leading to a 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.

The principal methodology used in these ratings was Regulated Water Utilities published in June 2018 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1121971. Alternatively, please see the Rating Methodologies page on www.moody.com for a copy of this methodology.

Yorkshire Water Services Limited (Yorkshire Water) is the fifth largest of the 10 water and sewerage companies in England and Wales by both RCV and the number of customers served. Yorkshire Water provides drinking water to around 5 million people and around 130,000 local businesses over an area of around 14,700 square kilometres encompassing the former county of Yorkshire and part of North Derbyshire in Northern England.

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 Management, 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.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1288435.

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REFERENCES / CITATIONS

[1] CMA issues final decision on water price controls, 17 March 2021, <https://www.gov.uk/government/news/cma-issues-final-decision-on-water-price-controls>

Please see www.moody.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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