Research Update:

Outlook On Yorkshire Water Services Ltd.'s Debt Revised To Negative On Inflationary Pressure

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PRIMARY CREDIT ANALYST

Julien Bernu
London
+ 442071767137
Julien.Bernu
@spglobal.com

SECONDARY CONTACT

Aarti Sakhuja
London
+ 44 20 7176 3715
aarti.sakhuja
@spglobal.com

Rating Action Overview

- High inflation is weighing on the credit metrics of Yorkshire Water Service Ltd. (YWS), creating both operating and financing cost pressure for the rest of the current regulatory period ending in March 2025 (AMP7).
- We project that YWS's funds from operations (FFO) to debt will average about 4.5% for its consolidated debt (class A and B) and 5.5% for class A only until the end of AMP7, gradually approaching our 6% and 7% targets by the last year of the current regulatory period.
- We therefore revised our outlook on the debt issued by YWS to negative from stable. We also maintained the stable outlook on our 'AA' issue rating on the senior secured bonds issued by YWS and guaranteed by Assured Guaranty Europe PLC.
- The negative outlook indicates that we could lower the ratings if we do not see a path for YWS's S&P Global Ratings-adjusted FFO to debt and debt to EBITDA to recover to levels that we see as commensurate with the rating by the end of AMP7.

Rating Action Rationale

High inflationary pressures will deteriorate the rating headroom on YWS' debt. Inflation can be a positive for the regulated water sector in the U.K., given that both future allowed revenue and regulatory capital value (RCV) rise in line with the average increase in prices measured by the consumer price index including owner occupiers' housing costs (CPIH). That said, significantly higher inflation is putting substantial pressure on financing costs, which is causing negative short-term effects on the sector's credit metrics--notably FFO to debt due to large noncash inflation accruals incorporated in our calculation. On top of inflation-linked financing, which accounts for approximately 30% of total debt at the end of March 2022, YWS has a large exposure to derivatives relative to its RCV compared with other water companies. Its portfolio of index-linked swaps has a notional amount of about £1.3 billion over the same period. We therefore expect inflation will continue to raise financing costs in financial year 2023 (ending March 31) and financial year 2024 given the higher level of noncash accretion that we expect YWS to incur during these years.

The company's derivatives portfolio is sizable, but has limited risks over AMP7. This swap portfolio includes mandatory early termination dates (mandatory breaks). We therefore consider it critical for the group to maintain a proactive approach in addressing these breaks at least 24 months ahead of due dates to avoid any pressure on liquidity. That said, historically, these have been well-addressed by management at least 24 months ahead of due dates to avoid any liquidity pressure. The next break event is scheduled for 2025, with a paydown of £23.4 million of unpaid accretion, before a £176.9 million swap maturity in 2026.

We believe high inflation will also affect operating conditions throughout the rest of AMP7, creating uncertainty around metrics' recovery. High energy costs are outpacing average inflation, and the lingering effects of the pandemic on supply chains are increasing input costs. With this in mind, we see persisting pressure on operating margins in the short term and elevated uncertainty around the macroeconomic environment until the end of AMP7. YWS' ongoing transformation program will address asset maintenance and process efficiency resulting in reduced future operating expenditure and mitigating inflation pressure on the group's operating costs base for the rest of AMP7, along with the company's modest increase in allowed wholesale revenues and total expenditure from the outcome of the appeal of the Competition and Markets Authority's (CMA's) final determination. It remains to be seen whether water companies will be able to pass through large average annual bill increases over the rest of AMP7 during the significant cost of living crisis in the U.K. and after just starting the process for the next price review (PR24). Although, like many of its peers, YWS will ensure it provides sufficient support to customers that are less able to absorb cost of living pressures through bill support. With an additional £15 million for support through to 2025 announced in September 2022, the total support for customers will amount to £115 million across the five years of AMP7.

Considering all these elements, we see significant pressure on YWS' credit metrics. We forecast that YWS' adjusted FFO to debt will remain below our 7% target for the class A only debt and 6% target for the consolidated debt, recovering toward a level we see as commensurate with the rating only by financial year 2025. The recovery relies on a marked improvement in the group's operating conditions toward the end of AMP7, thanks to our expectations of gradual normalization in inflation by financial year 2025. That said, there is significant uncertainty around this baseline, given the sensitivity of the group's credit metrics to movements in inflation until then. The group large capital expenditure (capex) program over the remaining years of AMP7, peaking at about £720 million in financial year 2024, also weighs on the company's credit metrics and further delays recovery.

We expect additional support from shareholders, considering the large capital investment program and repayment of intercompany loans to YWS. In October 2022, YWS announced that its shareholders will be funding an additional £100 million investment to its existing capex program out of a total £180 million, which targets an annual 20% reduction of sewage spills from storm overflows by 2025 from the 2021 baseline. This also follows the group's announcement that it agreed with the regulator (Ofwat) to recover two intercompany loans totaling £941.3 million as of March 31, 2022, which are owed by another subsidiary of Kelda Group (YWS' parent). These loans will be repaid by March 2027, with the help of capital injections (sourced from either additional debt raised at the holding company level or a direct equity injection from shareholders). £500 million of this quantum will be repaid over AMP7 (at least £300 million will be by June 2023). This announcement comes with YWS' broader commitment to reduce its financial regulatory gearing to no higher than 72% by April 2025, along with it undertaking a financial structure review.

Extreme weather conditions have weighed on YWS' operating performance for financial year 2022. YWS has only met 57% of Ofwat's performance requirements in financial year 2022. The group has notably faced several operational pressures including storms causing internal sewer flooding, water supply interruptions, and unplanned outages, despite its strong performance in external sewer flooding and managing void properties. Overall, YWS' net penalty position on its outcome delivery incentives (ODIs) increased to £15 million. This is an increase from the £3.4 million net penalty position it recorded in financial year 2021. YWS' current performance against regulatory benchmarks illustrates, in our view, the challenging regulatory settlement for the group for the current regulatory period. Furthermore, like many of its peers, YWS is increasingly exposed to extreme weather events further testing its network resilience. On top of storm Arwen, drought episodes pose significant operational challenges through burst and flash flooding incidents.

The ongoing regulatory investigation related to wastewater treatments illustrates stakeholders' greater focus on environmental issues and the growing reputational and financial risks for water and sewerage companies. On March 9, 2022, Ofwat announced it was opening enforcement cases into five water and wastewater companies, including YWS. The five companies have been served formal notices to gather further information for enforcement purposes, following concerns about how they are compliant with their environmental obligations, especially regarding wastewater treatment works. This is against the backdrop of increased public scrutiny on environmental issues for the sector, with consumers and stakeholders demanding a higher quality of service from water and sewerage companies, as well as greater environment protection. The outcome of Ofwat's investigation could lead to litigation-related costs and fines for certain companies, with the regulator indicating that it can impose fines of up to 10% of annual turnover based on the level of customer harm arising from any license breach. Large financial fines related to a failure to comply with environmental obligations could ultimately affect our credit ratings on YWS, as well as our environmental, social, and governance credit indicators. In our base-case scenario, we do not expect any penalty for YWS, but will reassess should any fines materialize. We also note that the Environmental Agency lowered the score of YWS' environmental performance from four stars to two stars during its last annual assessment, in line with the general outcome for most of its peers, and reflecting a revised methodology in calculation of the EPA score.

Outlook

The negative outlook reflects our view that YWS' credit metrics, notably its adjusted FFO to debt, are at risk of only recovering to levels we see commensurate with the rating toward the end of AMP7, despite our expectations of a gradual normalization of inflation in the next 12 to 24 months. We now believe that FFO to debt may not be above 7% and debt to EBITDA below 8x for its class A debt, and 6% and 9x for its consolidated debt for much of the remainder of AMP7.

Downside scenario

We could lower the rating on the debt issued by YWS if the group is unable to mitigate the negative impact of the current high inflation. This would lead to FFO to debt not recovering above 7% for its class A only debt and 6% for its consolidated debt, and debt to EBITDA remaining below 8x for class A debt and 9x for consolidated debt by the end of AMP7.

We could also lower the rating if:

- YWS faced significant financial or reputational damages from the conclusion of Ofwat's ongoing investigations, although this is not in our current base case.

- YWS' operational performance deteriorates significantly compared with our current base case, resulting in a significant net penalty position for the group on its ODIs for the rest of AMP7.
- We were to think that YWS' risk and liquidity management practices are less prudent than before. This could be the case, for instance, if we continue to view YWS' 12-month liquidity as tight.

Upside scenario

We could revise the outlook to stable if we were to observe a gradual easing of current inflationary pressures, leading to a quicker and more certain recovery in ratios at levels we consider commensurate with the rating, with FFO to debt consistently above 7% for class A only debt and 7% for consolidated debt. This assumes that YWS will not be subject to any forms of regulatory intervention limiting its ability to increase bills in line with inflation for the rest of AMP7. We also assume that the group and owners will remain committed to the rating with an equally supportive financial policy and that YWS will not face tougher operating conditions as part of PR24.

Our Base-Case Scenario

Assumptions

- Revenue growth in line with regulatory assumptions and CMA determination, along with the ability to entirely pass through CPIH inflation for the 12 months to November 2022.
- Gradual improvements in EBITDA margins towards the end of AMP7 to about 55% from the current 51%.
- RPI inflation in the U.K. of 12.6% as of March 31, 2023; 4.5% as of March 31, 2024; and 2.5% as of March 31, 2025.
- Modest to neutral ODI net rewards position for the rest of AMP7.
- Higher capital intensity for the last three years of AMP7 with average annual capex of about £600 million-£650 million during 2023-2025.
- About a £90 million dividend in 2023 to service interest payments outside of the YWS operating company. No external dividends to pay YWS' ultimate shareholder as these are assumed to remain with YWS to offset its inter-company loan £941 million quantum, which the group has committed to pay down by financial year 2027.
- Debt to RCV at about 72.5% by the end of AMP7, similar to current level as of end March 2022.

Yorkshire Water Services Ltd.--Key Metrics*

	--Fiscal year ended March 31--			
Mil. £	2022a	2023f	2024f	2025f
EBITDA	576.00	600-620	645-665	720-740
Capital expenditure	357.00	550-570	710-730	570-590
Debt	5,701	5,900-6,100	6,300-6,500	6,600-6,800

Yorkshire Water Services Ltd.--Key Metrics* (cont.)

	--Fiscal year ended March 31--			
Mil. £	2022a	2023f	2024f	2025f
Funds from operations to debt (%)	3.1	1-4	4-6	6-8
Debt to EBITDA (x)	9.9	9-10	9-10	8.5-9.5

a--Actual. f--Forecast.

Liquidity

We view YWS' liquidity as adequate, but note that its liquidity is particularly tight on a 12-month basis as it has not yet refinanced £450 million of the bond that matures between first and third quarter of 2023.

We expect liquidity sources over the next six months to exceed uses by more than 1.1x as of Sept. 30, 2022, assuming that the group would delay part of its capital investment program and dividend distribution in light of incoming maturities and parental extraordinary support. Our liquidity assessment also reflects the company's high standing in the capital markets, its good relationship with banks, and generally prudent risk management. We anticipate YWS will receive additional funding from entities outside of the ring-fence by June 2023, although, we note the timing and precise amount of this injection is unclear at this stage.

Principal liquidity sources:

- A cash balance of about £37 million;
- Access to £398 million of undrawn credit facilities maturing in October 2023; and
- Cash FFO of about £220 million.

Principal liquidity uses:

- No upcoming debt maturities over the next six months, but £450 million over the six months after that;
- Expected capital spending (net of customer contribution) of approximately £320 million; and
- Cash dividends used to service interest payments at the wider Kelda group level of approximately £45 million.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-3, G-2

Social factors are a moderately negative consideration in our credit rating analysis of YWS. As one of the U.K.'s water and wastewater network operators, YWS provides a key service with a significant social impact. This exposes the operator to additional scrutiny from regulators and the government to ensure high quality, reliability, and affordable costs for customers, as evidenced by the latest five-year price review that commenced from April 2020 and despite YWS' improving operating conditions following its appeal to the U.K. CMA. Environmental and governance factors are a neutral consideration for the ratings. In March 2022, Ofwat served notice on five U.K. water and wastewater companies including YWS to gather further information for enforcement purposes, following concerns about how they manage compliance with their environmental obligations, especially regarding wastewater treatment works.

Ratings Score Snapshot

Class A (senior secured) Debt

Issue Credit Rating	**A-/Negative**
Business risk:	Excellent
Country risk	Low Risk
Industry risk	Very Low Risk
Competitive position	Excellent
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral/Undiversified
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Positive
Stand-alone credit profile:	bbb+
Structural enhancements	+1 notch

Class B (subordinated) Debt

Issue Credit Rating	**BBB/Negative**
Business risk:	Excellent
Country risk	Low Risk
Industry risk	Very Low Risk
Competitive position	Excellent
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral/Undiversified
Capital structure	Neutral

Class B (subordinated) Debt

Issue Credit Rating	BBB/Negative
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Neutral
Stand-alone credit profile:	bbb

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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: 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

- Sutton and East Surrey Water PLC 'BBB' Rating Affirmed; Outlook Remains Negative, Nov. 10, 2022
- U.K. Water Operator South Staffordshire Group Outlook Revised To Negative On Inflationary Pressure, Nov. 3, 2022
- Outlook On U.K. Water Utility Dwr Cymru (Financing) UK PLC's Debt Revised To Negative On Inflationary Pressure, Nov. 1, 2022
- Outlook On U.K. Water Operator Affinity Water Finance PLC Debt Revised To Negative On Inflationary Pressure, Oct. 28, 2022

- Outlook On South East Water (Finance) Ltd.'s Debt Revised To Negative On Increasingly Inflationary Environment, Oct. 27, 2022
- U.K. Water Operator Anglian Water Services Ltd. Outlook Revised To Negative On Inflationary Pressure, Oct. 20, 2022
- United Utilities Water Rating Affirmed At 'BBB+', Parent United Utilities PLC Affirmed At 'BBB'; Outlook Stable, Oct. 13, 2022
- Northumbrian Water Ltd. And Northumbrian Water Group Ltd. Downgraded To 'BBB' From 'BBB+'; Outlook Stable, Oct. 12, 2022
- Severn Trent Water Ltd. 'BBB+' And Parent Company Severn Trent PLC 'BBB' Ratings Affirmed; Outlook Stable, Sept. 30, 2022
- Issue Ratings On Thames Water Utilities Finance PLC's Class A And B Debt Lowered On Strained Metrics; Outlook Stable, Sept. 16, 2022
- Why We See England And Wales' Water Regulatory Framework As Strong, July 1, 2022

Ratings List

Ratings Affirmed	
Yorkshire Water Services Finance Ltd.	
Senior Secured	A-
Senior Secured	AA
YW Services Ltd.	
Senior Secured	A-
Yorkshire Water Finance PLC	
Senior Secured	A-
Subordinated	BBB