FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - London - 03 Apr 2023: Fitch Ratings has affirmed Yorkshire Water Services Finance Limited (YWSF) and Yorkshire Water Finance Plc's (YWF) senior secured class A debt ratings at 'A-' and subordinated class B debt rating at 'BBB-' with Stable Outlooks. YWSF and YWF are financing companies of Yorkshire Water Services Limited - operating company (Yorkshire Water or YWS).

The rating affirmation and Stable Outlook consider the group's commitment to restore about GBP940 million of equity at YWS, largely by receiving repayments of legacy intercompany loans before the end of financial year ending in March 2027 (FYE27), resulting in an updated financial policy to target maximum regulatory gearing at YWS of 72% by FYE25.

The ratings also consider the operational and regulatory performance of YWS, and the secured nature of the group's financing structure. The latter benefits from structural enhancements, including trigger mechanisms (gearing and interest coverage covenants) and debt-service reserve liquidity.

KEY RATING DRIVERS

Gearing Headroom to Improve: Fitch expects adequate gearing headroom by FY25, mainly due to a gradual repayment of GBP940 million intercompany loans at YWS. This will largely support financial resilience through reduced debt funding requirements, while GBP100 million will be used to fund investment into the reduction of storm overflow spills. We forecast Yorkshire Water's adjusted class A net debt to regulated capital value (RCV) of about 70% against our negative rating sensitivity of 72%.

The Kelda corporate group publicly committed to the UK's water regulation authority (Ofwat) to repay its intercompany loans between Kelda Eurobond (borrower) and YWS (lender) following Ofwat's investigation on compliance of its intercompany loans with its license requirements. Kelda expects to repay its intercompany loans in three tranches across price control period ending March 2025 (AMP7) and ending March 2030 (AMP8): GBP300 million FY24, GBP200 million FY25 and the remaining GBP440 million in FY27.

Class B Deleveraging: We forecast YWS to maintain ample net debt to RCV headroom for the class B debt against our negative rating sensitivity of 82%, with strong cash and nominal PMICRs, on reduced class B debt, and comfortable headroom for class A debt. This may be positive for the class B debt rating if confirmed in the AMP8 business plan.

Weaker, but Comfortable PMICRs Expected: About 60% of YWS's total debt is inflation-linked (IL), partly through swaps in FY22. While IL debt provides a hedge to RCV that grows with inflation over time, we expect the higher accretion on the IL debt and swaps to contribute to weak nominal post-maintenance interest cover ratio (PMICR), reflecting overall cost of debt. However, we forecast average AMP7 class A nominal PMICR above our negative rating sensitivity of 1.7x.

We expect AMP7 average class A cash PMICR above our negative rating sensitivity of 1.4x, but regular accretion paydowns is expected to weaken interest coverage towards the end of AMP7.

Totex Under-Performance Expected: We expect YWS to underperform its total expenditure (totex) allowance by GBP340 million across AMP7, almost equally split between operating expenditure (opex) and capex underperformance. YWS is investing about GBP180 million (GBP80 million expected to be recovered through the cost-sharing mechanism) in combined storm overflows (CSOs) to improve environmental outcomes and reduce penalties. These investments, which are within our expectations, aim to meet a minimum 20% reduction in average number of discharges from CSOs by 2025 against 2021 base year.

Net ODI Penalties Assumed: We forecast GBP35 million-40 million of net cash outcome delivery incentives (ODI) penalties (nominal) related to operational performance in AMP7. In the first two years of AMP7, YWS incurred penalties mainly in internal sewer flooding, water supply interruptions and water quality, and lagged behind other regulated UK water companies in Ofwat's overall performance category. YWS only achieved 57% of its performance commitments in 2021/22.

Subordinated Debt Rating: As YWF's class B debt is subordinated to class A debt and sizeable super-senior IL swap liabilities, we do not expect the recovery of class B debt to be above average in an event of default scenario and hence do not apply the one-notch sector-specific recovery uplift in the class B debt rating.

Reduced but Sizeable MTM Liability: YWS's negative mark-to-market (MTM) liability on IL swaps was reduced to GBP1.8 billion at end-September 2022 (about 24% of RCV) from about GBP3 billion (about 41% of RCV) from end-March 2022, mainly reflecting higher RPI and interest-rate expectations. Despite the reduction, YWS's exposure remains one of the largest in the UK water sector.

In our rating case, we do not assume crystallisation of the MTM liability nor do we adjust our debt to include it. The MTM liability would only crystallise in the event of a non-payment under the swaps, which we view as unlikely.

Swap Breaks Managed: YWS proactively manages its IL swap breaks and accretion pay-downs. IL swap breaks due in 2023 have been extended by 5-17 years and regular accretion paydowns avoid a documentary super-senior trigger event covenant of 6% RCV. If total accretion to notional value exceeds 6% of RCV, the amount above 6% would equal the accretion paydown.

Borrowing Through Swaps: Fitch treats 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 about 2% of shadow RCV at FYE25.

Standalone Assessment under PSL: Fitch rates YWS on a standalone basis using the stronger subsidiary/weaker parent approach under its Parent and Subsidiary Linkage (PSL) Rating Criteria. This assessment reflects 'insulated' legal ring-fencing as underlined by a well-defined contractual framework, and tight financial controls imposed by Ofwat and designed to support YWS's financial profile. We view access and control as overall 'porous' as YWS operates with separate cash management and a mixture of external and intercompany funding.

DERIVATION SUMMARY

YWS's class A senior secured 'A-'/Stable rating reflects the highly geared nature of the company's secured covenanted structure, with gearing of about 70% at end of AMP7 compared with peer United Utilities Water Limited's (BBB+/Stable; senior unsecured debt: A-) lower gearing of about 63.2%, and its standard corporate structure. YWS's financing structure benefits from structural enhancements, including trigger mechanisms (such as class A dividend lock-up of 75%, senior gearing dividend lock-up of 85%, interest cover covenants) and debt-service reserve liquidity.

The non-participatory notes issued by YWSF are rated 'BBB+'/Stable, one notch lower than class A debt rating. The non-participatory note holders did not accept exchange for class A unwrapped bonds, and do not benefit from the YWS's share pledge. However, they benefit from other creditor protections and structural features of the overall covenant package from YWS and YWSF.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Ofwat's final determination financial model (after the Competition and Markets Authority outcome) is used as a main information source

- Allowed wholesale weighted average cost of capital (WACC) of 2.12% (RPI-based) and 3.12% (CPIH-based) in real terms

- Fifty per cent of RCV is RPI-linked and another 50% plus capital additions is CPIH-linked, since FY21

- RPI of 10.8% for FY23, 8% for FY24 and 3.9% for FY25

- CPIH of 8.5% in FY23, 6% in FY24 and 2.8% in FY25

- Fitch case assumes totex underperformance of about GBP340 million across AMP7

- Net nominal cash ODI penalties of around GBP35 million-40 million for AMP7

- Equity injections from Kelda to YWS of GBP500 million in 2023-2025

RATING SENSITIVITIES

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

- Class A: adjusted net debt to RCV below 67%, cash and nominal PMICRs above 1.6x and 1.8x, respectively

- Class B: Total senior adjusted net debt to RCV below 77%, total senior cash and nominal PMICRs above 1.3x and 1.6x, respectively, and substantial elimination of the negative MTM swap liability

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

- Class A: adjusted net debt to RCV above 72%, cash and nominal PMICRs below 1.4x and 1.7x, respectively

- Class B: Total senior adjusted net debt to RCV above 82%, total senior cash and nominal PMICRs below 1.2x and 1.5x, respectively

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

Adequate Liquidity: As at FYE22, YWS held about GBP28.5 million of unrestricted cash and cash equivalents and undrawn committed revolving credit facility (RCF) of GBP560 million. The RCF has been replaced with GBP480 million RCF with an ability to upsize by up to GBP180 million (currently fully undrawn) in November 2022, with maturity in November 2027, with two one-year extension up to November 2029.

In addition, YWS benefits from a designated debt service reserve liquidity facility of GBP170 million (committed undrawn) increased to GBP182 million in March 2023, sized to cover 12-months of interest payments (including hedge payments), together with a committed undrawn operating and maintenance reserve facility of GBP90 million, increased to GBP120 million in March 2023 - both only available upon trigger event. Next significant debt maturity of GBP149 million is due in FY24.

ISSUER PROFILE

YWS is the fifth-largest Ofwat-regulated, regional monopoly providers of water and wastewater services in England and Wales, based on its RCV of about GBP7.7 billion as of FYE22. YWS provides water and wastewater services to over 5 million domestic customers and over 141,000 business properties across Yorkshire, part of North Lincolnshire, and part of Derbyshire.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Statutory cash interest reconciled with investor reports

- Statutory total debt reconciled with investor reports

- Capex and EBITDA net of grants and contributions

- Cash PMICRs adjusted to include 50% of the accretion charge on IL swaps with five-year pay-downs, and 100% of the accretion charge on IL swaps with less than five-year pay-downs

- Debt adjusted for borrowing through swaps

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
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				
senior secured	LT	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
senior secured	LT	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

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

Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 28 Oct 2022)

Corporate Rating Criteria (pub. 28 Oct 2022) (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), v8.1.0 (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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