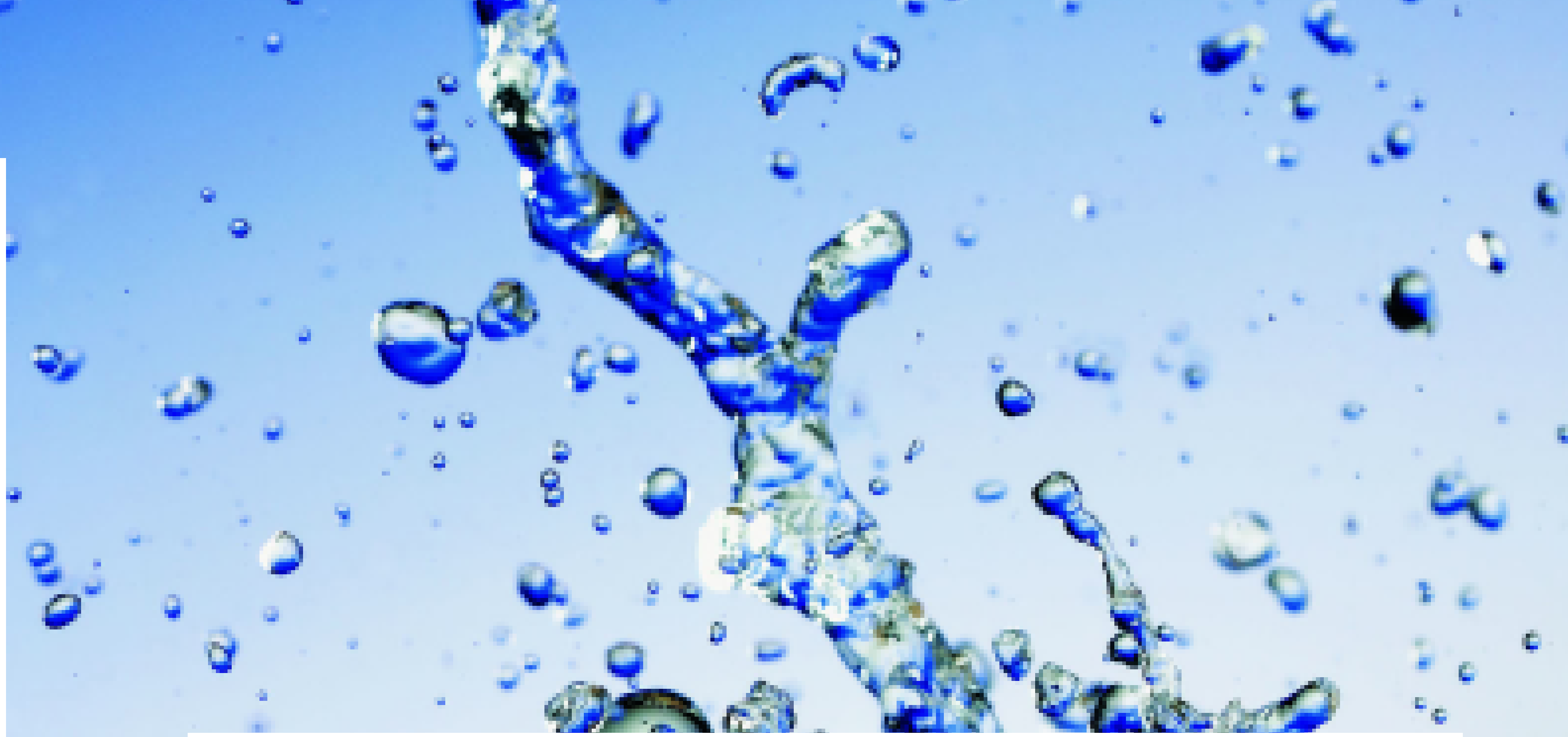
MAKING WAVES

WITH A PRICING REVIEW BY WATER REGULATOR OFWAT LOOMING, HOW UK WATER COMPANIES FUND THEMSELVES IN THE FUTURE COULD ALL BE SET TO CHANGE – MORE STRUCTURED FINANCE IS DEFINITELY ON THE HORIZON, BUT THIS MAY BE TEMPERED WITH MORE EQUITY ISSUANCE, SAYS **DENISE BEDELL**.



Leveraged financing techniques have been the mainstay of funding for UK water companies for some time now and a number of the structures pioneered in the water industry are now being looked at by other types of regulated entities, which may prove beneficial across a wider range of asset classes.

In the meantime, water companies are facing a pricing review by the water regulator, Ofwat, which could affect how such entities fund themselves going forward – be it through equity or leveraged debt – and will affect how much funding they look to get from the market.

Many companies have started their preparations already: some by getting structured debt financings done before the market slows down in the run-up to the review; others by reducing their gearing levels, using equity instead of debt, in preparation for possible growth in capex needs post-review. Either way, the sector is going through a period of uncertainty and may indeed look very different in 12 months than it did a year ago.

REGULATORY REVIEW. With the review looming, the funding needs of UK water groups for the coming years is up in the air. Many are currently waiting to see how the review plays out before going to market for new financing, and issuance is likely to be slow for the next few months. The review will affect not only the prices regulated companies can charge, but also the capex needs of such firms going forward – and how those needs can and will be met in the market.

The review, carried out by the economic regulator, Philip Fletcher, who is the Director General of Water Services, will lay out water company price limits for 2005 to 2010. It will be released in November this year, with guidance on likely outcomes expected in July. Based on the draft business plans of the companies themselves, and developments in terms of infrastructure investment requirements and water quality improvement regulation, the review will look at expected capital expenditures for that period, what pricing can be charged on to customers and therefore what portion of that capex requirement will be funded through equity and debt investment.

The prime goal of the regulator is to ensure water companies can finance themselves while still keeping price increases within reasonable levels. Andrew Moulder, a senior credit analyst at Barclays Capital, explains: "All the signs coming from the water regulator are positive that there will be a reasonable floor in terms of the cost of capital. He does not want to present the market with any surprises, and he wants to make it reasonable for both equity and debt financing to be available."

Says one market participant: "The key question is, how are you going to fare in the review period? The last review was negative, from a stock market point of view. Price rises were modest, so a lot of the capex investment came at the company's own expense. The new regulator has been careful to get his message out that where he is coming from is very different."

In December, Ofwat sent out a release noting the potential for significant price increases, primarily relating to environmental and other quality improvements.

The market player adds: "It is a very different political situation now versus the last review period. After the situation with Railtrack and in the hospitals and so on, the government wants significant investment to happen in infrastructure, especially with an election in 2005. They are now deliberating on how they can mitigate those price rises and still meet the requirements for water quality and other improvements."

This means making debt and/or equity investment accessible at reasonable prices. Fletcher has not expressed a preference for what type of financing he prefers, but with large capex needs in light of environmental reviews it is likely that most will come in the form of debt, which has a much lower cost of capital.

Fletcher has to strike a reasonable balance, according to Moulder at Barclays. He says: "If he wants to encourage equity investors, he has to leave room for reasonable returns in the form of dividends." Under the last review, given low returns set by the regulator, debt was much more attractive than relatively expensive equity capital.

Moulder says: "Is there room for more debt? That depends on how it is structured. With highly structured deals, there is certainly more appetite from investors." These deals are successful because they include strong covenants, often ring-fenced assets or cash lock-ups – where no cash can be removed from the company if there is any problem with meeting debt maintenance needs – clear documentation, clear rules and safety for investors.

The first company to explore highly leveraged structured financing was Sutton and East Surrey Water (SESW) when, in March 2001, it ring-fenced and securitised assets, and returned £100m of equity capital to shareholders after replacing it with debt.

The SESW deal was followed a year later by the stunning Glas Cymru securitisation, which raised £2bn, and a year after that by Anglian Water, which brought in £1.7bn (see *The Treasurer*, December 2002 and October 2003 respectively). A number of smaller companies then followed suit using the Artesian conduit, set up by The Royal Bank of Scotland (RBS), for just that purpose (*The Treasurer*, January 2003).

Last year another big deal came to market, Southern Water. The £1.87bn whole-business securitisation of Southern Water Services, lead managed by RBS, provided an exit route for former parent ScottishPower, and in the process provided the group with relatively cheap funding that will meet its needs for some time to come and set up a stable platform from which further financing can go forward. As with other deals, it included strong monoline participation.

OUTSIDE WATER. This type of structure is now moving beyond just water companies. "It is a structure that could potentially be adopted in any regulated business," says one market commentator. "It requires strong visibility on cashflows and earnings going forward, therefore giving good indications of the group's ability to service debt levels at low interest cover in the future."

Rating agency Standard & Poor's (S&P) agrees. According to a recent report by S&P, relatively few companies have as yet chosen highly leveraged hybrid structures, but there is more in the pipeline. The report notes: "Standard & Poor's expects similar structures will be assumed by other regulated water companies and possibly in other sectors in the near future."

One area of interest is gas distribution. With a number of assets on the vending block from UK utility Transco, there has been much talk by financial bidders of looking at securitisation structures similar to those used in water. The Artesian conduit has already hosted a deal in the schools sector, and RBS is looking at other asset classes.

GEARING AND EQUITY. Anglian, Glas Cymru and Southern Water tend to run at a pretty high gearing ratio – at 75%-80% or higher. However the regulator assumes a pro forma net debt-to-regulatory asset value (RAV) of about 55% in evaluating water companies. Groups can attract investment at these higher gearing levels simply because of the structured nature of much of their debt. Investors are comfortable with the high ratios because their investments are protected by covenants, by monoline backing or by ring-fenced assets. Most other companies tend to run at much lower gearing level – around the 55% level assumed by Ofwat.

Moulder at Barclays believes there is an investor base for both highly geared and less leveraged companies. He says: "A lot comes down to the individual investor. You have to decide whether you would rather be in a company with gearing at 80%, but with a lot of covenants, or uncovenanted at 45%-50%, but with the possibility of debt creeping up."

IN FAVOUR OF EQUITY. With debt issuance flourishing and gearing levels rising, some companies have chosen to look to equity financing instead. Northumbrian Water (*The Treasurer*, January/February 2004) and United Utilities (UU) are two examples. Although there is little to compare between the two deals – Northumbrian was a buyout and initial public offering (IPO) orchestrated by boutique Ecofin and brokers Collins Stewart, while UU was a rights issue – they do have some things in common. In both instances, structured debt deals were considered – and rejected – in favour of equity. In addition, both were innovative deals using new structures to make equity financing attractive both for the companies themselves and to investors.

The £439mn accelerated IPO for Northumbrian Water saw Ecofin buy out the group from former parent Suez and immediately list the company on AIM with a ready-made IPO set up by lead arranger Collins Stewart. Investors were lined up in advance of the IPO and allowed for the immediate IPO once the buyout closed. It was attractive for investors as a defensive play and because of the high dividend yield it offered.

In contrast, the deal for UU was a £1.02bn rights issue, with shares offered at 330p on a five-for-nine basis. With the review looming, it was clear to UU that its capex requirements from 2005-2010 would be high, says Martin Pengelley, a Director in the UK Corporate Broking team at Deutsche Bank. He explains: "To fund those needs cost effectively in the debt markets the group realised it would need to take on further equity as it aims to keep gearing at levels towards the upper end of the 45-55% range of debt to total capital, referred to by Ofwat in their March 2003 methodology paper."

Given the extra capex requirements that it foresaw, if UU did not raise fresh equity capital then gearing would rise beyond that range over the 2005-2010 review period. But with this equity injection, it not only has a great deal of liquidity on hand, but also the ability to bring on more debt post-review and gear up once again to the 55% target.

Pengelley says: "Although the cost of equity seems high, compared with debt, with such large capex requirements to come, it made sense to raise equity and keep the cost of debt at investment-grade levels. This then brings down the overall cost of capital through the group. A further benefit from this equity-based model is that the company's capital base will be in a stronger position in 2010 at the end of the review period, so that it can more easily respond if there are further significant capex requirements in the following review period 2010-2015."

This is not the case for all of the UK water market, as many companies can run quite easily at high levels of gearing, but for those with high capex needs forecast for a long period, a lower net-debt-to-RAV may be more desirable long term. Those with large infrastructure investments to come or with big environmental clean-up commitments may be prime candidates.

UU STRATEGY. The UU deal was unique, in that it was the first rights issue for a UK water company, and it was structured in two tranches to coincide with the funding needs of UU as they develop. The first £500m tranche closed last summer and the second will not be launched until 2005, after the review is finished and the company knows its expected capex requirements for the following five years.

It is possible that some companies that find themselves with high capex needs could follow the UU strategy of issuing equity to bring down gearing before tapping the market again for debt. However, it is unlikely that much will happen before July, when the regulator gives guidance on how the review will play out. But the coming year could indeed see much more equity issuance in the regulated water market.

As one analyst says: "Whether equity financing is attractive going forward will depend on what happens in the review. The equity market is definitely open to the possibility, and I believe we will see some deals going ahead in the next year. But debt investors are also comfortable with the structured deals, even at high levels of gearing. As more companies use structured debt the market becomes more comfortable with it, and we will certainly see more of that type of issuance."

Denise Bedell is a journalist and regular contributor to *The Treasurer*.