GOING WITH THE FLOW

BEFORE ARTESIAN FINANCE, SMALLER WATER COMPANY BORROWERS BARELY GOT A LOOK-IN AT THE BENEFITS OF AAA GUARANTEED INDEX-LINKED FINANCING. **JOANNA PARKER** INVESTIGATES.

Drawing on the whole business securitisation techniques that have been developed over the past two years in the water industry, Artesian Finance has brought the benefits of index-linked financing to smaller water company borrowers that might not otherwise have been possible. By setting up a special purpose vehicle to issue a series of index-linked bonds under the auspices of the sponsor and monoline insurer, regulated water companies are able to leverage up and tap the capital markets for long-term sterling with palatable upfront costs.

Artesian Finance is the brainchild of The Royal Bank of Scotland (RBS) and the inaugural issue was made for Portsmouth Water. Portsmouth Water was part of a listed group juggling the aspirations of two classes of shareholder – those with and without voting rights. RBS had a pivotal role in the public-to-private transaction that resolved these historical ownership issues and made more efficient financial restructuring inevitable.

Neville Smith, Finance Director of Portsmouth Water, says: "Seeing the developments that were being made in the restructuring and financing in the water industry we decided it was in the best interests of shareholders and the company to increase gearing, thereby lowering our cost of capital, while at the same time taking the company private."

Portsmouth approached RBS after monitoring the success of the two securitisation issues they had championed: Sutton and East Surrey Water (SESW), with £100m index-linked securitised bonds issued in March 2001, and Dwr Cymru (or Welsh Water), with £1.9bn of structured bonds, the cornerstone of the whole business securitisation. Both were credit-wrapped, SESW *in toto* and Glas to the tune of £1bn. The May 2001 pioneering transaction for Welsh Water was a winner of *The Treasurer*'s 2001 Deals of the Year and a detailed write-up can be found in the December 2001 issue of the magazine that reported: "The creation of Glas Cymru has been declared one of the most innovative and radical corporate restructurings of recent times… and designed around the acceptance of regulatory regime, rather than against it."

Chris Jones, Finance Director of Welsh Water, says: "The index-linked financing was a very important part of the restructuring Welsh Water undertook in May 2001 and is naturally attractive to companies with RPI-linked revenues. The Artesian conduit provides a very neat and ingenious way of pooling demand from borrowers while at the same time providing sufficient size to investors."

TABLE 1
THE THREE TAPPERS.

Date (2002)	Borrower	Index-Linked Bonds	Margin over the Gilt*
26 June	Portsmouth Water	66.5	63
22 August	Dee Valley Water	35.2	75
4 December	Mid Kent Water	135.8	70
		237.5	68.8

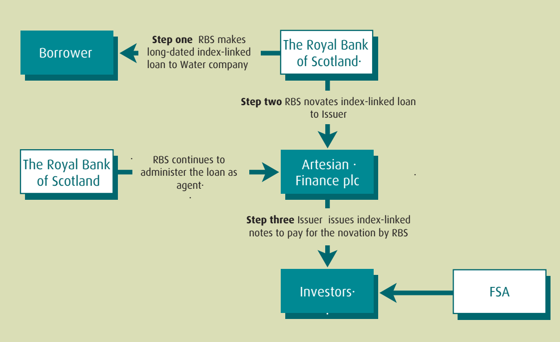
**Reference Gilt = 4 1/8% to 22 July 2032*

BURSTS OF ACTIVITY. After testing the water with investors, RBS set up a £500m securitisation programme in June 2002 that established a fully documented, wrapped and rated template for regulated water companies to tap the index-linked long-dated sterling capital markets through Artesian Finance. Richard Bartlett, Head of Corporate Securitisation at RBS, says: "Artesian Finance issues bonds and onlends the proceeds to the water companies. This is equally viable for an entity needing a relatively small sum, as low as £10m to £20m or one that has sufficient clout of its own but wants to avail itself of the ready made and proven structure with its increasing liquidity."

Three borrowers have raised funds through this conduit in the short period since the programme was launched in June 2002:

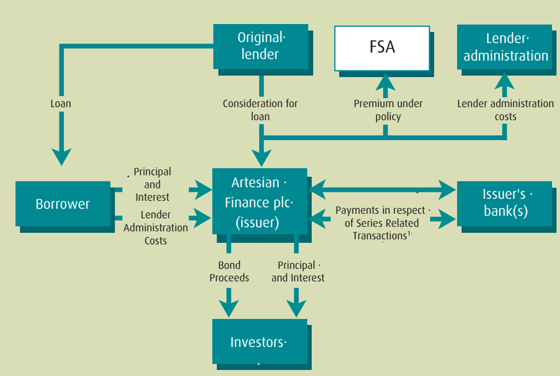
- the inaugural issue backed by a £66.5m loan to Portsmouth Water in June refinanced the public to private transaction led by RBS seven months previously;
- the £35.18m transaction for Dee Valley Water in August 2002 was used to redeem £32m of public shares, leaving it as a largely debt financed entity with a c.85% debt to regulated asset value (RAV); and
- the ink has barely dried on the December issue backed by the

FIGURE 1
LOAN NOVATION.



Source: RBS

FIGURE 2
CASH FLOWS.



[1] The Issuer may, with the consent of the controlling creditor, enter into a Series Related Transaction to hedge any exposure arising from differentials in timing of cash flows between payments from the Borrower received over the term of each Loan and the Issuer's obligations under each Series.

Source: RBS

£135m loan to Mid Kent Water to refinance the short-term acquisition facility drawn in May 2001.

The bonds financing these loans are fungible between each issue and the market liquidity enhances with each wave. The £237.5m bonds currently outstanding are traded with RBS acting as primary market maker.

None of these borrowers could have raised relatively small amounts of long-term debt on an index-linked basis at economical cost through any other means or existing vehicle. High up-front costs for the preparation of circulars, accounting, legal costs and the like, as well as investor concerns over trading liquidity, would usually deter the issue of standalone bonds at sizes of under £100m. However, letting Artesian front the bonds saves considerable management time and the need for senior executives to partake in road shows. Smith says: "Artesian Finance gave us access to capital markets that would not normally be available to companies of our size."

Pricing was also keen. With a liquid programme, well understood securitisation techniques and a triple-A rating from Financial Security Assurance (FSA), pricing for each of the issues has ranged from 63bp to 75bp over the underlying reference gilt (4 1/8% to 22 July 2030). The first issue for Portsmouth at 63bp over the gilt compares favourably to the 85bp Anglian Water achieved a month later through larger triple-A wrapped tranches. A further series backed by a loan to Mid Kent has just issued at 70bp over the gilt. The water companies in all such wrapped deals obviously have to bear other costs, such as the undisclosed fees for the credit wrap that arbitrages the cost of funding between the triple-A and the unwrapped underlying credit.

Bartlett says: "The cost of capital is more than usually important to water companies, as the regulator establishes a weighted average cost of capital based on the debt/equity split of a hypothetical company, applicable to the industry on a five-year basis. Companies taking on a greater level of debt than this average will produce greater returns for their stakeholders, on the basis that debt is cheaper than equity. In response to various securitisations that have taken place in the industry, Ofwat has recently reiterated it will not move radically from the hypothetical 55% debt level currently assumed. The level of leverage of debt to RAV that may be achieved through Artesian will automatically boost stakeholder returns even before counting the benefits of the fine margins that the bonds have attracted to date."

CREDIT-WRAPPED TO TRIPLE-A STATUS. RBS approached the monoline financial guarantee insurance companies in the UK to credit-wrap the financial obligations of Artesian. Each is closely monitored by the rating agencies and enjoys long-term triple-A ratings. FSA, with 23% of the UK monoline market and a global insured portfolio of $232bn, won the day on price and terms after competitive bids were tendered. It had also worked closely with RBS on the Sutton and East Surrey deal and has pioneered the asset-backed securities market with $261bn of gross principal insured in ABS/MBS transactions since its inception.

FSA's role is to unconditionally and irrevocably guarantee scheduled repayments of principal and interest under the bonds and it waives all defences, even those such as fraud, and non-payment of premia. The involvement of the insurer is key to investors, as with a large sum of capital at risk, its interests are aligned with bondholders and the process of intensive due diligence and ongoing active surveillance provides additional comfort.

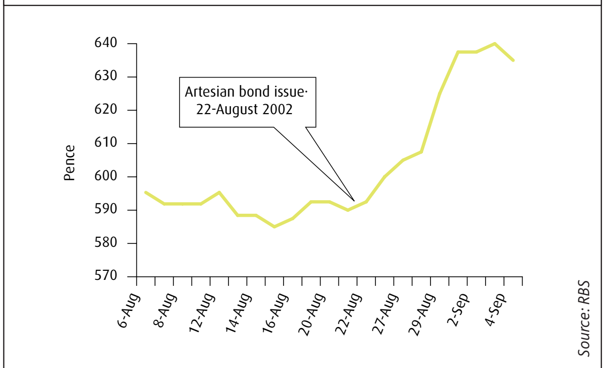
Doug Segars, Director at FSA, says: "A key feature of the bonds is that FSA waived its customary right to prepay the bonds at par in the event of a default in the underlying credit. This is attractive to investors as prepayment at par exposes them to market risk, although credit risk is taken by the monoline."

FSA retains the right to prepay the bonds at spens or buy bonds in the market following a borrower default, which effectively extends the guarantee to cover any premium. 'Spens' refers to Lord Spens who introduced a market formula for compensating investors for broken funding.

The rating agencies have assigned a long-term definitive rating of triple-A to the bonds, which is based solely upon the unconditional and irrevocable guarantee of principal and interest by FSA under the financial guaranty insurance policy. This, however, does not deter them from making useful observations on the underlying credit. Moody's Global Credit Research September 2002 report states: "The regulatory framework of the UK water sector is regarded by Moody's as well-established and, in general, supportive of credit quality."

The licences of certain borrowers contain certain ring-fencing provisions and, in the case of Dee Valley Water Plc, these are further reinforced by additional measures typical of the water whole business securitisations in order to create bankruptcy remoteness

FIGURE 3
DEE VALLEY SHARE PRICE.



from the parent, particularly in the event of a future expansion into non-regulated businesses.

"This structure will enable small water and sewerage companies to broaden their funding options and access a market they would normally be precluded from because of their size," says Anthony Flintoff, the credit analyst at Standard and Poor's, who also rated the issue.

PRIMING THE PUMP. RBS primes the pump for admitting a new borrower to the programme with the necessary due diligence and monoline and rating approvals before committing a long-dated index-linked loan to a water company (see *Figure 1*). Eligibility criteria for inclusion in the programme include an initial maximum ratio of net debt to RAV and covenants restricting the borrower from diversifying from its core business; the adherence to certain financial covenants relating to interest cover, tests for the incurrence of additional financial indebtedness and information provision covenants. RBS and FSA undertake their own due diligence in the normal course of providing the initial loan and in insuring the bond issue – the underlying water company is saved the expense of preparing its own offering circular and verifying company specific disclosure with associated accounting and legal costs. RBS then novates the loan to Artesian, which issues index-linked notes under the £500m programme to pay for this novation.

Figure 2 shows the structure with all the cashflows relating to the programme in place. The key for Artesian is in matching the cashflows to ensure the cash coming in from the water companies is the same as the cash going out to the bondholders, save for a 1bp turn required in the issuer. Seemingly simple on the surface, tying up the payments requires more than a moment's thought. For each bond, the issue price needs to adjust for the fixed coupon of 3.625%. The interest rate achieved on the loan will vary with the price of the benchmark 4$^{1}/_{8}$% 2032 Gilt and the margin on the Artesian bonds at the time of pricing in the market. The underlying loans from the water companies need to be priced to cover the upfront costs of the credit wrap and the like and in order to give the borrower the required proceeds, the nominal value of the bonds may differ from that of the loan. Ongoing cashflows need to match too and these can be reconciled through a swap with Artesian.

APPETITE FOR INDEX-LINKED. With water and other regulated utilities, permitted price increases are linked to inflation and the alignment of the cost base to inflation helps insulate profits. Financing on an index-linked basis is therefore highly desirable but hard to come by.

Bartlett says: "The only factor preventing Welsh Water from issuing more than £450m index-linked bonds in May 2001 was the appetite in the market at that point in time."

Banks cannot usually take the risk of providing index-linked finance from their own balance sheets, nor is it economic to provide for an inflating principal through the swap markets. The only appetite comes through the capital markets, from pension funds and the like looking for long-dated sterling index-linked assets. Demand is increasing from these pools of investors as a result of regulatory pressure to switch into bonds and economic pressure to invest in quality credit. With abnormal demand over the past few years the spread on index-linked corporate debt fell dramatically, as supply does not meet demand. In turn, this squeeze on index-linked bonds attracted attention from borrowers who perhaps had previously dismissed the product.

This dynamic can be seen through the figures. The index-linked market became more active in 1999, when £797m worth of bonds were issued, as many as had been issued over the previous 15 years. Since then, about £2bn has been issued each year and Bartlett believes: "The main challenge in the market is finding enough issues to meet demand."

Index-linked finance works by establishing a fixed coupon, for example, 3.625% for Portsmouth's issue, and applying it to the underlying principal amount after it has been inflated by the annual increase in RPI. Breakeven analysis is heavily dependent on inflation and the cash outflows are skewed towards the latter half of the bond's life.

Smith says: "The present value of the savings after playing with various sensitivities and taking all issuance costs into consideration were real and worth it."

SIMMERING DEMAND. There are more issues in the pipeline and the next are close to fruition. Tempting as it may be, RBS cannot and will not disclose the identity of potential further borrowers, as this is confidential and highly price sensitive. Historic performance is no indication of future performance or across the differing circumstances of each player, but the impact of the £35m financing for Dee Valley was rewarded by the market with a 37% boost to the share price within weeks of the announcement (see *Figure 3*).

Future issues could bring the club bond to the benchmark issue size of £500m and simmering demand may well require the £500m current programme size to be increased. Beyond doubt, RBS will be generating further business, but good luck to it for taking the initiative to sponsor the programme and open up the market for smaller players.

TALKING AND TINKERING. The issue endorses the importance for treasurers and finance directors of all companies to keep abreast of pioneering transactions and structures in the market that may, at first glance, seem beyond their balance sheets or of little relevance but could be tailored to their needs, no matter the magnitude. Keeping abreast of dynamic markets to ensure products previously discounted remain unattractive is also a full-time job. But talking with key players and tinkering with ideas will always add value. That, after all, is what structured finance is about.

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