

Market Reform Finance Forum

14 September 2010

Defra, Ergon House, Westminster

Meeting Note

Attendees:

Jean Spencer, Anglian Water

Julian Davies, Linklaters

Neil Webb, Dŵr Cymru/Welsh Water (on behalf of Chris Jones)

Carl Pheasey, HMT

Frank Grimshaw, Severn Trent Water (on behalf of Tony Ballance)

Tim Martin, Shareholder Executive

Mark Holloway, Thames Water

Sonia Phippard, Defra (chair)

Andy Pymer, Wessex Water

Gabrielle Edwards, Defra

Graeme Sims, United Utilities

Cathryn Ross, Ofwat

Barrie Clarke, Water UK

Keith Mason, Ofwat

Andrew Beaver, Ofwat (notes)

Seymour McConnell, Ofwat

Apologies:

Jo Stimpson, South East Water

Claire Bennett, Welsh Assembly Government

Lewis Neal, HMT

1. Update from the Chair

The Chair apologised for the cancellation of the last meeting following the general election and summarised the UK Government's progress:

- Maintaining the confidence of water investors remains of critical importance to the UK Government.
- The UK Government has published a proposed timetable for introducing reforms to the sectors as part of the [Defra Structural Reform plan](#).
- This plan outlines proposals for two white papers, one on Natural Environment policy in April 2011 and then a second on Water policy in June 2011.

- These White papers will also consider the recommendations of both the Cave and Walker reviews. Whilst ministers have yet to take formal decisions they have expressed an appetite for extending competition and a desire to address the long-term challenges in particular in relation to water supply.
- These White papers will be followed, as necessary, with legislation at the next available opportunity to implement the White paper proposals. This legislation could take place in the second parliamentary session.
- There has already been significant consultation on the Cave review but further consultation is planned in relation to the Walker review recommendations.
- The Chair also re-affirmed the UK Government's commitment to a step-by-step approach to reform.

2. Retail separation and the RCV

Ofwat gave a presentation examining the scale of the potential allocation of Regulatory Capital Value (RCV) into 'retail'. Once the scale of RCV allocation is estimated the presentation then considered whether such an allocation was likely to lead to a technical breach of covenants which govern maximum levels of gearing. The presentation made the following key points:

- Legal separation of retail would involve the transfer of some capital assets but there are alternative approaches to separating the RCV which might include 1) no RCV transfer by leaving all of the existing RCV with the wholesale business regardless of the transfer of assets, 2) transferring RCV in the same proportion as the Net Book Value of assets allocated to retail and 3) transfer of assets out of RCV at their Net Book Value. The presentation considered the second option but other approaches could be taken.
- Defining retail according to the separated accounts provided by companies in their 2010 June Return information suggests that for those companies with highly covenanted financial structures the total amount of RCV (as a proportion of the total NBV of assets) would be between 0.2-1.9% of RCV (0.6% average) and smaller if metering assets are excluded (0-0.6% or 0.2% average). Figures for the industry as a whole are 0.2-3.2% of RCV (0.4% average) and 0-2.9% of RCV if metering assets are excluded (0.2% average).

- Assuming that the appointee splits into retail and wholesale companies that are associate companies within the group there is unlikely to be a deterioration in creditworthiness at the parent company level as there is no change in gearing, no change in asset value and no change in risk. This does however assume that the credit rating agencies view little change in risk in the sector following separation.
- Ofwat considered the impact on gearing levels reported in 2007, '08 and '09 if RCV was reduced by 2% and the wholesaler received no compensation (i.e. net debt of wholesaler is the same as it was for the Appointee).
- For 'equity' companies which are covenant light, all companies exhibited headroom for a Baa1 credit rating.
- For 'structured finance' companies, i.e. those with many covenant protections in place, solely for gearing covenants, two options were considered but in the event of separation the structure adopted is a matter for negotiation with creditors.
- If retail separation involved the creation of a retailer within the securitised ring-fence and covenanted gearing was defined at the holdco level then there would be no breach of gearing if covenanted thresholds remained the same.
- If retail moved outside the securitised ring-fence the wholesaler may need to restrict dividends (compared to Appointee) to avoid lock up. If there was no loss of customers then wholesale plus retail dividends should compensate parent investors. The analysis found one occasion between 2007-09 where one company would have had insufficient headroom as a result of sharply declining RPI- the presentation therefore concluded that unless there was an RPI drop at the point of separation lock-up is unlikely.
- It is possible that retail separation could increase wholesale creditworthiness by transferring bad debt to the retailer. Although it was noted the wholesaler would retain some bad debt risk; for example a retailer could fail while still owing money to the wholesaler.
- The presentation noted in particular that a) it had focussed on the covenanted levels of gearing and further work was needed on the other covenants that were relevant to these issues, and b) the views of the credit rating agencies must also be considered in particular their assessment of the level of risk in the sector following separation.

In discussion the following key points were made:

- It was emphasised that there are numerous other covenants that are relevant to the separation issue which the presentation does not consider. It was considered that in addition to gearing levels, the analysis should review adjusted interest cover as a key financial ratio.
- Whilst for those companies with highly covenanted financial structures the total amount of RCV (as a proportion of the total NBV of assets) would be between 0.2-1.9% of RCV (0.6% average) (option 2 above), we must assess the size of retail if assets were transferred out of the RCV at their NBV (option 3 above) and there are also further options;
- The presentation did not consider the separated retail business, including the business risk of retail (especially if domestic retail is separated, with its unique bad debt risk as a consequence of non-disconnection), the terms of the separation itself and how the business would operate in particular in relation to issues such as bad debt or how the retail business would be financed. These issues need to be considered going forward. The ability to recover value by selling the retail entity will also depend on these factors.

3. Review of covenants and issues

Ofwat, the Shareholder Executive and Julian Davies from Linklaters gave a joint presentation on key covenants and issues arising from legal separation. The presentation made the following key points:

- In total 11 companies have adopted a highly covenanted financial structure.
- A previous presentation given by Julian Davies of Linklaters (see [minutes from November 2009](#)) was also presented to the forum on these covenants and the associated issues.
- There are different stages and forms of covenant breach, in particular there is a difference between a financial and operational 'trigger' covenant and covenants leading to an event of default.
- Ofwat have reviewed the 'Common Terms Agreements' (CTA's) or the 'Security Trust and Intercreditor Deeds' (STID's) of the directly affected companies to understand the key covenants that might be breached under functional and legal separation of retail options.
- Ofwat have assumed that retail separation would involve transfer of RCV in the same proportion as the total NBV of assets (not a statement of policy) this suggests that the RCV of retail would be very small (0.4% of NBV on average including meters and between 0.2-1.9% of RCV for individual companies with highly covenanted financial structures).

- The extent to which covenants could be breached depends on a) the covenants themselves, b) what Government does and c) what the companies' response to this is.
- Whilst the overall covenant packages are similar there are differences between all relevant companies.
- Both the Ofwat and Linklaters work suggested that any form of functional separation will not breach covenants.
- For legal separation the picture is different across companies but there are two broad groups of covenants:
- Covenants where whether or not there is a breach will be determined by security trustee and whether its approval or the consent of the secured creditors is required
- Covenants where the outcome can be explicitly assessed against the covenant e.g. for some companies disposals of up to 2.5% of RCV are permitted in a 12 month period if they *are in accordance with the instrument of appointment*.
- It is also very important to consider the market perception of regulatory risk and the wider impact of reform on financeability.
- Consents can also be categorised as technical or substantive. A technical consent does not change the economic position of lenders or their perception of the credit position. A substantive amendment is more significant e.g. a loss of security which fundamentally changes the credit proposition. It was considered that the separation proposed by the Cave review would most likely be primarily 'technical' in nature.
- It may be possible to structure a transaction to avoid all need for creditor consent – but this would still have to pass the Rating Agency test to avoid a downgrade and not “spook the market”.

In discussion the following key points were made:

- It was noted that whilst the presentation covered some of the key covenants there were others not addressed and it would be for each company to consider their own covenant issues on an individual basis.
- The group considered that it would be important for Government to set out the full extent of any proposed reforms in the future, not just any initial changes. This will help to create regulatory certainty and support investor confidence.

- It was noted that existing subsidiaries could not be used to avoid breaching covenants in relation to the creation of a subsidiary. The general securitised structure is a) Holdco (which gives share charge) b) Appointee c) Financing subsidiary (solely a vehicle for raising finance for Appointee). Within the ring fence there generally won't be any other subsidiary.
- The group rejected the use of a statutory transfer scheme.
- It was considered that there were two key constituencies for any change in relation to covenants, a) the rating agencies in relation to changes to business risk and b) the security trustee/the secured creditors, who would likely rely on legal advice to determine if there will be a breach and if so the extent of that breach. Neither could speak on behalf of the other.
- A preference was expressed for the creation of an associate company within the securitised ring-fence as a better approach rather than outside it but this will be an issue for individual companies to consider.
- It was noted that some of the companies in particular those using the Artesian Special Purpose Vehicle would have monoline wrapping and in these instances consent could be sought from the monoline.
- One suggested approach to seeking consent was to develop a STID proposal and test this with rating agencies and the secured trustee and/or the monoline if there is one in place. This approach requires further work.

Summary actions:

1. The secretariat to develop a further presentation for the next meeting in December to:
 - outline all risks associated with separation;
 - consider other alternatives to RCV separation that differ from the approach presented in item 2; and
 - consider the financing and operation of the separated retail business..
2. The secretariat to further develop the STID proposal idea and define this process more clearly for further discussion.