Paper modelling

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Powergen's £300 million receivables securitisation, which was launched at the beginning of December, should herald a busy year for the UK's utilities in the asset-backed market. Many market experts have forecast that most new issuance across Europe during 2001 will be from corporates and utilities rather than banks. Securitisation opens up a new, cheap source of funds for these companies, most of which have huge capital expenditure requirements going forward.

If only it were that simple. Firstly, Powergen is far from the first UK electricity company to launch a securitisation programme ? Seeboard beat them to that honour a full four years ago. Since then at least four other electricity companies in the UK have followed suit but the predicted rush of issuance from the sector has failed to materialise. Secondly, there are several features of the utilities sector ? not least the fact of widespread government regulation ? that can be an anathema to such transactions. But there are signs that the advent of high-profile programmes such as that of Powergen, together with a general decline in corporate ratings, could spur the sector on to examine securitisation as a financing option. This development has been underscored by Railtrack's announcement on December 16 that it plans to launch a £4 billion asset-backed programme this year.

The £300 million Powergen deal is just part of the company's financing programme to tackle its growing debt position following the acquisition of US-based LG&E Energy. Powergen purchased the company in 2000 for $3.2 billion, leaving it with debt of around £5 billion on its balance sheet. The company now plans to reduce that figure by £1 billion through refinancing of the original acquisition financing and a series of disposals. The LG&E acquisition, which was only passed by the regulators in December, was financed through a $4 billion credit facility underwriten by Deutsche Bank, Dresdner Bank, HSBC, JP Morgan and Warburg Dillion Read. The facility comprised a $1.5 billion one-year revolving credit, a $1 billion five-year revolving credit and a $1.5 billion five-year term loan. It was syndicated in March last year. Powergen opted to finance the acquisition through a loan rather than an equity swap because of the sluggish state of utility stocks in both the US and UK.

Having wrapped up the LG&E deal, Powergen is now concentrating on reducing its debt burden. It wiped £890 million off its balance sheet through the sale of assets in Thailand, Indonesia, Australia and India to Hong Kong-based CLP Power and completed the sale of its 49.9% stake in Portugese utility Turbogas Produtora Energetica for $161 million equivalent to German utility RWE. In addition to the new asset-backed CP programme, Powergen has also announced a $490 million bond buyback programme and a $3 billion US CP programme. ?We have already achieved disposals of over £1 billion,? explains Graham Wood, group treasurer at Powergen, but when asked whether further disposals are in the pipeline he declines to comment. With the possibility of Powergen being bought out in the near future by German utility E.On, the company will probably be looking to strengthen its balance sheet further.

The Powergen securitisation issue was put together by Bank of America, which seems to have cornered the market in electricity company securitisation in the UK. The deal is its fifth for a UK utility, having previously put together issues for, among others, Cable & Wireless and Seeboard. Among the UK electricity suppliers, in addition to Seeboard, London Electricity, GPU (Midlands), Northern Electricity and TXU (owners of Eastern Electricity) are all understood to have securitisaton programmes in place. The Powergen deal was similar in structure to the Seeboard issue, which was first

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launched in 1996 by then Natiinsbank (now Bank of America). It was initially £155 million, was subsequently increased to £200 million and was further increased to £250 million in November last year. ?The idea to securitise came from the US and it sat well with us at the time as we had just been acquired and had £1 billion debt to refinance,? explains Mark Braithwaite, group financial controller and treasurer at Seeboard. He says that it enabled the company to achieve ? revolver-type? pricing and to diversify its lenders. He says that the facility has had a number of benefits for Seeboard. ? The rating gives you a small amount of upside ? but only small ? and the facility is excluded from gearing as it is treated as a sale of receivables and not a borrowing.? Wood at Powergen believes that the rating provides the company with a significant boost. ?Securitisation is going to become a growing financial technique as corporate credit ratings continue to decline,? he predicts. Strengthening of the balance sheet by the reduction in net debt was also a big driver for the Powergen deal.

Both the Seeboard and the Powergen paper are issued through the same CP conduit in the US: Kittyhawk, although the Powergen deal includes a Jersey-based intermediary. Kittyhawk is rated short term A1+/B1 (long-term AAA), which is a marked improvement on Powergen's corporate rating of Baa1/BBB+. Thus the cost saving. The current programme runs for 364 days and will roll over. The two facilities have many features in common ? such as the need to deal with receivables from both regulated and non-regulated activities and both current and future receivables.

?A number of Powergen subsidiaries are contributing receivables to the transaction, some of which are regulated entities and some of which are not,? explains Steven Gandy, head of global asset-backed securitisation for Europe, Middle East and Asia at Bank of America. The regulated receivables are those from Powergen's domestic electricity supply business, and the non-regulated receivables are those from other activities such as supply of gas and the provision to include telecom services. Although the Seeboard facility includes both regulated and inregulated receivables, the Powergen deal is the first in this sector to securitise gas receivables. The fact that there is a mix of activities means that the regulated receivables much be ring-fenced to protect them from any difficulties in the non-regulated businesses. Certain elements of the deal are, therefore, not cross-collateralised and reps and warranties are done severally rather than jointly. ?You have to be very careful that you do not support the non-licensed businesses with the licensed electricity business,? explains Kevin Ingram at Clifford Chance, which worked on the deal for Bank of America. ?Electricity supply is currently a highly regulated business whereas, for example, gas supply is a more competitive market with more permissive regulation.?

The mix of both current and future receivables comes from the way in which the UK regulated electricity companies buy their power. All companies use power supplied by the National Grid, which monitors their usage. The National Grid then bills the company for the amount used. There is a time lag between the company receiving the bill from the National Grid and apportioning the cost to its customers. This appears on the company's balance sheet as unbilled receivables, and the Powergen and seeboard deals involve the securitisation of both current receivables and these unbilled receivables. ?We have added a future flow securitisation element to the deal by securitising the unbilled and future receivables,? explains Gandy at Bank of America. ?Because of the favourable legal environment in the UK we were able to structure the deal as a true sale of future generated receivables using the same principles that have made operating asset securitisations possible (for example, in the Madame Tussauds deal),? he says. Powergen may now be considering a similar deal for its US receivables. ?A US receivables deal is entirely feasible,? says Wood, declining to comment on whether the company is already working on such a structure. It would, however, be difficult to incorporate any future flows into a US securitisation.

?The future flows in this [Powergen] transaction are quite complicated but the real added difficulty in putting the deal together was the inter-relationship between UK and US accounting standards,? explains Ingram at Clifford Chance. The process was made more complex than it had been in the previous electricity securitisations because of the recent replacement of FAS 125 in the US with FAS 140, which will come into effect on April 1 this year. In particular, FAS 140 tightens up the definition of a qualifying special purpose entity which impacted significantly on how the vehicles used in thetransaction could be structured and would operate. ?These changes had the potential to prejudice the deal,? explains Ingram. ?You are trying to analogise features of US legal structures and analysis into European jurisdictions and they

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don't always fit that well!? Moreover FAS 140 focuses on the definition of what is a financial asset , and certain types of future flows ? those where there is a continuing reliance on the originator ? do not qualify. This also caused structural issues for the transaction. In general, he explains that in some cases US GAAP can point in a completely different direction to the UK analysis. For example, in the US a qualifying special purpose entity must be completely passive vehicles with no decision-making ability, whereas in UK structures it is often desirable for such vehicles to be seen to take real decisions.

The fact that the issuer is a utility has both positive and negative implications for such deals. On the positive side, the fact that they provide essential services means that there is stable cash flow as they are not permitted to cease production. On the negative side is the spectre of government regulation. But Braithwaite at Seeboard plays down the significance of this. ?There is no direct linkage,? he claims. ?Investors at the US end are simply buying CP from Kittyhawk on the basis of its rating. There is not that visibility. It would be unfair of investors to take future regulation into account as they are buying CP backed by current assets,? he continues. ?The risk is the customer paying the bills, not future regulation.? Wood at Powergen agrees. ?All the investor in the US sees is some cashflow-backed paper that is rated tripleA,? he says. ?The strength of the cashflows supports the credit rating of the conduit. The slack is taken up by the size of the issuance.?

But the key question in getting these deals off the ground is, inevitably, getting the rating agencies comfortable. ?Our first question is what type of securitisation is it ? whole business or just receivables,? says Paul Lund, infrastructure analyst at Standard and Poors in London. ?We give these programmes credit for their off-balance sheet nature but you have to consider how easily they can come back onto the balance sheet,? he warns. A short-term rolling programme such as Powergen's could move back onto the balance sheet relatively easily which is a concern for the rating agency.

Colin Lally, securitisation analyst at Nomura Securities in London points out that it is not only external factors such as regulation that could hinder utilities securitisations. One important factor that must be taken into account is that securitisation issues can often subordinate corporate debentures in the market. As, for many companies, investors in the two types of issue will can often be the same people embarking on a securitisation could alienate existing investors. ? There is a delicate line to tread in doing these issues and keeping all your investors happy,? he says. ?Sometimes the unsecured investors will become nervous ? this definitely is a concern for them,? says Wood. But he explains that the two sets of investors are not usually the same people. ?You are approaching short-term CP investors for the securitisation and long-term investors for the bonds,? he says. ?We simply explained to the bondholders that this was part of the refinancing. Their position has not worsened ? in fact, because of the strengthening of the balance sheet it has improved.? Mark Braithwaite at Seeboard says that it is vital to keep everyone informed. ?With our original [1996] proposal lenders lower down the food chain were kept fully aware of what we were planning to do so that while it could have been a problem, it wasn't,? he says. Other features of the company's existing debt, such as negative pledges, will also scupper a securitisation deal.

But despite the distance placed between ongoing regulation in the UK and the buyers of this CP, regulation does still seem to affect the viability of asset-backed issuance from UK utilities. To date there have been no such deals for any UK water utilities despite the efforts of some, such as Nomura with its Hyder proposal, to float the idea. ?The latest regulations from OFWAT were quite penal to the water companies, which will now find it a strain to meet the low level of charges and their capital expenditure requirements,? says Lally at Nomura who looked at the potential for a Hyder deal during Nomura's ill-fated attempt to buy the company. ?It is easier for the regulator to see competition in the electricity sector,? he says. ?And the fact that a lot of the companies are foreign-owned makes it harder for the UK government to interfere.? The small number of UK water companies are, however, all monopolies in their own area and own their own infrastructure. Lally reckons that water companies are in a much worse position than their power counterparts as they have huge CAPEX requirements and charges will be strictly controlled until there is more evidence of competition. ?In the power sector there is much more visible and clearer competition,? he says.

Railtrack's announcement of a huge £4 billion programme at the end of last year will test the extent to which asset-

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backed issues can be successfully completed for a company in a highly regulated industry with an enormous capital expenditure requirement. The deal, which is being advised by UBS Warburg, will be a receivables securitisation, based on income from the train operating companies. Railtrack is in a far better position than any of the water companies to countenance such a deal as income from the TOCs is set to grow at 5% per year going forward. The deal has the full backing of Sir Alastair Morton, head of the Strategic Rail Authority, as an off-balance sheet route for the company to finance its desperately overdue infrastructure investment programme.

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