



## Fitch Revises Ratings for UK Water Securitisations

Fitch Ratings-London-16 February 2006: Fitch Ratings has today revised the unwrapped senior secured ratings for the following three secured and covenanted water transactions:

Anglian Water Services Financing plc's EUR10.0 billion global secured medium-term note (MTN) programme  
Class A unwrapped debt's rating is upgraded to 'A' from 'A-' (A minus)  
Class B unwrapped debt's rating is upgraded to 'BBB+' from 'BBB'  
The Class A wrapped bonds remain rated 'AAA'

Dwr Cymru (Financing) Ltd's GBP6.0bn multi-currency programme  
Class B unwrapped debt's rating is upgraded to 'A' from 'A-' (A minus)  
Class C unwrapped debt's rating is upgraded to 'BBB+' from 'BBB'  
The Class A wrapped bonds remain rated 'AAA'

Southern Water Services (Finance) Limited's GBP6.0 bn multi-currency programme  
Class A unwrapped debt's rating is upgraded to 'A' from 'A-' (A minus)  
Class B unwrapped debt's rating is upgraded to 'BBB+' from 'BBB'  
The Class A wrapped bonds remain rated 'AAA'

These rating actions follow the application of Fitch's Recovery ratings methodology to these regulated UK water companies' financings. For more details, please see the Criteria Report "Impact of Recovery Given Default for UK Water Securitisations" published today. This report also compares these secured and covenanted transactions with other unsecured and uncovenanted water and sewerage companies' financings. Fitch's EMEA utility team has also published today its criteria for utility companies in its Criteria Report "EMEA Energy and Utilities - Issuer Default Ratings and Recovery Ratings".

The process of establishing ratings for the obligations of issuers rated between 'AAA' and 'BB-' (BB minus) will refer, for the most part, to aggregate recoveries on the defaulted bond market as a whole for that sector and not to issuer-specific analysis. Fitch's process reflects the fact that assumptions on enterprise value and creditor mass at default for these entities would be largely arbitrary. For this reason, recovery assessments and thus individual issue ratings will be based more on the long-term averages of recovery for that type of security in a given sector, after giving consideration to additional issues such as collateral value, relative subordination and other determinants of recovery. For issuers rated 'B+' and below, Recovery ratings derive from a customised analysis of the individual issuer and their capital structure, assuming emergence from a defaulted stress scenario.

Other rating upgrades announced today for the Northumbrian, Sutton and East Surrey, Wessex, United Utilities, and Yorkshire water groups have resulted from the application of Fitch's generic above-average recovery given default expectations for most utilities to regulated UK water and sewerage companies. This analysis is incremental to the existing structural features for these three secured and covenanted financings. In particular, the ratings continue to reflect the combined features of these transactions' 'Additional Indebtedness' covenant (capping Class A debt at 75% net debt/RAV, Class B at 90%), the priority of payments given default, and the certainty of recovery value for UK water utility companies given the nature of these businesses and the regulatory framework. No IDRs for these transactions have been published since the issuers are special purpose vehicles.

Although these transactions have been labeled "securitisations" or "whole business securitisations", they are effectively a mixture between a secured corporate utility and the tranching, additional liquidity and high total leverage typically seen in a securitisation.

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Water/Wastewater Utility/UK  
Criteria Report

Impact of Recovery Given  
Default Analysis for UK Water  
Securitisations

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■ Background

Following the implementation of Fitch's Issuer Default rating ("IDR") and Recovery rating ("RR") methodology (please see "EMEA Energy and Utilities – Issuer Default Ratings and Recovery Ratings" dated 16 February 2006) the same Recovery Rating methodology has been applied to the three secured and covenanted water company transactions of

1. Dwr Cymru (Financing) Limited
2. Anglian Water Services Financing plc
3. Southern Water Services (Finance) Limited

In essence, these transactions had already been rated one notch above comparable unsecured uncovenanted water and sewerage companies ("WASCs") with similar financial metrics. This uplift reflected, amongst other things, (i) the additional covenant protection (enhanced liquidity, forward-looking financial covenants restricting dividends and additional debt,) with some mechanisms linked to the Trigger Event or Standstill regime, which is supportive of creditors' positions prior to any actual insolvency or distress; (ii) a security package which affords creditors certain control mechanisms over the company; (iii) the tranching of, and subordination between, debt classes and resulting priority of payments mechanisms; and (iv) the typical 'securitisation' enhancement of a 12 months debt service liquidity facility at the issuer level.

Rating upgrades have resulted from the application of Fitch's generic above-average recovery given default expectations for most regulated utilities to regulated WASCs. This analysis is incremental to the above noted structural features for these three secured and covenanted financings. Consequently, the previous senior secured ratings for these transactions' unwrapped Class A debt (or Class B debt in the case of Dwr Cymru) have been upgraded by one notch from 'A-' (A minus) to 'A'. The Class B debt (Class C debt for Dwr Cymru) has been upgraded from 'BBB' to BBB+'. In particular, the ratings continue to reflect the combined features of these transactions' Additional Indebtedness covenant (capping Class A debt at 75% net debt/RAV, Class B at 90%), the priority of payments given default, and the certainty of recovery value for UK water utility companies given the nature of these businesses and the regulatory framework. No IDRs for these transactions have been published since the issuers are special purpose vehicles.

Although these transactions have been labelled "securitisations" or "whole business securitisations", they are effectively a mixture between a secured corporate utility and the tranching of debt, additional liquidity and high total leverage typically seen in a securitisation.

Recovery Ratings and Notching from IDRs

Recovery Rating	Recovery Band (%)	Recovery Prospects	IDR Notching	
			Investment Grade	Non-Investment Grade
'RR1'	91-100	Outstanding	IDR +2	IDR +3
'RR2'	71-90	Superior	IDR +1	IDR +2
'RR3'	51-70	Good	IDR +1	IDR +1
'RR4'	31-50	Average	IDR +0	IDR +0
'RR5'	11-30	Below Average	IDR -1	IDR -1
'RR6'	0-10	Poor	IDR -2	IDR -2 or -3

Source: Fitch

■ RRs – Generic Allocation

Unsecured and Uncovenanted UK Water Utilities

For regulated UK water utilities rated 'BB-' and above Fitch has generally assumed that recovery given default will be higher than the average across all industry groups (31%-50%). The characteristics which drive this higher level of recovery are as follows:

- The demand for the product or service is relatively price-inelastic;
- Water networks are regional monopolies for which:
  - there are often legal restrictions preventing competing networks of a significant scale;
  - there are significant economic disadvantages for new entrants to build competing or replacement networks, even if this is permitted by law, supporting recovery value.
  - obsolescence and substitution risk is very low. That is - the risk that the network will have a reduced value because of low use due to lack of demand for water is negligible;
  - monopoly regulation is likely to ensure that the network is maintained to an adequate standard which would generally promote recovery given default;
  - in the UK the transparency of the regulatory process is such that future revenues, operating costs and capital costs are relatively predictable. Thus, purchasers of distressed networks have greater certainty over the future cashflows of the business, minimising uncertainty discounts and protecting recovery value. In addition, the nature of economic regulation generally makes the Enterprise Values of these businesses much less volatile than the

average for corporates and therefore the discount on distressed valuations is likely to be smaller than the average for corporates; and

- there are usually a number of trade buyers for distressed network assets, because of the characteristics mentioned above and the similarity of network operations in different countries. Recently, the UK has seen WASCs such as Glas Cymru, Wessex, Southern, and Northumbrian being bought/sold or valued at, at around 90-95% of RAV. Of the three, the only near-distress entity valuation was that of Glas Cymru.

■ Recap of Structural Features in the Three Water 'Securitisations'

Typical Obligation Recovery Ratings for 'AAA', 'AA', 'A', 'BBB' and 'BB' Rated Issuers

Recovery Rating	Representative Securities
'RR1'	<b>Outstanding recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Senior secured loans (fully secured, backed by strong asset or enterprise value, low senior leverage).</li> </ul>
'RR2'	<b>Superior recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Senior secured loans (secured, average senior leverage)</li> </ul>
'RR3'	<b>Good recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Secured bonds</li> <li>• Secured bonds in weaker sectors (or under-collateralised, high senior leverage)</li> <li>• Unsecured obligations in selected sectors with generically above average rates of recovery given default</li> </ul>
'RR4'	<b>Average recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Senior unsecured bonds or strong subordinated bonds</li> </ul>
'RR5'	<b>Below-average recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Subordinated bonds or weak senior unsecured bonds</li> </ul>
'RR6'	<b>Poor recovery prospects given default</b> <ul style="list-style-type: none"> <li>• Preferred Stock</li> </ul>

Source: Fitch

Having applied the above-average generic rate of recovery approach to all regulated UK WASCs and their holding companies' senior unsecured debt ratings, the following details illustrate these transactions' structural features which further enhance the prospects for recovery, given a default.

In particular, the combination of the Additional Indebtedness covenant (capping Class A debt at 75% net debt/RAV, Class B debt at 90% net debt/RAV), the priority of payments given default, and the certainty of recovery value for UK water utility companies given generic features and the regulatory framework.

See Comparison of Different Features in Secured and Covenanted, and Unsecured and Uncovenanted UK Water Financings, on p.4.

#### ■ Bond Documentation Provisions in the Secured WASC Transactions

The upgrade of Fitch's senior secured rating of Class A debt from the initial 'A-' to 'A' has some repercussions given certain mechanisms in existing bond documentation for the secured and covenanted transactions.

The transactions define a "Rating Requirement" as:

"... confirmation from any two Rating Agencies that, in respect of any matter where such

confirmation is required, the shadow rating is, in the case of the Class A Wrapped Debt, 'A-' by Fitch and S&P and 'A3' by Moody's or above and in the case of the Class A Unwrapped Debt is 'A-' by Fitch and S&P and 'A3' by Moody's or above."

Rating Requirements are required for various events. To date, these have included financial lease exposure above the documentary minima, and also include any change in the level of covenanted financial ratios:-

"... the level of any financial ratio contained within the covenants set out in ... Financial Covenants ... may, following a Periodic Review or any material change in the regulation of the water industry in the United Kingdom, be amended by [the Appointee] provided that each Financial Guarantor and the Security Trustee (acting on the instructions of the Majority Creditors) agree and the Rating Requirement has been met."

If the documentation intended to heighten a downgrade from the initial rating (the rating at closing of 'A-'), this mechanism no longer works because of the upgrade of the senior secured rating of the Class A debt to 'A'. Nevertheless, Fitch will make known its rating intentions or decisions to relevant parties if the, then, current rating may change (i.e. be downgraded from 'A').

Comparison of Different Features in Secured & Covenanted, and Unsecured and Uncovenanted UK Water Financings

**Unsecured and Uncovenanted, Single Tranche Debt per Appointee, Structures**

**Northumbrian Water Services Limited**

senior unsecured: 'A-'

**United Utilities Water Plc**

senior unsecured: 'A'

**Wessex Water Services Limited**

senior unsecured: 'A-'

**Yorkshire Water Services Limited**

senior unsecured: 'AA-'

**Secured and Covenanted, Multi-Tranche Debt per Appointee, Structures**

**Anglian Water Services (Finance) plc**

senior secured Class A unwrapped: 'A'

senior secured Class B unwrapped: 'BBB+'

**Dwr Cymru (Financing) Limited**

senior secured Class B unwrapped: 'A'

senior secured Class C unwrapped: 'BBB+'

**Southern Water Services (Finance) plc**

senior secured Class A unwrapped: 'A'

senior secured Class B unwrapped: 'BBB+'

Structural Enhancements

**Security Package:** In Fitch's view, given all WASCs' limitations on pledging their assets and the overriding statutory Special Administrative Receivership regime, the secured bonds' security package provides a direct co-ordinated claim (enhancing rate of recovery per class of debt given default upon the asset-owning Appointee) and creates a regime to take pro-active preventative pre-default actions (which also lowers the probability of default in comparison to the unsecured and uncovenanted structures). However, even if Special Administrative Receivership intervention occurs, realisation proceeds are expected to be distributed by the security trustee to the secured creditors in accordance with the transaction's priority of payments. Equally, the debt may continue to exist as part of a transfer of the company to a new owner. Certainly, the secured bonds' security package affords more control of the above processes than unsecured bondholders'.

**Unsecured Bonds**

WASCs' assets and protected land can not be pledged.

**Secured Bonds**

WASCs' assets and Protected Land can not be pledged.

Only the shares in the Appointee and any assets not comprising Protected Land are pledged as security. However, it is acknowledged that a change of ownership (on enforcement of the share security) would trigger an ownership re-evaluation (including "fit and proper person" criteria) by Ofwat.

Fitch has portrayed the security package as a nice-to-have, rather than not, control mechanism. Its undoubted monetary benefit may be questioned given the potential intervention of the statutory Special Administrative Receiver, although the pre-distress Trigger Event/Standstill regime is designed to prevent the need for such 'nuclear-button' intervention by government or the regulator.

**Special Administrative Receivership:** If Enforcement commences under the secured bonds a statutory-appointed Special Administrator would override any bondholders' insolvency appointee and will deal with the assets as if they were not charged. As well as running the business to ensure continuity of water services the Special Administrator would seek to sell the business obtaining the "best price which is reasonably available on a sale which is consistent with the purposes of the special administration order" as opposed to an amount not less than "open market value" which would apply to a conventional insolvency regime. During the period of the order, the company is to be managed for the achievement of the purposes of the order and in a manner which protects the respective interests of members and creditors. This does not necessarily indicate full payment of interest during this period. The above quotation does not require the Special Administrator to adhere to any bondholder requirements of full recovery of its debt, indeed the company could be transferred with or without the debt. Bondholders have a right to petition if the sale is "unfair" or fair value consistent with the above mandate was not achieved. In any event, bondholders would not be in control of the realisation procedure. If the asset is sold without the debt, realisation proceeds received by the Special Administrator would be forwarded to creditors (in the secured bond's case, the Security Trustee would then distribute in accordance with the priority of payments which prioritises Class A debt, wrapped and unwrapped rank pari passu, before Class B debt).

Special Administrative Receivership is always a possibility for any WASC. There is no equivalent Trigger Event/Standstill co-ordination amongst these WASCs' unsecured creditors ahead of near-default levels, other than their equity ownership intervention or pressure.

Special Administrative Receivership is always a possibility for these transactions, although such a deterioration is alleviated by the preemptive pre-distress Trigger Event/Standstill regime.

**Trigger Event/Standstill Regime:** These step-in provisions/covenant levels that trigger a **Standstill** for the secured bonds are designed to co-ordinate efforts to sort out problems prior to a scenario of imminent insolvency or other grounds that can give cause for an appointment of a Special Administrator. During the Standstill period, interest is expected to be current on Class A and B debt to the extent of available cashflow as applied through the applicable Priority of Payments, or available liquidity. Technically, there is no Event of Default during a Standstill (potentially of up to 18 months) since the secured transaction's finance parties have agreed to not Enforce or automatically call an Event of Default during a Standstill. A legal view is prevalent that this prevents Ofwat petitioning for a Special Administrator on certain grounds. The existence of 12 month's capex committed facilities or pre-funded cash similarly enables the company to fulfil its licence requirement to undertake its activities thus there is a view that the potential scenario of Ofwat revoking an Appointee's licence on these grounds may not take place.

Comparison of Different Features in Secured & Covenanted, and Unsecured and Uncovenanted UK Water Financings (continued)

**Unsecured and Uncovenanted, Single Tranche Debt per Appointee, Structures**

**Secured and Covenanted, Multi-Tranche Debt per Appointee, Structures**

Soundings from Ofwat indicate that it is happy that this preventative step-in mechanism grants a period of private sector rectification prior to a scenario of near-insolvency. It regards this mechanism as akin to the shareholder pressure/action that also takes place under similar scenarios for an equity model WASC. However, given the importance of water infrastructure/services and other mechanisms for Ofwat to step-in, if Ofwat had grounds to appoint a Special Administrator - particularly in relation to the public services the Appointee provides - this option, albeit a nuclear one, may well take place with potential negative results for creditors.

There are no such co-ordinated regimes for creditors to uncovenanted WASCs.

A framework for a co-ordinated, pro-active response from secured creditors.

There are no dividend restriction mechanisms for uncovenanted WASCs.

The Trigger Event/Standstill event is triggered by various conditions including forward-looking financial ratios (see Appendix III of the Southern Water report for a comparison of all three transactions). Upon a Trigger Event/Standstill, dividends are restricted. This acts to conserve cash for the Appointee and disciplines private or public equity to take action to prevent such a scenario.

**Liquidity**

Normal corporate treasury prudent policies for liquidity, rather than a covenant to do so.

Capex, Opex and Working Capital 6 or 12-months forward-looking covenant requirement for cash or liquidity facility for the Appointee.

Typical for 'securitisation' structures, there is a 12 month debt service liquidity facility specifically for the Issuer, in addition to those above for the Appointee.

**Additional Debt Test**

Usually, there are few restrictions in public bonds upon WASCs to gear-up the regulated entity.

The Appointee may raise additional debt for its operations provided that it is Permitted Financial Indebtedness (creditor has signed up to the Common Terms Agreement, maturity profile and fixed/floating interest rate conditions, and additional debt is within forward-looking financial covenants, etc.).

Permitted Financial Indebtedness is capped at around 75% debt/RAV for Class A, and 90% for Class A+B. Dwr Cymru levels are lower. Together with the priority of payments this means that debt ranking pari passu with Class A creditors is capped at around 75% debt/RAV, ditto Class B at 90% debt/RAV. In Anglian and Southern there is also a minimum post-maintenance interest cover test.

**Subordination of Class B or HoldCo Debt**

The equivalent "subordinated debt" in these transactions usually takes the form of debt raised at the HoldCo level, usually remunerated through discretionary dividends from the Appointee. Compared with the secured transactions where subordinated Class B bondholders are a direct creditor of the Appointee (through the issuer-borrower inter company loans), HoldCo bonds have no such direct recourse.

Class Bs are subordinated to Class A debt by the priority of payments mechanisms. This mechanism also prioritises payment flows (interest or principal, and between classes of debt) under different scenarios.

Class Bs are subordinated by virtue of indefinite inability to take any action upon non-payment of Class B interest while Class A debt is outstanding. Non-payment of interest under Class B notes is not an event of default. This subordinated tranche of debt is equity-like in having the feature of possible non-payment (accrual) of interest.

Class Bs are further subordinated by their inability to vote to cease a Trigger Event/Standstill regime or waive an Event of Default while Class A bonds are still outstanding. Consequently, Class B bondholders are not able to have a say in enforcing the transaction's security.

**Other Features**

None

**Refinancing Policy:** bullet debt maturities within certain time parameters

**Hedging Policy:** high element of fixed/protected interest rate hedging per quinquennium

**Stricter Ring-Fence:** As encouraged by Ofwat, the transaction enhances licence ring-fencing provisions re: Appointee's sole business activities, no cross-default, no on-lending, connected-party transactions, dividend restrictions. Fitch has been clear that the rating of the WASC parent is irrelevant to the rating of this transaction thanks to the above ring-fencing and financial covenants including the dividend restriction.

**Discipline of Forward-Looking Financial Covenants**

Source: Fitch

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