



The acquisition of AWG plc by Osprey Acquisitions Limited and its impact on Anglian Water Services Limited

A consultation paper by Ofwat

December 2006

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1 Purpose

1.1 This document:

- describes the acquisition by Osprey Acquisitions Limited (Osprey), of AWG plc (AWG). AWG is the owner of Anglian Water Services Limited (ANG), an appointed water undertaker regulated by Ofwat.
- explains the statutory position on mergers;
- describes Osprey's ownership and structure; and
- sets out the regulatory issues and our initial assessment of these issues.

1.2 We invite views on the issues discussed in this paper, including:

- the capacity of Osprey and its owners to be the owners of a regulated water business;
- which entities should provide Condition P undertakings to ANG;
- the need for modifications to ANG's instrument of appointment (its 'licence') to ensure that, whoever its owners, it has sufficient financial and managerial resources to carry out its functions as a water company and is appropriately ring-fenced from the rest of the Osprey group.

1.3 Respondents may also comment on any other issues relating to the acquisition that they believe are relevant.

1.4 Responses to this paper are required by no later than Friday 26 January 2007.

2 Details of the acquisition and the consortium members

2.1 On 2 October 2006 the boards of Osprey and AWG announced that they had agreed the terms of a recommended cash offer by Osprey for AWG. AWG is the owner of ANG, an appointed water undertaker regulated by Ofwat. The final offer price was £15.78 per AWG share. This offer valued the entire share capital of AWG at circa £2,245m. On 24 November 2006, Osprey declared the offer wholly unconditional.

2.2 Osprey was formed at the direction of a consortium comprising:

- 3i Group plc;
- Canada Pension Plan Investment Board (CPPIB);
- Colonial First State Global Asset Management (CFSGAM) the asset management division of Commonwealth Bank of Australia (CBA); and
- Industry Funds Management (Nominees) Limited (IFM) in its capacity as trustee of the Industry Funds Management (International Infrastructure) Wholesale Trust.

2.3 The stakes that each member of the consortium have in Osprey, and which will ultimately be reflected in their holding of AWG, are approximately as follows:

	%
• 3i Group	16.1
• CPPIB	32.3
• CFSGAM	32.3
• IFM	19.4

2.4 3i Group plc is a private equity and venture capital business with investments in Europe, the United States and Asia. It is a FTSE 100 listed company. As at the date of the offer, it had a market capitalisation of approximately £6bn and manages assets of over £5.7bn.

2.5 CPPIB invests and manages the funds not needed by the Canada Pension Plan to pay current benefits. It is governed and managed independently of the Canada Pension Plan and at arm's length from the Canadian government. CPPIB manages more than C\$98bn (£48bn) in assets. Its infrastructure investments include interests in Wales and West Utilities – a regulated gas distribution business and Transelec – the largest electricity transmission network in Chile.

2.6 CFSGAM is the asset management division of the Commonwealth Bank of Australia. CFSGAM manages over A\$124bn (£50bn) of investments. It has over ten years experience in infrastructure investment and infrastructure management and is committed to long-term value based investment. Its investments include an interest in Inexus (a regulated gas transporter business in the UK) as well as interests in a number of other unlisted

Australian and UK based utility and infrastructure assets.

- 2.7 IFM is the trustee of the Industry Funds Management (International Infrastructure) Wholesale Trust. IFM holds investments in international infrastructure assets including Arqiva, MGN Gas Networks and Zec Lodz. IFMNL is a subsidiary of Industry Fund Services Pty Ltd (IFS), an Australian financial services provider. IFS is owned and controlled by a number of superannuation funds. In the course of 2006 it is expected that IFS will be absorbed into Members Equity Bank Pty Ltd. Members Equity Bank is 100% owned by a number of Australian superannuation funds and was formed to provide Australians with access to low cost financial products and services. As a bank it is regulated by the Australian Prudential Regulation Authority.
- 2.8 ANG is an appointed water undertaker, regulated by Ofwat. With a regulatory capital value of around £4,500m in 2005-06, it is the fourth largest of the ten water and sewerage companies in England and Wales. It serves around 2.8 million properties across East Anglia and the East Midlands.

3 The statutory position on mergers

- 3.1 The Water Industry Act 1991 (WIA91) put in place a special merger regime for mergers between water and sewerage companies. Under section 32 of WIA91 (recently amended by the Enterprise Act 2002 (EA02) and Water Act 2003), the Office of Fair Trading (OFT) must refer to the Competition Commission a merger of two or more water enterprises (which includes sewerage undertakings) in England and Wales where the turnover of each is £10 million or more.
- 3.2 In addition to the sector-specific merger provisions in WIA91, the EA02 sets out circumstances under which the OFT has a duty to refer a merger in any sector, including water, to the Competition Commission for further investigation of the competition issues arising from anticipated or completed mergers.
- 3.3 There is no obligation on Osprey or the consortium members to notify the OFT of the acquisition of AWG plc. At the time of publication we understand that no party to this acquisition has notified the OFT.
- 3.4 These are matters for the company and the OFT but we understand that neither Osprey nor any of the consortium members (or their group companies) has a controlling interest in any water or water and sewerage company in England and Wales.
- 3.5 The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition in relation to ANG as the appointed water undertaker and whether any modifications should be made to ANG's licence.

4 Regulatory issues arising from the acquisition and the need for licence modifications

The capacity of Osprey to be the owner of a regulated water company

- 4.1 We accept that competition for ownership of water companies may be beneficial because it can stimulate existing owners to become more efficient in the provision of water and sewerage services as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.
- 4.2 However, we have a duty to act in a way which we consider is best calculated to secure that the functions of water and sewerage undertakers are properly carried out. Therefore we must be satisfied, in each particular case, that the prospective owner has the probity and the operational and financial capacity to assume that role.
- 4.3 Osprey is a private company incorporated in England and Wales on 24 August 2006. It has been formed at the direction of a consortium comprising the entities listed in paragraph 2.2.
- 4.4 We have described the consortium members in section 2. We understand that all the investors in the consortium are established international investment groups. Osprey has stated that each investor is looking for long-term secure returns with each investor committed to the long-term ownership and continued stability of ANG's business.
- 4.5 Each consortium member is entitled to appoint one director to Osprey for each 15% of issued ordinary shares that they will hold in Osprey, so CFSGAM and CPPIB will have two each and IFM and 3i will have a single director each. Together they must in addition appoint (at least) one independent director, making a total of (at least) seven directors at Osprey.
- 4.6 We understand that, collectively, the investors have experience of the regulated gas distribution and telecoms sectors in the UK as well as airports, electricity transmission and energy generation overseas.
- 4.7 The investors anticipate that their collective broader infrastructure investment experience such as performance benchmarking, introducing transparent and efficient reporting systems, applying appropriate asset management techniques and increasing transparency and accessibility for stakeholders will directly benefit ANG and its customers. The investors believe that this will supplement the expertise and experience of the existing management team which it has indicated will remain in place.
- 4.8 We invite views on the capacity of the consortium and Osprey to own ANG.

Management of the regulated water business

- 4.9 We want to be satisfied that ANG's acquisition by Osprey does not compromise effective management of the regulated business. Previous respondents to our consultation papers on changes of ownership have expressed concerns about the loss of managerial effectiveness as a result of the corporate activity.
- 4.10 Osprey considers the continuation of the skills and experience of ANG's management and employees to be an important factor in the future success of the business. It therefore intends to retain ANG's existing senior management team. Osprey has stated that it recognises the licence requirement for there to be at least three independent non executives in the regulated business and the importance of their role.
- 4.11 Osprey has informed us that it will have the right to appoint 4 new non-executive directors to the board of ANG (one representing each investor), although initially intends not to make any changes to the board. The investors recognise that the board of ANG is required by its licence to be able to act independently of any parent company or controlling shareholder and to act exclusively in the interests of ANG. Osprey has stated that the Investors will ensure that the composition of the board of ANG complies with the requirements of the licence, and will reflect a broad range of relevant skills and experience.
- 4.12 We understand that the consortium has no current intention to change the strategic focus or day-to-day operations of the appointed business.
- 4.13 All water companies need the active co-operation of their owners in carrying out their functions. Most water (and water and sewerage) companies have Condition P in their licences that require them to obtain legally enforceable undertakings from their owners. The companies giving the undertakings are required to:
- give the regulated business any information it needs to comply with its licence;
 - refrain from any action that could cause the regulated business to breach its licence; and
 - maintain a minimum of three independent non-executive directors on the board of the regulated business.
- 4.14 These undertakings help to protect customers by strengthening the ability of the regulated business to comply with the conditions of its licence and to maintain its independence from the rest of the group to which it belongs.

- 4.15 ANG already has Condition P in its licence. This requires ANG to obtain from AWG (or, if AWG ceases to be the ultimate holding company of ANG, from ANG's ultimate holding company) legally enforceable undertakings in favour of ANG.
- 4.16 We intend to modify Condition P of ANG's licence. The amended Condition will require ANG to secure undertakings from its Ultimate Controller (see below) and, when the Ultimate Controller is not the UK holding company, from its UK holding company. The purpose of this modification is to standardise this ring-fencing condition for all regulated water companies and to ensure that it allows the appointee to procure undertakings from the appropriate entities under a variety of ownership structures.
- 4.17 Ultimate Controller means any person (including, without limitation, a corporate body) who or which (alone or jointly with others and whether directly or indirectly) is (in the reasonable opinion of Ofwat) in a position to control, or to exercise material influence over, the policy or affairs of the regulated business or of any holding company of the regulated business.
- 4.18 Osprey have informed us that no individual consortium member has a majority of the voting rights, nor has the ability to veto any board decisions. However, Osprey recognises that each of the consortium members, through their board representation and shareholding, may be considered by Ofwat to be in a position to exercise material influence over the policy or affairs of Osprey, and therefore AWG and ANG.
- 4.19 Osprey has suggested that the following entities should provide condition P undertakings to ANG:
- 3i Group plc as a joint ultimate controller;
 - CPPIB as a joint ultimate controller. CPPIB is the entity ultimately responsible for discharging the functions set forth in the CPPIB Act, which include assisting the Canada Pension Plan in meeting its obligations to contributors and beneficiaries under the Canada Pension Plan by managing those assets of the Canada Pension Plan which are transferred to it and are not needed to pay current benefits;
 - Commonwealth Bank of Australia (CBA) as a joint ultimate controller. CBA is Australia's largest bank by market capitalisation and is the ultimate parent company of CommTrading Limited, the Maltese company which holds the CBA group's 32.3% equity interest stake in the Osprey group;
 - IFM as a joint ultimate controller. IFM is the sole trustee of the IFM (International) Infrastructure Wholesale Trust (the *Trust*) and holds its interest in Osprey in its capacity as trustee of the Trust. Under the terms of the trust deed establishing the Trust, IFM has all rights, powers, authorities and discretion in respect of the Trust and the

assets of the Trust, including the power to act as if it were the absolute owner of the assets of the Trust, and has absolute discretion as to the investment, realisation or other dealings with the assets of the Trust; and

- Osprey itself as the ANG's UK holding company.

4.20 In light of the information presented to us above, we see no reason to challenge Ospreys' view of which entities should provide the Condition P undertakings.

4.21 However ultimately it is the responsibility of ANG to ensure that it complies with its licence by procuring Condition P undertakings from the appropriate entities.

4.22 We invite view on which entities should provide the Condition P undertakings.

Financing

4.23 An important aspect of our assessment will be to determine whether ANG remains able to finance its functions as a water undertaker under the consortium's ownership.

4.24 The cash consideration paid under the offer was funded predominantly by way of equity from the consortium (in the form of shares and unsecured loan notes. The loan notes are to be listed on the Channel Islands Stock Exchange), with circa £900m of external bank debt financing at the holding company level (by way of a term loan facility and a cash bridge facility). The bid company is required to repay the cash bridge facility within 180 days of initial utilisation under the facilities agreement.

4.25 In 2002 AWG implemented a significant corporate restructuring and financing through the creation of the new ANG Financing Group within the AWG Group which created a contractual financial ring fenced around the cash flows and obligations of ANG in addition to the regulatory ring fencing requirements. Whilst the consortium currently intends to retain ANG's existing financing arrangements, following completion, it is possible that ANG's gearing will increase (on a net debt:RCV basis) from around 78% up to a maximum of 83% as a result of a dividend payment to the consortium members by ANG. This would leave some headroom against the covenanted level of gearing (85%) that would trigger a dividend lock up at ANG under its securitised structure.

4.26 The consortium has discussed the financing arrangements with the rating agencies. The agencies have not changed their ratings of ANG as a result of their respective reviews of Osprey's proposals.

4.27 Any activities of Osprey or the wider group that could prejudice the financial and managerial viability of ANG would be of concern to us. Such

concerns have, in the past, been addressed by licence modifications to ensure that the water company is ring fenced from the other activities of the group.

Ring Fencing

4.28 ANG already has the majority of financial ring-fencing licence conditions. Amongst other things these conditions:

- require ANG to operate as if it were a separate company, for its Board to be able to act independently of the parent company and solely in the interest of the water company;
- strengthen the ring fence ensuring that there is no cross subsidy between ANG and its associated companies;
- require ANG to ensure that its dividend policy rewards efficiency and the management of economic risk, and will not impair the company's ability to finance its functions as a water undertaker;
- require ANG to have sufficient financial and managerial resources and systems of planning and internal control to carry out its activities;
- ensure that its financial affairs can be assessed and reported on separately from other businesses and activities of its group;
- require ANG to maintain an investment grade corporate credit rating;
- prohibit (without Ofwat's consent) cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other companies in the group; and
- require it to publish its results as if it were listed on the Stock Exchange.

4.29 We signalled in MD218 our conclusion, following consideration of responses to the Financing Networks discussion paper, that there is merit in the gradual adoption by water companies of cash lock-up provisions similar to those already applied to energy companies. We indicated that whilst we saw no grounds for urgent change we would seek to introduce cash lock-up provisions into licences as and when suitable circumstances arise. The change of ownership of ANG through the acquisition of AWG by Osprey represents such a circumstance.

4.30 Osprey has stated that it is willing to accept the inclusion of a cash lock-up provision in Condition F of ANG's licence, provided that its scope does not extend beyond that set out in the Ofwat's Position Note¹ and does not

¹ Thames water capital restructuring: a position note by Ofwat, September 2006.

conflict with the provisions of ANG's current securitisation structure.

- 4.31 We invite views on whether the ring fencing conditions described are adequate or whether further conditions are required, above the introduction of a cash lock-up provision, to ensure that the regulated business remains appropriately ring fenced within the wider Osprey group.

Comparative information

- 4.32 One of the most important tools available to Ofwat for the regulation of water companies is the ability to make comparisons between them (comparative competition).
- 4.33 As a result of Osprey's acquisition, AWG's shares will no longer be listed on the London Stock Exchange and therefore we will no longer be able to rely on the listing of AWG to make comparisons of how the market values it relative to other listed companies. This type of analysis informs our judgements for example on the appropriate cost of capital for water companies.
- 4.34 ANG's licence does not contain the current standard provision that requires an appointee to maintain the listing of a financial instrument. In light of the de-listing of AWG's shares and the loss of the market information it provided, we are proposing to introduce this condition into ANG's licence.
- 4.35 Osprey intends to maintain Anglian Water's current bond listing on the LSE. Osprey considers that the terms of the current listed bonds in issue should satisfy any obligation to maintain the listing of a financial instrument on the LSE, and would ensure the continued existence of a helpful financial comparator, particularly when considered in conjunction with the ring-fenced accounting and financial reporting obligations under Condition F of ANG's licence.
- 4.36 We invite views on the impact of these proposals on comparative information.

Prices and service standards

- 4.37 Customers will expect ANG to provide proper standards of service at appropriate prices irrespective of its ownership. ANG will continue to have the obligations imposed upon it by legislation and the conditions of its licence. We will continue to regulate ANG under those provisions.
- 4.38 ANG's existing price limits will remain unchanged from those determined by Ofwat, at the 2004 periodic review, which allow it to maintain its service to customers. ANG accepted these price limits. Future price limits will be set as for all other companies. Customers should be able to assume that a
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change of ownership will have no adverse impact on the price or the quality of service that they receive. We will monitor this and, where appropriate, we will exercise our powers to that end.

Conclusions on the need for licence modifications

- 4.39 We do not consider that the acquisition raises significant regulatory issues. However we do propose to introduce the cash lock-up provision, a standard condition P and the requirement to maintain a listed instrument into ANG's licence.
- 4.40 We would like to hear the views of others on whether they believe further licence modifications are necessary.

5 Responses to this consultation paper

5.1 We have discussed with ANG, Osprey and the consortium the issues noted above. With the exception of the cash lock-up provision, no further licence modifications are proposed.

5.2 Responses to this consultation should be made in writing by no later than 5.00pm 26 January 2007 to:

Keith Mason
Director of Regulatory Finance and Competition
Office of Water Services
Centre City Tower
Hill Street
Birmingham
B5 4UA

Fax: 0121 625 3609
E-mail: keith.mason@ofwat.gsi.gov.uk

5.3 At the end of the consultation period, each response will be placed in Ofwat's Library for public inspection unless respondents specifically request otherwise.