The completed acquisition of Cambridge Water plc by Cheung Kong Infrastructure Holdings Limited

A consultation paper by Ofwat

June 2004

Contents

1. Purpose

1.1 This document:

- describes the completed acquisition of Cambridge Water plc (Cambridge) by Cheung Kong Infrastructure Holdings Limited (CKI);
- explains the statutory position on mergers;
- describes CKI's ownership and group 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:

- CKI's capacity to be the owner of a regulated water business;
- the current arrangements for the ring fencing of the appointed water business, Cambridge; and
- the need for modifications to Cambridge's instrument of appointment (referred to as its 'licence' in this consultation paper).

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

1.3 Responses to this paper are required by no later than 14 July 2004.

2. Details of the acquisition

2.1 On 29 April 2004, CKI announced that it had acquired from Spanish group Union Fenosa all of Cambridge's equity for £51.4 million. CKI has funded 100% of the acquisition through equity. Cambridge's immediate owner is CKI UK Water Ltd (CKI UK), newly established by CKI as a holding company for Cambridge.

2.2 Cambridge is an appointed water undertaker. With a regulatory capital value of £41.3 million in 2002-03, it is one of the smallest of the twelve water only companies in England and Wales. It supplies 73 million litres of water per day to approximately 110,000 homes and 10,000 business customers in a 1,200km^2 area of south Cambridgeshire that includes the city of Cambridge.

2.3 CKI, which has its headquarters in Hong Kong, is a diversified infrastructure company that focuses on investing in, developing and operating infrastructure businesses. It is the largest such company listed on the Hong Kong Stock Exchange, with a market capitalisation of approximately £2.8 billion, and is one of the 33 constituent stocks of the Hang Seng Index. It has investments in energy, water, transportation, infrastructure materials and related businesses in Hong Kong, Mainland China, Australia, Canada, the Philippines and other countries.

3. The statutory position on mergers

3.1 Under section 32 of the Water Industry Act 1991 (WIA91), the Secretary of State for Trade and Industry must refer a merger of any two water or water and sewerage companies in England and Wales to the Competition Commission. Prior to the acquisition, CKI and its associated companies, including its parent company Hutchison Whampoa Limited (HWL), did not have an interest in any water or water and sewerage companies in England & Wales. Therefore, the duty under section 32 of WIA91 does not arise.

3.2 In addition to the water-specific merger provisions in the WIA91, the Enterprise Act 2002 (EA02) sets out circumstances under which the Office of Fair Trading (OFT) has a duty to refer a merger in any sector, including water, to the Competition Commission for further investigation. The OFT must make a reference if it believes that:

- a 'relevant merger situation' has been created[1]; and
- the merger may result in a substantial lessening of competition within any market in the UK for goods or services.

3.3 Our view is that the merger does not result in a relevant merger situation, but this is a matter for the OFT. The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition and whether any modifications should be made to Cambridge's licence.

[1] A 'relevant merger situation' has been created if the merger meets either the 'turnover test' or the 'share of supply test' as set out in EA02. The turnover test is met if the target company has a UK turnover of £70 million. Cambridge had a UK turnover of only £14.5m in the year ending 31 March 2003. The share of supply test is met if the merging parties will together supply at least 25 per cent of goods and services of a particular description, either in the UK as a whole or in a substantial part. This test is only met if the share of supply increases as a result of the merger. For the reasons set out in paragraph 3.1, CKI's acquisition of Cambridge does not meet the share of supply test.

4. CKI’s ownership and group structure

4.1 Cambridge, along with many other water (and water and sewerage) companies, has a condition in its licence (Condition P) that requires it to obtain legally enforceable undertakings from its owners. All water companies need the active co-operation of their owners in carrying out their functions. The companies giving the undertakings are required to:

- give Cambridge any information it needs to comply with its licence;
- refrain from any action that could cause Cambridge to breach its licence; and
- maintain a minimum of three independent non-executive directors on Cambridge’s board.

These undertakings help to protect customers by strengthening Cambridge’s ability to comply with the conditions of its licence and to maintain its independence from the rest of the group to which it belongs.

4.2 At present, Cambridge’s licence Condition P requires it to obtain undertakings from:

- its UK holding company; and
- its ultimate holding company.

4.3 We are proposing changes to Condition P to enable the provision of seamless undertakings on any future change of ownership. We also propose to change the condition to require undertakings from Cambridge’s UK holding company and its Ultimate Controller, where:

> 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 the Director) in a position to control, or to exercise material influence over, the policy or affairs of the Appointee or of any holding company of the Appointee.

4.4 Following CKI’s acquisition of Cambridge, we have sought undertakings from:

- CKI UK, as Cambridge’s UK holding company; and
- CKI, as Cambridge’s Ultimate Controller.

4.5 Despite the links between Hutchison Whampoa Ltd and CKI, the two companies are separately listed on the Hong Kong Stock Exchange (HKSE) and are managed as independent entities. The HKSE listing rules contain provisions designed to prevent ‘connected persons’ such as CKI and HWL from exerting any influence over each other or their respective subsidiaries except after notification to the HKSE and after full disclosure. CKI have given us assurances that these provisions would prevent HWL from influencing any decisions of CKI that related to, or affected, Cambridge. This would include, for example, any future proposals relating to Cambridge’s financial structure.

4.6 If at any time in the future HWL’s relationship with Cambridge changed in such a way that it became Cambridge’s Ultimate Controller, HWL would be required to provide Cambridge with the requisite undertaking as its Ultimate Controller at the same time as this change. This might happen, for example, if HWL became able to exert influence over Cambridge or if it became apparent that HWL were in fact exerting influence.

4.7 We invite views on whether CKI and CKI UK are the most appropriate companies to give undertakings under Cambridge’s licence Condition P.

5. Other regulatory issues arising from the acquisition

CKI's capacity to be the owner of a regulated water company

5.1 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 services as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.

5.2 However, we have a duty to act in a way 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 operational and financial capacity to assume that role.

5.3 CKI is active in managing infrastructure assets. It has investments in energy, transportation, infrastructure materials and related businesses in Hong Kong, Mainland China, Australia, Canada, the Philippines and other countries. Its Australian investments include a number of regulated gas and electricity distribution businesses. The acquisition of Cambridge is CKI's first venture in the UK

5.4 In March 2004, CKI and its associate CKI Life Sciences acquired AquaTower, which holds a concession to supply water to 50,000 people in Victoria, Australia. CKI previously owned a water treatment plant in Yueyang in China.

5.5 CKI intends to provide managerial, advisory and other services to Cambridge, using its experience of owning and managing large scale regulated businesses in other countries to improve Cambridge's performance. We will seek to ensure that any services are provided on an arm's length basis and in compliance with our Regulatory Accounting Guideline 5.03 (RAG5).

5.6 We are conducting our own investigations into the capacity of CKI and CKI UK to be the owners of a regulated water company, but we would also like to hear the views of others on this issue before forming an opinion.

Financing

5.7 An important aspect of our assessment will be to assess whether Cambridge remains able to finance its functions as a water undertaker under CKI's ownership.

5.8 CKI is one of Hong Kong's largest companies with a market capitalisation of £2.8 billion. It has a credit rating of A- from Standard & Poor's. Its annual profits have increased year-on-year since its flotation in 1996. Its profit attributable to shareholders in 2003 was around £240 million.

5.9 The acquisition of Cambridge was financed with equity contributed by CKI. At present therefore, Cambridge's capital structure remains as it was pre-acquisition.

5.10 Should CKI seek to change Cambridge's financial structure in future, we may need to review the proposals, particularly if they lead to a material increase in the level of debt in Cambridge. As the proportion of debt to equity is increased, the financial flexibility of the company and its ability to raise new debt is more limited. We would therefore need to be content that any future proposals for Cambridge would be sufficiently flexible to withstand any cost shocks and that it would enable Cambridge to access additional finance if necessary to undertake its capital investment requirements.

Ring fencing

5.11 Any activities of CKI group companies that could prejudice the financial and managerial viability of the regulated business 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.

5.12 Cambridge's current ring fencing provisions:

- require it to operate as if it were a separate company, to act solely in the interests of the water company and for its board to act independently of the parent company;

- require the new owner to give a legal commitment to facilitate the proper performance of Cambridge's functions;

- prohibit cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other company;

- require it to publish its results as if it were listed on the London Stock Exchange; and

- require it to ensure that its dividend policy avoids any adverse effect on the company's ability to finance its functions as a water undertaker.

5.13 Other water companies have similar ring fencing provisions. In addition to these, we have required companies that have been involved in corporate activity to have additional licence conditions requiring them to:

- maintain an investment grade corporate credit rating; and

- list a financial instrument on a stock exchange.

Most recently we have made these licence modifications for Anglian Water following its financial restructuring, for Mid Kent Water after its acquisition by Swan Capital Group and for Portsmouth Water after its acquisition by South Downs Capital. The presence of these conditions in companies' licences helps to reassure us that they remain in a position to finance their functions.

5.14 In Cambridge's case, there would be costs associated with these requirements as the company neither has nor requires a credit rating under its current financing arrangements and was not listed on any stock exchange before its acquisition by CKI. Cambridge is a small company that has maintained its low level of gearing (its debt as a proportion of its capital base) following its acquisition by CKI so we do not currently propose to introduce these or other new ring fencing conditions. However, we will review this if CKI seeks to change Cambridge's financial structure in the future.

5.15 We invite views on whether the ring fencing conditions described are adequate or whether further conditions are required to ensure that the regulated business remains appropriately ring fenced within the CKI group.

Management of the regulated water business

5.16 We want to ensure that Cambridge's acquisition by CKI does not compromise effective management of the regulated business. In response to previous consultation papers issued by Ofwat on mergers, concern was expressed about the loss of managerial effectiveness as a result of mergers.

5.17 CKI intends to retain Cambridge's existing management following the acquisition, leading to minimal impact on Cambridge's day-to-day business. Cambridge has one transitional arrangement with Union Fenosa, relating to IT services, which for continuity will run until the end of 2004.

5.18 CKI has appointed five directors to Cambridge's board to replace the previous five directors appointed by Union Fenosa. The remaining board members – three independent directors and the managing director – remain unchanged.

5.19 There are currently no plans by CKI to separate the ownership of Cambridge's assets from their operation through substantial outsourcing of the company's functions. Should it choose to do so in future, we might require further licence modifications, including modifications to ensure that the licence holder retains control of its outsourced functions, to enable it to meet its responsibilities as a water undertaker.

5.20 We are not proposing any further licence modifications in connection with the management of Cambridge.

Comparative information

5.21 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). We want to ensure that CKI's ownership of Cambridge will not adversely affect our ability to make those comparisons.

5.22 Because CKI has no other water interests in the UK, the initial acquisition does not involve the loss of an independently owned comparator for use in making regulatory judgements about efficiency and standards of services.

5.23 Cambridge was not listed on any stock exchange before the acquisition and there is therefore no loss of market information. Cambridge is already required to publish results as if it were listed on the Stock Exchange.

Prices and service standards

5.24 Customers will expect Cambridge to provide proper standards of service at appropriate prices irrespective of its ownership. Cambridge will continue to have the obligations imposed upon it by legislation (especially the WIA91 and Water Act 2003) and the conditions of its licence. We will continue to regulate Cambridge under those provisions.

5.25 Cambridge's existing price limits will remain unchanged from those determined by Ofwat at the 1999 periodic review, which allow it to maintain its service to customers. The acquisition by CKI will have no impact on our treatment of the company in the 2004 periodic review and future price limits will be set as for all other companies. Customers should be able to assume that a 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

5.26 We revised Cambridge's licence to enhance the ring fencing conditions when it was acquired by Union Fenosa in 2000. Consequently, we propose only to make limited changes to Condition P of Cambridge's licence to reflect its new ownership. Other than this, we do not believe that the acquisition raises significant regulatory issues and we are not proposing any further licence modifications at this stage. However, we would like to hear the views of others on whether they believe further licence modifications are necessary.

6. Responses to this consultation paper

6.1 We will discuss with CKI the issues noted above and we will seek appropriate commitments from CKI about our proposals for the modification of Cambridge's licence.

6.2 Responses to this consultation should be made in writing by no later than 14 July 2004 to:

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6.3 At the end of the consultation period, each response will be placed in Ofwat's Library for public inspection.