The Completed Acquisition of Swan Group by the Hastings Diversified Utilities Fund and the Utilities Trust of Australia and its impact on Mid Kent Water Limited

A Consultation Paper by Ofwat

April 2005

1. Purpose

This note describes the completed joint acquisition by the Utilities Trust of Australia (UTA) and Hastings Diversified Utilities Fund (HDUF) of Swan Group (Swan). Prior to the acquisition Swan was an intermediate holding company of Mid Kent Water Limited (Mid Kent Water), an appointed water undertaker regulated by Ofwat. The Office of Fair Trading is carrying out a separate consultation on whether the transaction has resulted in a relevant merger situation. 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 Mid Kent Water's licence.

UTA and HDUF announced on 14 February 2005 that they would each acquire a 50% interest in Swan through their acquisition company MKW Holdco 1 Ltd (MKW Holdco). UTA and HDUF confirmed completion of the acquisition 1 March 2005.

We invite views on the issues discussed in this paper, including:
- the capacity of UTA and HDUF to be the owners/controllers of a regulated water business; and
- the need for modifications to Mid Kent Water's instrument of appointment (its 'licence').

Respondents may also comment on any other issues relating to the acquisition that they believe are relevant. Responses to this consultation should be made in writing by no later than 5.00pm on Friday 20 May 2005 to:

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

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

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

2. Details of the acquisition

On 14 February 2005, UTA and HDUF announced that they were the successful joint bidders and would each acquire a 50% interest in Swan Group plc (now called Swan Group), then an intermediate holding company of Mid Kent Water. UTA and HDUF are both unit trusts in Australia. UTA is an unlisted entity and HDUF is listed on the Australian stock exchange. HDUF consists of three “stapled” trusts (i.e. investors hold a unit in each of the three trusts). The three trusts have an identical structure and ownership to each other. Hastings is the responsible entity for each of these three trusts. UTA and HDUF each invested approximately A$100 million (£41m) for their 50 per cent interests in Swan. UTA funded its share of the acquisition from its own equity sources. Westpac Banking Corporation (Westpac) provided bridging finance to HDUF for its share of the acquisition. HDUF expects to repay the bridge financing through the public offer of hybrid securities to be arranged and underwritten by UBS AG. The offer was announced on 15 March 2005 and closes on 3 May 2005.

Both funds are managed on a day to day basis by Hastings Funds Management Limited (Hastings). In the case of HDUF, Hastings is also its 'responsible entity' (i.e. trustee). This means that for HDUF, as well as being fund manager, Hastings is the legal title holder to the trusts’ assets and is HDUF’s decision making body. The trustee of UTA is Utilities of Australia Pty Limited (UofA). These governance arrangements are discussed further in the section 4 below on Licence modifications.

Hastings currently has A$3.2 billion (£1.3bn) funds under management. This includes approximately A$380m invested in HDUF and A$930m in UTA. Westpac, a large Australian commercial and retail bank, currently owns 51 per cent of Hastings and will acquire the remaining 49% by 30 June 2005.

Mid Kent Water is an appointed water undertaker, regulated by Ofwat. With an average regulatory capital value of £170.9m in 2003-04, it is the fourth largest of the thirteen water only companies in England and Wales. It supplies water to approximately 245,000 homes and business customers in and around Kent and part of East Sussex.

3. The statutory position on mergers

The Water Industry Act 1991 (WIA91) contains a special merger regime for mergers between water and sewerage companies. Under section 32 of WIA91 (recently amended by the Enterprise Act 2002 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. We understand that prior to the acquisition neither UTA nor HDUF had an interest in any water or sewerage companies in England & Wales.

In addition to those sector-specific merger provisions in 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; and
- the merger may result in a substantial lessening of competition within any market in the UK for goods or services.

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 in excess of £70 million. Swan's 2003-04 turnover was £48.2m. 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.

The OFT issued an Invitation to Comment on the acquisition on 1 April 2005, the responses to which informed the OFT's decision as to whether a relevant merger situation under WIA91 or EA02 had been created. The OFT announced on the 20 April 2005 that the acquisition did not constitute a merger under either WIA91 or EA02.

4. Regulatory issues arising from this acquisition

UTA and HDUF's capacity to be the owner of a regulated water company

Competition in ownership may stimulate existing owners to be more efficient in the services provided as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing owners. However, we have a duty to act in a way which we consider 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.

UTA was established in November 1994. It is an unlisted unit trust currently owned, in the main, by a number of Australian superannuation funds.
Its investment strategy broadly includes the following:

- to assemble a portfolio of unlisted infrastructure assets with monopoly characteristics;
- to influence management and asset performance through representation on the boards of companies it invests in;
- to seek return characteristics that have consistency in returns and low correlation with listed equities and property markets; and
- to achieve diversification across risk and stage of maturity within the infrastructure asset class.

HDUF was established to invest in utility infrastructure assets with a moderate risk profile and which offer predictable cash flows. It has been an Australian listed fund since December 2004. HDUF's current investments include the following pipelines in the Australian gas transmission network:

- Moomba to Adelaide Pipeline System
- South West Queensland Pipeline
- Pilbara Pipeline System
- South East Pipeline

Its target investments include:

- Gas transmission and distribution assets
- Electricity generation, transmission and distribution assets
- Hydro and wind power generation assets
- Water and other essential utilities
- Regulated and unregulated assets
- Australian and offshore assets (OECD)

UTA and HDUF have said that Mid Kent Water's management will not change as a result of the acquisition. This gives us further confidence that Mid Kent Water will continue to have the expertise necessary to conduct its business.

We are conducting our own investigations into the capacity of UTA and HDUF to be the owners of a regulated water company, including seeking references from the regulatory authorities relevant to their current investments. However, we also invite the views of others on this issue before forming an opinion.

Ring-fencing

Any activities of UTA or its trustee and HDUF or its responsible entity that could prejudice the financial and managerial viability of Mid Kent Water 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.

When Swan Capital Investments (SCI) acquired Mid Kent Holdings plc in 2001, the holding company of the then Mid Kent Water Plc (changed to Mid Kent Water Limited on 16 February 2005), we consulted on the regulatory issues involved in the new structure of the company. This included consultation on licence modifications designed to ensure that the regulated business is firmly ring-fenced within its new group. As a result, Mid Kent Water currently has the most up to date ring fencing conditions for a water undertaker. These licence modifications:

- require Mid Kent Water 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 Mid Kent Water to maintain an investment grade issuer credit rating;
- prohibit, without Ofwat permission, cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other companies in the group;
- require it to publish its results as if it were listed on the Stock Exchange; and
- require Mid Kent Water's dividend to avoid any adverse effect on the company's ability to finance its functions as a water undertaker.

Licence modifications

Condition P of Mid Kent Water's licence currently requires it to obtain from its ultimate holding company and ultimate controller, undertakings that they and other group companies:

- provide information;
- avoid actions that might interfere with Mid Kent Water's obligations as water undertaker; and
- ensure that at all times the Board of the Appointee contains not less than three independent non-executive directors.

These undertakings are designed to enable Mid Kent Water to continue to fulfil its obligations as a water undertaker. Where Mid Kent Water's ultimate controller or ultimate holding company changes, its current licence requires that these undertakings be provided by the new owner/controller.

The Australian Corporations Act and general fiduciary principles set out the governance arrangements for unit trusts established in Australia. These principles are important in determining which entity or entities under the new ownership structure should provide undertakings to Mid Kent Water under Condition P of its licence. The distinction made in Australian law between beneficial (economic) ownership and legal ownership has also been important.

In the case of HDUF, which is a fund listed on the Australian Stock Exchange, we have been advised that Hastings is its 'responsible entity'. This means that although Hastings has only a minimal economic interest in HDUF (and therefore ultimately Mid Kent Water), in its capacity as responsible entity it is the legal owner of HDUF's assets, is the decision making body for HDUF and is the manager responsible for the day-to-day administration of the fund. Similarly UofA, as trustee of UTA, is the legal owner of UTA's assets and is its decision-making body. The power to appoint directors to the board of Mid Kent Water's UK holding company (MKW Holdco) ultimately resides with Hastings and UofA. Each of UofA and Hastings is required by law in taking any action or decision to act only in the interests of the unit holders of UTA and HDUF respectively.

With regard to Westpac, it holds the economic interest in Hastings. However, under Australian law, Westpac is not deemed to control HDUF through its interest in Hastings. This is because Hastings does not have the necessary economic interest in HDUF – it is the legal not economic owner.

In light of the information presented to us above, we therefore accept that UofA and Hastings, in their capacities as trustee and responsible entity respectively, should be jointly regarded as Mid Kent Water's ultimate controllers so that they (as well as its UK holding company, MKW Holdco) should provide to Mid Kent Water the proposed Condition P undertakings as slightly revised to take account of this joint ownership structure. The text of Condition P will also need amending to reflect the new structure.

As a result the new owners have agreed to provide undertakings from UofA and Hastings as joint ultimate controllers, and MKW Holdco as the UK holding company, in place of Swan Capital Group Ltd. and Westdeutsche Landesbank Girozentrale. We have are in the process of securing the required undertakings.

5. The impact of the acquisition on the financing of Mid Kent Water

An important aspect of our assessment will be whether Mid Kent Water remains able to finance its functions as a water undertaker under HDUF's and UTA's joint ownership. We have recently concluded our review of price limits for 2005-10 which Mid Kent Water accepted.

The new owners intend to introduce new debt, at the parent level (ie MKW Holdco) through a £24m convertible loan facility. £6.8m of the proceeds has been injected as equity into Mid Kent Water and is being used to simplify the debt structure at Mid Kent Water by repaying Mid Kent Water's working capital facility (previously provided by SCI) and its redeemable debentures. The existing Artesian loan which makes up the majority of Mid Kent Water's debt is expected to remain in place. The convertible loan facility is currently drawn to £6.8m and is expected to be drawn to £11.7m at the end of May 2005. The acquisition should result in lower gearing at Mid Kent Water. We are reviewing the financial projections provided to us.

Should Hastings/UofA seek to significantly change Mid Kent Water'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 Mid Kent Water. 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 Mid Kent Water would be sufficiently flexible to withstand any cost shocks and that it would enable Mid Kent Water to access additional finance if necessary to undertake its capital investment requirements.

Effect on customers of the proposals

Ofwat can see no reason why the quality of service provided to Mid Kent Water's customers should deteriorate as a result of the transfer. UTA and HDUF acknowledge the need for adequate ring fencing of Mid Kent Water and for independent local representation on the Board of that company. The obligations imposed by the licence issued under the Water Industry Act 1991 and elsewhere in that Act would continue to apply.

Office of Water Services
21 April 2005