



**Position note on the acquisition of Swan Group  
by the Hastings Diversified Utilities Fund  
and the Utilities Trust of Australia**

June 2005

## **POSITION NOTE ON THE ACQUISITION OF SWAN GROUP BY THE HASTINGS DIVERSIFIED UTILITIES FUND AND THE UTILITIES TRUST OF AUSTRALIA**

The Utilities Trust of Australia (UTA) and Hastings Diversified Utilities Fund (HDUF) announced on 14 February 2005 that they would each acquire a 50% interest in Swan Group (Swan) through their acquisition company MKW Holdco 1 Limited (MKW Holdco). UTA and HDUF announced completion of the acquisition on 1 March 2005. Prior to the acquisition Swan was an intermediate holding company of Mid Kent Water Limited (Mid Kent), an appointed water undertaker regulated by Ofwat.

On 20 April 2005, the Office of Fair Trading cleared the acquisition without referring it to the Competition Commission. On 21 April 2005, we issued a consultation paper, '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.' The purpose of the paper was to consult on any regulatory issues arising from the acquisition and whether any modifications should be made to Mid Kent's instrument of appointment (its 'appointment').

This note sets out the issues raised by respondents and our position on those issues. Annex 1 lists the respondents.

### **Capacity of HDUF and UTA to be the owners of a regulated water company**

No concerns were raised by respondents on this issue.

WaterVoice Southern, which represents Mid Kent's customers, was reassured that our processes for establishing whether the new owners are fit to operate and control Mid Kent include references to the regulatory authorities in the sectors that HDUF and UTA currently operate.

The Australian Competition and Consumer Commission (ACCC) is the Australian competition regulator. In relation to HDUF and UTA, the ACCC has regulatory authority over their Australian airport, gas and electricity businesses. Whilst the ACCC informed us that it does not have a role in assessing the probity or the operational or financial capacity of these businesses, it did not identify any regulatory concerns with the management of the businesses under HDUF's and UTA's current ownership.

To ensure that Mid Kent Water has the co-operation of its owners in carrying out its functions, we inserted Condition P into the company's appointment when Swan Capital Investments acquired Mid Kent in 2001. This condition required the water company to obtain legally enforceable undertakings from its ultimate holding company and '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 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.

The undertakings state that the companies will:

- give Mid Kent any information it needs to comply with its appointment;
- refrain from any action that could cause Mid Kent to breach its appointment; and
- maintain a minimum of three independent non-executive directors on Mid Kent's board who have knowledge of the areas in which Mid Kent Water operates and an understanding of the interests of Mid Kent's customers and how these can be respected and protected.

Previously, Mid Kent Water had only one ultimate controller. However, the new ownership structure, in which UTA and HDUF each have 50% interests in Swan Group, means that for the purposes of Condition P Mid Kent Water has joint ultimate controllers. We are therefore proposing to change the wording of the Condition such that Mid Kent will have to obtain legally enforceable undertakings from its UK holding company and both its ultimate controllers.

Mid Kent Water has already obtained Condition P undertakings from its new ultimate controllers (Utilities of Australia Pty Limited and Hastings Funds Management Limited) and new UK holding company (MKW Holdco). The rationale for this was set out in our consultation paper. We received no different views on this.

WaterVoice Southern supported this proposed minor amendment to Condition P to accommodate the joint ownership structure. With regard to the requirement to maintain a minimum of three non-executive directors it expressed its wish that one of these had a customer care remit. Its concern is that the new board structure, with the customer service area of Mid Kent reporting to the Finance Director, could lead to a less customer focused business strategy. UTA and HDUF had acknowledged to us the need for adequate ring fencing of Mid Kent Water and for independent local representation on the Board of that company.

Condition P is designed to encourage the non-executives on the board collectively to consider the customer service aspects of the Appointee. We believe that this should provide at least the same benefits, if not more, than having one nominated customer 'champion'.

We believe this should reassure customers that Mid Kent's parents are committed to helping the water company continue to act in its customers' interests.

### **Effect on customers**

WaterVoice Southern commented that in recent years Mid Kent:

- provided a consistently good performance in most areas of customer service;
- aimed to provide a high quality service to its customers; and
- developed good links with the local community, local organisations and WaterVoice.

It does not wish to see any deterioration in this service. Furthermore, it believes that the challenges of balancing the demand for water with supply, especially in view of the projected increase in the company's customer base, requires long-term commitment from its owners in order to plan.

We would not expect the quality of service provided to Mid Kent's customers to deteriorate as a result of the transfer.

### **Complexity of the new ownership structure**

WaterVoice Southern noted that the new structure was fairly complex. We are satisfied that the existing licence conditions of Mid Kent, which were introduced when Swan Capital Investments acquired it in 2001, adequately ensure that Mid Kent is ring-fenced from the activities of other entities within the group.

### **The impact of the acquisition on the financing of Mid Kent Water**

WaterVoice Southern indicated that it looks to us to ensure that the financial arrangements put in place by HDUF and UTA do not have a detrimental impact on the customers of Mid Kent.

In our consultation paper we said we would need to assess whether Mid Kent Water remains able to finance its functions as a water undertaker under HDUF's and UTA's joint ownership. Mid Kent adopted a highly geared financial structure following acquisition by the Swan Group in 2001.

Since the acquisition Hastings has sought to simplify Mid Kent's debt structure by injecting cash to the value of £6.8m. This cash has been used to repay a working capital facility (provided by its previous owners) which was subordinated to existing debt raised through the Artesian financing vehicle. The existing Artesian debt is expected to remain in place.

We have reviewed a set of financial projections provided by Mid Kent. Amongst other things, they set out forecasts for gearing and cash-based financial ratios. These projections seem satisfactory and forecast an improved financial position compared to that achieved under the previous ownership.

We have also discussed the financial projections with the company in the context of licence Condition F6.12, which requires that the dividends declared by the company are in accordance with a dividend policy which has been

approved by the Board of the Appointee and which complies with the following principles:

- the dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business; and
- under a system of incentive regulation dividends would be expected to reward efficiency and the management of economic risk.

The company has confirmed that its new owners will ensure compliance with this Condition.

As part of its existing licence Mid Kent has a requirement to maintain an investment grade issuer credit rating. Under the terms of its bond Mid Kent is required to have a 'shadow' issuer rating which is indicative of the underlying credit quality of the water company. The credit rating agencies, Standard and Poor's and Moodys have recently completed reviews of Mid Kent and have confirmed an investment grade credit rating. This rating is not in the public domain but Mid Kent has confirmed that there has been no deterioration in credit quality.

### **Conclusion on licence modifications**

Other than the small changes to Condition P to accommodate the joint ownership structure already discussed, we see no need for additional licence modifications as a result of this transaction.

### **Next steps**

In accordance with Section 13 of the Water Industry Act 1991, we have issued a formal notice of our intention to modify Mid Kent's appointment by varying Condition P. We are not proposing any appointment modifications in addition to those highlighted in our April 2005 consultation paper.

## **ANNEX 1 – LIST OF RESPONDENTS**

### **WaterVoice**

WaterVoice Southern

### **Regulators**

Drinking Water Inspectorate

### **Water companies**

Folkestone & Dover Water Services Limited

Dŵr Cymru