



**The proposed takeover
of Thames Water plc
by RWE AG**

**A consultation paper
by the
Office of Water Services**

September 2000

THE PROPOSED TAKEOVER OF THAMES WATER PLC BY RWE AG
A CONSULTATION PAPER BY THE OFFICE OF WATER SERVICES

Background and purpose

1. On 25 September 2000, RWE AG ("RWE") announced an offer to acquire all of the issued share capital of Thames Water Plc, the holding company of Thames Water Utilities Ltd which is a licensed water and sewerage undertaker (the "Appointee").
2. The recommended cash offer values each Thames Water Plc ordinary share at £12.15 and the whole of the issued share capital at £4.3bn (including Thames Water Plc B shares). RWE also announced on 25 September 2000 that they have acquired 20% of the issued share capital of Thames Water Plc. As part of the offer RWE will assume all of Thames Water Plc's debt (approximately £1.8bn).
3. Thames Water Plc is the largest UK water and wastewater company serving approximately 12 million customers in the London and Thames valley area. The company is based in London and its shares are listed on the London Stock Exchange. As well as its water and sewerage business, Thames Water Plc has acquired a number of other businesses since being privatised in 1989 and is currently acquiring the US water company E'town.
4. RWE is one of Germany's largest utility companies with headquarters in Essen, Germany. The company is active in a number of sectors including energy, mining and raw materials, environmental services, petroleum and chemicals, industrial systems, construction and telecommunications. RWE is currently merging with VEW AG ("VEW"), a German regional gas and electricity provider. RWE, which is active in the supply of water and sewerage services in Germany, has acquired recently joint control of Berlin Wasserbetriebe (the Berlin water and sewerage company).
5. In order to provide advice to the Director General of Fair Trading ("DGFT") on the issues raised by the proposed takeover of Thames Water Plc by RWE, the Director General of Water Services ("the Director") welcomes views on the issues raised in this consultation document.

The regulation of mergers and takeovers

The European Commission dimension

6. Under the European Communities Merger Regulation¹ ("the Regulation"), a merger having a Community dimension should be appraised by the

¹ Council Regulation 4064/89 as amended by Council Regulation 1310/97

Commission of the European Union (“the Commission”) with a view to establishing whether or not it is compatible with the common market. Because of the parties’ combined worldwide and EC turnover, the proposed acquisition of Thames Water Plc by RWE appears to meet the relevant criteria for a merger having a Community dimension. The Commission has one month from the date of receipt of a complete notification to decide whether the merger raises serious doubts as to its compatibility with the common market and whether to initiate an in-depth investigation under Phase II of the Regulation.

Provisions for returning the case to the UK

7. The relevant authorities of the Member State (i.e. OFT and DTI) can make an application under Article 9 under competition issues or Article 21 citing ‘legitimate interest’ to request the Commission to refer a merger to it, setting out their reasoning for the request. The timetable for making a request and for the Commission to respond is set out in the Regulation (see annex 1 for further details on returning cases to the UK).

The role of the Regulators and Ministers

8. It is the responsibility of the DGFT to advise the Secretary of State for Trade and Industry (“Secretary of State”) whether he should seek the return of a case to the UK in order for the merger or acquisition to be considered under UK competition law. If a case is repatriated then the OFT will advise the Secretary of State whether the merger should be referred to the Competition Commission (either under the provisions of the Fair Trading Act or as a compulsory reference under the Water Industry Act 1991 (“Water Act”). Alternatively the DGFT could advise that instead of such a reference, it might be appropriate for the Secretary of State to seek binding undertakings from the new owners to remedy any adverse effects the DGFT has identified. If a case is returned, the provisions of the Fair Trading Act 1973 will automatically apply.
9. Where a merger proposal involves a regulated business, the DGFT seeks advice from the relevant Regulator (or Regulators in the case of a multi-utility), before advising the Secretary of State on aspects of the proposal that would impact on their ability to regulate the licence holder(s).
10. The Director needs to consider what advice he might give to the Government, with a view to Government drawing the attention of the Commission to matters relating to the merger. This paper sets out the key issues on which the Director believes he will need to advise. The Director invites the comments of interested parties about those issues. However, those responding should feel free to deal with whatever other aspects of the proposals they believe to be important. If the offer were to proceed, the Director would need to consider what modifications might be required to the licence held by Thames Water Utilities Ltd, in order to deal with the

regulatory issues arising from the takeover. Possible licence modifications are set out in this paper.

11. If the case is not returned to the UK then the Director can still be given dispensation by the Commission to seek licence amendments. This has been the case in previous mergers with a European dimension, most recently the acquisition of Hyder Plc by Western Power Distribution.
12. Section 32 of the Water Act provides that the Secretary of State must refer to the Competition Commission a merger between two water enterprises which fulfils asset value thresholds. RWE does not control any water enterprises in England or Wales and so the Water Act merger provisions do not apply in this case.

Duties of the Regulator

13. The duties of the Director are set out in the Water Act as amended and in competition legislation. The Director's duties are to ensure that companies properly carry out their functions and that they can finance the proper provision of those services. The Director also has duties to protect customers. The Director has further duties to promote efficiency and economy by the regulated businesses and to promote the efficient use of utility services by consumers. He also has duties to facilitate effective competition in the provision of utility services and (concurrently with the DGFT) to investigate and deal with anti-competitive behaviour on the part of licensed utilities such as Thames Water Utilities Ltd. These powers have been recently strengthened by the Competition Act 1998.
14. An important aspect of competition is in the market for ownership and control of those utilities. Competition in ownership may stimulate existing owners to be more efficient in the service provided as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.
15. Therefore, the Director accepts in principle that changes of ownership following takeovers may be beneficial. At the same time, because he is concerned that the functions of water and sewerage undertakers should be properly carried out, he wishes to be satisfied, in each particular case, that the prospective owner has the probity and operational and financial capacity to assume that role. This issue is of particular importance as RWE has no directly relevant experience of the provision and financing of UK water and sewerage services although it does own a small German water supply business and has an interest in the joint venture which owns Berlin Wasserbetriebe. Before the Director forms an opinion about RWE's standing, he wants to know the views of others in this respect.

Regulatory issues

16. Previous examples of takeovers like this one from outside the water and sewerage industry, include that by Enron Corp. ("Enron") for Wessex

Water Plc (“Wessex”) and more recently the purchase of Cambridge Water Plc (“Cambridge”), a small water only company, by Union Electrica Fenosa SA (“Union Fenosa”). The Director considers that the current offer does present similar issues to both the Enron/Wessex and Union Fenosa/Cambridge cases and other previous mergers and invites comments on the proposed measures which are set out below.

Comparative information

17. One of the Director’s most important tools for the regulation of water and sewerage companies is the ability to make comparisons between them (comparative competition). When advising DGFT, the Director will assess whether RWE’s prospective ownership of Thames Water Plc might adversely affect his ability to make those comparisons.
18. Thames Water Plc’s shares are listed on the London Stock Exchange (the “Stock Exchange”). If it is taken over by RWE, that listing will cease. The de-listing of Thames Water Plc’s shares would also disapply the Stock Exchange’s public disclosure rules and remove its performance from scrutiny by the public, City analysts and shareholders. It would reduce the Director’s ability to form a judgement about how the financial markets perceive Thames Water Plc and its operations, of which the Appointee’s activities are a major component. That in turn would remove the Director’s ability to compare the market’s ratings of Thames Water Plc with other listed owners of licensed water and sewerage utilities. It would also affect his ability to make judgements about an appropriate cost of capital for the water and sewerage industries.
19. It would also reduce to 4 (from the original 10) the number of listings of water and sewerage companies (excluding multi-utilities). As listings are lost the value of those remaining becomes greater. It should be noted in this context that Thames Water Plc is the largest water and sewerage company in England and Wales.
20. These detriments might be remedied in one of several ways. First, the Appointee could agree to licence modifications to publish financial information as if it were listed and subject to the rules of the Stock Exchange. Further RWE might agree to re-list its UK water interests on the Stock Exchange in the near future. It might alternatively list a class of equity, which would provide investors with a return related to the Appointee’s performance, as well as financial information for them and the Director. A further possibility is the listing of preference shares, bonds or other financial instruments in the Appointee’s holding company, which would provide some market information, albeit less than would a listing of equity.
21. Apart from this prospective loss of stock market information, the proposed merger would not involve the loss of a comparator for use in making regulatory judgements about efficiency and standards of services, but the

regulated business would represent a smaller part of a far larger group. The proposed arrangements for access to information and ring-fencing, discussed below (see paragraphs 25 to 26 and 30 to 31), would help to secure continued comparability.

Financing of functions

22. RWE is already an international operation. Its exposure in other ventures in other parts of the world may mean that, if it suffered a sufficiently severe reverse elsewhere, its response might impede or diminish the Appointee's financial capacity. Anything which could prejudice the financial viability of the Appointee would be of concern to the Director.
23. These concerns could be dealt with by licence modifications on ring-fencing, management and dividend policy, similar to those agreed in the Enron/Wessex and Union Fenosa/Cambridge takeovers.
24. It should be noted that, following the announcement of RWE's offer to purchase Thames Water Plc, Standard & Poor's (a leading credit rating agency) affirmed its credit rating on the borrowings of RWE as AA- and revised the creditwatch implications on Thames Water Plc (current corporate credit rating A+) and its subsidiaries from developing to positive. Following RWE's announcement Moody's Investor's Services (another leading credit rating agency) also confirmed RWE's rating (Aa3 long term) and has put under review for possible upgrade the (long term) debt ratings of Thames Water Plc (A2), Thames Water Utilities Ltd (A1) and E'town (A2). These credit ratings are well within the investment grade category².

Ring-fencing of the Appointee's core businesses and assets, including management resources

25. The Director is considering whether RWE's prospective ownership of Thames Water Plc (and therefore, its control of the Appointee) calls into question the adequacy of the ring-fencing arrangements around the Appointee's core water and sewerage businesses. Ring-fencing arrangements are seen as necessary to enable effective regulation of the water utility in a wider group. Such ring-fencing arrangements were introduced into the licences of Wessex and Cambridge when they were acquired by Enron and Union Fenosa respectively. Ring-fencing arrangements are also seen as important in other regulated industries. It is Ofgem's policy to include standardised financial ring-fencing conditions in the licences of all the principal national and regional energy network companies. Such conditions presently apply to all public electricity suppliers in England and Wales and to BG Transo's gas transportation business.

² Investment grade rating: An assessment by credit rating agencies of the likelihood of the business being able to meet its financial obligations. There are two ranges of ratings, investment grade and non-investment grade.

26. The Director believes that if RWE's offer were to be successful, the ring-fence around the Appointee's core business and assets ought to be strengthened by means similar to those employed in those earlier cases. For example:

- The Appointee's trading with other parts of the RWE's enlarged group should be at arm's length and be subject to market testing. The Appointee's Board should certify annually to the Director that the terms of all such contracts safeguard the Appointee's ability to perform its core functions and achieve proper standards of service;
- The Appointee should be prohibited from offering financial support to other parts of the RWE group (whether by guarantee or loan or equivalent) without the Director's consent. It should also be prohibited from taking up loans which contain cross-default covenants;
- The Appointee's ability to finance its functions might be further safeguarded by requiring RWE to agree that all loan facilities made available to the Appointee or the Appointee for the purposes of Appointee's core businesses should secure and retain investment grade credit ratings, or an equivalent. An alternative approach would be to introduce a licence condition that requires the Appointee at all times to maintain an investment grade issuer credit rating; and
- The Appointee should be required to obtain from RWE an undertaking that the latter would provide to the Appointee all information about other activities which the Appointee might be required to provide to the Director for the purposes of his supervision of the Appointee's core businesses and that RWE would ensure that no group company did anything which might result in the Appointee breaching any of its statutory or licence obligations as a water or a sewerage undertaker.

Management of the Appointee's water and sewerage undertakings

27. Thames Water Plc's acquisition by the RWE group should not compromise the effective management of the Appointee. In response to previous consultation papers issued by the Director on mergers, concern was expressed about the loss of managerial effectiveness as a result of the merger.

28. Furthermore, the Director needs to know where key decisions are taken and to have a close relationship with the Board who will be taking those decisions. This in turn raises the question of where the licence is held. The Director considers that the licence should be held where the key decisions are taken and if the licence holder is a subsidiary company, it should be able to demonstrate an adequate degree of independence and that its directors have clear responsibilities for regulatory matters. Ofwat understands from RWE that, following the takeover of Thames Water Plc, the Appointee will remain a separate subsidiary of the new Thames Water group of companies.

29. In previous mergers, the Director agreed licence amendments which strengthened the management independence of the water utility as follows: -

- The Appointee should be required to conduct its core businesses as if it was substantially the sole business undertaken and it was a separate public limited company;
- The composition of the Board should be such that it could act independently of the parent, the directors of the Appointee should act exclusively in the interests of the water utility if conflicts of interest arose and that they should not vote on contracts where they have interests by virtue of other directorships;
- The Appointee's dividend payments should not exceed amounts which would, in the Director's opinion, preserve its ability to continue to discharge its water and sewerage utility functions and to finance them; and
- The Appointee should be required to obtain from its ultimate parent company an undertaking to ensure that the appointee's Board contains at least three non-executive directors of standing and having relevant experience in the recognition and protection of customers' interests.

Access to information

30. The Director has powers to require information from regulated companies about their regulated activities. He needs to secure continued access to sufficient high quality information to allow him to carry out his duties.

31. The task of obtaining information on the water utility could be made more difficult by the merger. Licence amendments will be necessary, as in the case of earlier mergers, to ensure sufficient access to information from any company within the enlarged group. This involves information both on present performance and on that needed for future reviews of price limits.

The need for licence modifications

32. The Director will wish to consider whether it will be appropriate to propose modifications to the Appointee's licence to incorporate the measures outlined above, or whether additional or alternative measures might better safeguard the interests of customers and the Director's ability to discharge his functions. Furthermore, he wishes to know whether there are any other such matters that require similar treatment.

Prices and service standards

33. Customers will look to the Director to ensure that the Appointee's core businesses continue to provide requisite standards of service at

appropriate prices. Irrespective of the ownership of Thames Water Plc, the Appointee will continue to have the obligations imposed upon it in primary legislation (especially the Water Industry Act 1991) and the conditions of its Appointments as a water and a sewerage undertaker. The Director will continue to regulate the Appointee under those provisions. The Appointee's existing price limits will remain unchanged from those set out in the 1999 Periodic Review which allow it to maintain its service to customers. Customers should be able to assume that a change of ownership makes no difference. The Director will exercise his powers to that end.

Responses to this consultation paper

34. The Director will formulate his advice to the DGFT. To meet the latter's timetable for advising the Commission, responses to this consultation should be made by Friday 20 October 2000.
35. The Director will also discuss with RWE the issues noted above. He will seek from RWE appropriate commitments about his proposals for the modification of Appointee's licence, to deal with his concerns, as noted earlier in this paper. He will reflect the outcome of those discussions in his advice to the DGFT.
36. Responses to this consultation paper should be sent to Keith Mason, Head of Regulatory Accounts, Office of Water Services, Centre City Tower, 7 Hill Street, Birmingham B5 4UA (keith.mason@ofwat.gsi.gov.uk or fax 0121 625 3609). Each response will be placed in Ofwat's Library for public inspection, unless it is clearly marked "in confidence".
37. A copy should also be sent to Ms Teresa Krajewska at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX.

Keith Mason
Head of Regulatory Accounts
Office of Water Services

Annex 1

Provisions for returning the investigation to the UK

Article 9 of the Regulation provides for the Commission to refer a merger to the competent authorities of a Member State where:

- a) a concentration threatens to create or to strengthen a dominant position as a result of which effective competition would be significantly impeded in a market within that Member State, which presents all the characteristics of a distinct market; or
- b) a competition in a market within that Member State which presents all the characteristics of a distinct market and which does not constitute a substantial part of the common market.

The competent authorities of the Member State can also make an application under Article 9 to request the Commission to refer a merger to it, setting out its reasoning for the request. The timetable for making a request and for the Commission to respond is set out in the Regulation.

If a merger is referred back to the Member State under Article 9, the Member State may take only measures strictly necessary to safeguard or restore effective competition in the market concerned. Unless the Commission decides to refer the merger to the UK, the UK will be precluded from applying its national legislation on competition to the merger. The Commission then has exclusive jurisdiction to determine whether the proposed acquisition, with or without conditions, does or does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or a substantial part of it and accordingly whether it is or is not compatible with the common market.

Article 21 of the Regulation provides for a Member State to take appropriate measures to protect legitimate interests other than those taken into consideration by the Regulation.

Article 21 provisions were employed by the UK in 1995, when Lyonnaise des Eaux SA announced its intention to purchase Northumbrian Water Group Plc, in order to merge their respective water businesses in the North East of England. In this case the UK government made a successful application for the recognition of a legitimate interest in relation to sections 32 to 34 of the Water Industry Act 1991 as amended by the Competition Service (Utilities) Act 1992.

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