



**THE PROPOSED ACQUISITION OF  
MID KENT HOLDINGS PLC  
BY SWAN CAPITAL INVESTMENTS**

**A consultation paper by Ofwat**

March 2001

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# **1. INTRODUCTION**

## **Purpose of this document**

1.1 This document:

- Describes the proposed acquisition of Mid Kent Holdings plc (MKH) by Swan Capital investments (Swan);
- Explains the statutory position on mergers; and
- Sets out the regulatory issues and requests comments on Ofwat's assessment of these issues.

1.2 Ofwat will make recommendations to the Director General of Fair Trading (DGFT) in relation to this merger. In order to allow comments to be considered by Ofwat, responses to this paper are required by no later than 5pm on Monday 9 April 2001.

## **2. DETAILS OF THE PROPOSED ACQUISITION**

- 2.1 On 8 March 2001, Swan announced that it had made a recommended offer to acquire all of the issued share capital of MKH, the holding company of Mid Kent Water Ltd (Mid Kent Water), which is a licensed water undertaker.
- 2.2 Mid Kent Water supplies water to approximately 235,000 customers in the Kent area in the south east of England. MKH is based in Snodland, Kent and its shares are listed on the London Stock Exchange (the Stock Exchange). As well as its water business, MKH also owns a number of unregulated businesses.
- 2.3 Swan is a subsidiary of Swan Capital Group Limited (Swan Capital), a privately-held acquisition vehicle set up by Westdeutsche Landesbank Girozentrale (WestLB) specifically for the purpose of acquiring MKH. Finance for the offer and for Mid Kent Water's future working capital and capital expenditure requirements is being provided by WestLB.
- 2.4 Under the proposals, Swan would significantly increase the levels of borrowing in MKH. It will retain a small element of equity, which will be held principally by MKH's management and employees and WestLB. This equity will not be listed on any stock exchange.
- 2.5 Swan has indicated that it has no present intention to restructure the regulated water business of Mid Kent Water. Should it choose to do so in future then Ofwat might require further licence modifications, including modifications to ensure that the licence holder retains control of out-sourced functions, to enable it to meet its responsibilities as a licenced water undertaker.

### **3. THE STATUTORY POSITION ON MERGERS**

- 3.1 Neither Swan, nor WestLB currently controls any water enterprises in England & Wales. Therefore, the Secretary of State for Trade & Industry (the Secretary of State) is not required to refer the offer to the Competition Commission (the Commission) as a merger of water enterprises under the Water Industry Act 1991 (The Water Act).
- 3.2 However, the offer by Swan does give rise to a qualifying merger situation under the Fair Trading Act 1973 (FTA). Under the FTA, the Secretary of State may refer a proposed merger or acquisition to the Commission. The Secretary of State has indicated that he would normally only make such references on competition grounds and on the advice of the DGFT.
- 3.3 It is the responsibility of the DGFT to advise the Secretary of State whether such a reference should be made (or whether instead of a reference, it might be appropriate for the Secretary of State to seek undertakings from the new owners to remedy any adverse effects which the DGFT has identified). Where a merger proposal involves a water company, the DGFT will seek advice from Ofwat, before advising the Secretary of State, on aspects of the proposal which would impact on Ofwat's ability to regulate the licence holder.
- 3.4 If the Secretary of State refers Swan's offer to the Commission, it must consider whether the take-over is likely to have effects adverse to the public interest. If the Commission so concludes, the Secretary of State may either prohibit the take-over, or seek remedies. If the Commission makes no adverse public interest finding, the offer may proceed.
- 3.5 If the offer were to proceed, Ofwat would need to consider what modifications might be required to the licence held by Mid Kent Water, in order to deal with the regulatory issues arising from the take-over. Proposed licence modifications are discussed in this paper.

## **4. REGULATORY ISSUES ARISING FROM THE PROPOSED ACQUISITION**

4.1 If Swan is successful in acquiring MKH, this will be the first acquisition of its type by a dedicated financial vehicle. However, the unsuccessful offer by St. David Capital plc (a financial vehicle established by the Principal Finance Group of Nomura International plc) for Hyder plc in April 2000, the parent company of Dŵr Cymru Cyfnegdig, which was the subject of a joint consultation by Ofwat and Ofgem, gave rise to similar issues. Moreover, there have been a number of take-overs by parties with no prior involvement in the water sector, where similar issues were relevant, including Azurix Europe plc's acquisition of Wessex Water plc in 1998, RWE's recent acquisition of Thames Water plc and the recent proposals for the acquisition of Dŵr Cymru Cyfnegdig by Glas Cymru Cyfnegdig.

4.2 Ofwat considers that the proposal raises concerns about five issues:

- Financing of Mid Kent Water's functions;
- Incentives for ongoing efficiency;
- Ring-fencing of the regulated business;
- Comparative information; and
- Management of Mid Kent Water.

Each of these issues is discussed below.

### **Financing of Mid Kent Water's functions**

4.3 Swan intends to increase the levels of borrowing in Mid Kent Water to 95% of its Regulatory Capital Value, leaving only a small amount of equity which will be owned by MKH's management and employees and WestLB. Because the small element of equity in the company would not be publicly listed Swan would have no recourse to the equity markets should it encounter financial difficulties. Ofwat will therefore need to assess whether the structure is sufficiently flexible to withstand any cost shocks.

4.4 Swan intends that most of the risk in the structure will be borne by the providers of the 'mezzanine facility' which will in the first instance be WestLB. Mezzanine finance is a form of debt, which is subordinated to senior debt – that is, it carries a greater risk of default in the event of financial difficulties. Swan believes that this tranche of mezzanine finance will provide an effective enhancement of the equity buffer, protecting customers from risk. Ofwat would welcome views on whether the proposed financial structure may be expected, over the longer term, to prove sufficiently robust to withstand cost shocks.

## **Incentives for ongoing efficiency**

- 4.5 The water companies have become more efficient following privatisation as a result of the combined pressure from shareholders and the system of incentive-based regulation under which they operate.
- 4.6 Swan will retain an element of equity but this will be much smaller than in other water companies and will be held principally by management and employees of the company and WestLB.
- 4.7 Management will be investing their personal assets to acquire an equity stake in the company. Swan believes that this will provide management with very strong incentives to drive the efficiency of the company. However, the equity holdings of management will represent a relatively small part of the overall consideration. Ofwat also believes that these incentives should be not only financial but related to maintaining and improving the service standards.
- 4.8 The principal source of risk capital in the structure will be the mezzanine finance, which will be held initially by WestLB. WestLB will also hold warrants (giving it the right to acquire stock at a given price) over a significant minority of Swan's equity. It will therefore have a substantial interest in the overall success of the regulated business and the outperformance of regulatory targets, unlike ordinary providers of debt who are concerned principally with repayment of their interest and capital.
- 4.9 Swan believes that the pressure from WestLB, as holders of material levels of risk capital and warrants, combined with the incentives of management to recoup their personal investments, should provide strong pressure for efficiency.
- 4.10 Ofwat would welcome the views of others on whether these measures provide equivalent incentives to those under the conventional shareholder model.

## **Ring-fencing of the regulated business**

- 4.11 In mergers involving a change of ownership, Ofwat has sought licence modifications to strengthen the existing ring-fencing provisions in companies' licences. These are conditions designed to enable Ofwat to regulate effectively the water utility within a wider group and to provide re-assurance that it remains able to finance its regulated activities. Although Mid Kent Water would not be part of an extended group under Swan's proposals, its proposed financing structure poses analogous potential threats to its financial position. Ring-fencing arrangements are also seen as important in other regulated industries. For example, 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 & Wales and to Transco's gas transportation business, and will shortly take effect in National Grid Company's transmission licence.

- 4.12 Therefore, Ofwat will expect Mid Kent Water to agree licence modifications designed to ensure that a proper ring-fence is maintained around the regulated business. These modifications would prevent Mid Kent Water from:
- raising finance for the regulated business on terms that included cross-default provisions;
  - holding or acquiring investments of any kind except those connected with the carrying out of its activities as a water undertaker; and would
  - require Mid Kent Water to use all reasonable endeavours to maintain an investment grade corporate credit rating.

### **Comparative information**

- 4.13 One of Ofwat'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, Ofwat will assess whether Swan's prospective ownership of MKH might adversely affect its ability to make those comparisons.
- 4.14 MKH's shares are listed on the Stock Exchange. If it is taken over by Swan, that listing will cease. The de-listing of MKH's shares would also disapply the Stock Exchange's public disclosure rules and remove its performance from scrutiny by the public, City analysts and institutional shareholders.
- 4.15 It would reduce the Director's ability to form a judgement about how the financial markets perceive MKH and its operations, of which Mid Kent Water's activities are a major component. That in turn would remove the Director's ability to compare the market's ratings of MKH with other listed owners of licensed water companies. It would also affect his ability to make judgements about an appropriate cost of capital for the water companies. It would further reduce the number of listings of water companies and as listings are lost, the value of those remaining becomes greater.
- 4.16 However, the low frequency of trading in MKH's shares means that this is not as great a detriment as in the case of the owner of a larger water and sewerage company. Swan has indicated that it intends to maintain a listing of a bond or other financial instrument, which would provide some market information, albeit less than would a listing of equity.
- 4.17 In addition, Ofwat would require Mid Kent Water to agree to a licence modification requiring it to publish financial information as if it were listed and subject to the rules of the Stock Exchange.
- 4.18 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.

## **Management of Mid Kent Water**

- 4.19 It is important that MKH's acquisition by Swan should not compromise the effective management of Mid Kent Water. Ofwat considers that the licence for a water undertaker should be held where the key decisions are taken. If the licence holder is a subsidiary company it should be able to demonstrate an adequate degree of independence and its Directors should have clear responsibilities for regulatory matters.
- 4.20 In previous mergers Ofwat has agreed licence modifications which strengthened the management independence of the water company as follows:
- the water company 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 water company should act exclusively in the interests of the water company if conflicts of interest arose and should not vote on contracts where they have interests by virtue of other directorships;
  - the water company's dividend payments should not exceed amounts which would, in the Director's opinion, preserve its ability to continue to discharge its water utility functions and to finance them;
  - the water company 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; and
  - the board of the water company should be required to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the Listing Rules of the UK Listing Authority.
- 4.21 These modifications reflect current best practice in terms of the licence conditions.

## **Prices and service standards**

- 4.22 Customers will look to Ofwat to ensure that Mid Kent Water is able to provide requisite standards of service at appropriate prices irrespective of the ownership of MKH. Mid Kent Water will continue to have the obligations imposed upon it by legislation (especially the Water Act) and the conditions of its Appointment as a water undertaker. Ofwat will continue to regulate Mid Kent Water under those provisions. Its existing price limits will remain unchanged from those determined by the Competition Commission following the 1999 Periodic Review, which allow it to maintain its service to customers. 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 they receive. Ofwat will exercise its powers to that end.

### **The need for licence modifications**

- 4.23 Ofwat will wish to consider whether it will be appropriate to propose modifications to Mid Kent Water's licence to incorporate the measures outlined above, or whether additional or alternative measures might better safeguard the interests of customers and Ofwat's ability to discharge its functions. Respondents may believe that there are other matters that require similar treatment.

## **5. RESPONSES TO THIS CONSULTATION PAPER**

- 5.1 Ofwat will discuss with Swan the issues noted above. We will seek appropriate commitments from Swan about our proposals for the modification of Mid Kent Water's licence, to deal with the issues discussed in this paper.
- 5.2 On the basis of those discussions and responses to this consultation paper, Ofwat will formulate our advice to the DGFT. To meet the DGFT's timetable, responses to this consultation should be made in writing by no later than 5pm on Monday 9 April 2001 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](mailto: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 it is clearly marked "in confidence". A copy should also be sent to Graham Winton at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX (Fax: 020 7211 8504; E-mail: [graham.winton@oft.gov.uk](mailto:graham.winton@oft.gov.uk)).

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