

The Completed Acquisition of Northumbrian Water Limited

A Consultation Paper by Ofwat



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1. Introduction

- 1.1 In this document we describe the recently completed acquisition of Northumbrian Water Limited (Northumbrian Water) by Aquavit plc (now Northumbrian Water Group plc) and set out the regulatory issues associated with the transaction.
- 1.2 We invite views on the issues discussed including the financing of Northumbrian Water, the new owner's capacity to be the owner of a regulated water business, the current arrangements for the ring-fencing of the licensed water business, whether incentives to efficiency have changed and the need for further modifications to Northumbrian Water's licence. Respondents may also comment on any other issues relating to the acquisition that they believe are relevant.
- 1.3 On the basis of responses to this consultation and further analysis of the proposed financial structure, we will review whether the imposition or modification of licence conditions, is required. We will announce our conclusions following consultation.

2. Details of the completed acquisition

- 2.1 On 17 May 2003, Aquavit plc announced that it had agreed to purchase 75% of the share capital of the parent company of Northumbrian Water. The former owner of Northumbrian Water, Suez, will retain the remaining 25%. Aquavit plc completed the acquisition on 23 May 2003 and changed its name to Northumbrian Water Group plc (NWG plc).
- 2.2 Northumbrian Water is a licensed water and sewerage undertaker supplying water and sewerage services to a population of approximately 2.6 million in the North East of England and water services to a population of approximately 1.7 million in Essex and Suffolk. Northumbrian Water owns Kielder Water (Kielder), the largest man-made reservoir in Europe, which it operates on behalf of the Environment Agency on a long-term agreement. Kielder is not presently part of the regulated business.
- 2.3 As well as its water business, NWG plc owns a number of small non-regulated businesses.
- 2.4 NWG plc is a company formed for the purposes of this acquisition that initially comprise a group of about 25, mainly British, institutional investors. A consortium including stockbroker Collins Stewart and financial advisors Deutsche Bank and Ecofin arranged the acquisition. Deutsche Bank provided the initial finance for the acquisition and remains a lender to the new company.
- 2.5 On 23 May 2003 NWG plc was admitted to a listing on the Alternative Investments Market of the London Stock Exchange (AIM), which means that shares in the company can be publicly traded. It is intended to seek a full listing on the London Stock Exchange in due course.
- 2.6 Prior to the acquisition the new owners did not control or materially influence any water company 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 companies under the Water Industry Act 1991 (WIA91).
- 2.7 Should the acquisition give rise to a qualifying merger situation under the Fair Trading Act 1973 (FTA)¹ the Office of Fair Trading (OFT) will invite views on whether there are any competition concerns arising from the merger.

¹ The merger provisions of the Enterprise Act 2002 are due to come into force shortly. The provisions formalise the competition-based test for assessing whether a merger should be referred to the Competition Commission for investigation. In addition they transfer decision making from the UK government to the OFT and Competition Commission in the majority of circumstances.

- 2.8 We would expect consultees to respond direct to the OFT on this issue. Our view is that the merger does not give rise to any competition concerns, but these, if there are any, are a matter for the OFT.
- 2.9 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 Northumbrian Water's licence.

Regulatory issues arising from the acquisition

3.1 The financing of Northumbrian Water

3.1.1 An important aspect of our assessment will be whether Northumbrian Water, under NWG plc's ownership remains able to finance its functions as a water and sewerage undertaker, including funding its current and future capital investment programmes.

New Equity Listing

3.1.2 This is the first time that an acquisition in the water industry has been partly financed by the issuing of listed equity. Shareholder equity can play an important role as a spur to greater efficiency and as a cushion against external events.

3.1.3 At a time when many have argued that the appetite of equity investors to invest in the water industry appeared to have diminished, we regard the ability of NWG plc to issue new equity as a positive endorsement of the fundamental investment attractions of the industry.

Gearing

3.1.4 Nonetheless, the proportion of equity in the business is not significantly greater than has been seen in other thin equity structures. The value of the equity investor's contributions equates to around £520m, of which 25% remains with Suez. This is equivalent to around 24% of the Regulatory Capital Value² (RCV) of Northumbrian Water. The value of the new equity amounts to some £344 million (net of costs). The remaining finance for the group as a whole comes from debt, with the total group net debt (£1.7 billion) being equivalent to around 80% of Northumbrian Water's RCV. The acquisition has resulted in an additional £536 million of net debt at the group level.

3.1.5 The gearing of the regulated business (including some £352m of this group debt raised for and guaranteed by the regulated business) remains the same as a result of this acquisition at 63% of the RCV³.

3.1.6 On the face of it, therefore, the position of the regulated business, in terms of its ability to finance its functions, should not be significantly different from before the transaction.

² The Regulatory Capital Value is the capital base used in setting price limits; £ 2,170 million at 31 March 2003

³ Ofwat has no plans to include Kielder in Northumbrian Water's RCV but if it were included it might increase the RCV by some 8% compared to the current level (on the basis of Northumbrian Water's valuation of Kielder).

- 3.1.7 However, the holding company of Northumbrian Water has additional net debt, currently amounting to some £321m, the level of which has increased following this transaction. This additional debt is supported by the free cashflow from the Northumbrian Water regulated business, from Kielder and from its non-regulated sister companies (which also have their own borrowings amounting to £60m). For 2001-02 the regulated business accounted for all of group profits.
- 3.1.8 It is therefore understandable that, in considering the financial position of the regulated entity Northumbrian Water, investors and other stakeholders such as the ratings agencies will take into account the debt at the holding company level as well as debt issued directly by the regulated business.
- 3.1.9 Specifically, the level of debt at the holding company has been taken into account by the credit rating agency Standard & Poor's in assigning a credit rating to the regulated business. It is therefore appropriate to consider the effect of the overall structure on the ability of Northumbrian Water to finance itself.
- 3.1.10 Whilst the licence of Northumbrian Water has ring-fencing provisions designed to protect the regulated business from risks associated with the activities of other group companies (these are summarised in Annex 1), Standard & Poor's has published its view that this, on its own, is not sufficient to isolate the water company from the activities and financial exposure of its parent.
- 3.1.11 Accordingly, following completion of the acquisition Standard & Poor's downgraded the corporate credit rating of Northumbrian Water from A- to BBB (a drop of two notches). There are none of the features of other highly leveraged structures such as restricting access by other group companies to assets or cashflows, and inter-creditor agreements that have, in the opinion of Standard and Poor's, supported the credit quality of the regulated business in those cases.
- 3.1.12 Furthermore some of the existing debt at the holding company has been downgraded from BBB+ to BB+ by Standard and Poor's, below investment grade status. The extent of the downgrade (three notches) reflects Standard & Poor's concerns that the acquisition debt provided by Deutsche Bank, of which £160m remains outstanding, has been secured by a pledge of the shares of Northumbrian Water and this ranks ahead of the existing unguaranteed debt.
- 3.1.13 Moreover Standard & Poor's take the view that the relatively weak credit rating assigned to Northumbrian Water increases the risk of regulatory intervention to prevent the use of Northumbrian Water's cashflows to service this debt. Whilst not directly a concern to the regulated business, because this debt is not guaranteed by it, this downgrading may effect market sentiment towards the group as a whole and may limit the regulated business's access to finance in the future. Following Standard and Poor's downgrade, some existing bondholders have questioned whether NWG plc will be able to refinance the £200m unguaranteed bonds of Ondeo Services UK due in 2006 on comparable terms to

those that apply to the existing bonds. In the absence of a further injection of equity this is likely to significantly reduce the group's financing flexibility.

- 3.1.14 Fitch IBCA's indicative rating of Northumbrian Water is marginally more favourable at BBB+. This rating is subject to a review of the final documentation. Fitch IBCA has also maintained an investment grade credit rating (BBB-) for the holding company debt.
- 3.1.15 NWG plc has said it intends to refinance the remaining acquisition debt which is the principal reason for the ratings downgrade of the holding company debt. Until these proposals are forthcoming we will have to consider the acquisition on the basis of the present position.

Regulatory Implications

- 3.1.16 In setting price limits we assume that companies are able to maintain a financial profile consistent with a credit rating comfortably within the investment grade category to ensure that they maintain the ability to access the public capital markets readily and on reasonable terms.
- 3.1.17 Given the nature of the present financing arrangements we would, as a minimum modify Northumbrian Water's ring-fencing licence conditions to bring them up to the current standard. This would require only two modifications – the first of which requires Northumbrian Water to maintain an investment grade corporate credit rating. The purpose of this licence condition is to assist the company with raising capital in the future. In addition it is designed to provide us with an early signal if the company's ability to raise future finance is at risk. The second licence modification would require the listing of a financial instrument on the London stock Exchange or an exchange of similar standing (detailed in Section 3.5 Comparative Information).
- 3.1.18 Northumbrian Water's current BBB rating is investment grade and would therefore comply with the our proposed licence condition requirement, However it is not clear whether the BBB rating will allow Northumbrian Water to access the debt markets on reasonable terms in order to finance the business going forward. In particular where general market conditions are unfavourable, access to credit markets for those companies with weaker credit ratings is likely to be more limited. However the apparent success of the equity listing may mean that Northumbrian Water will be able to raise new equity.
- 3.1.19 ***We would particularly like to hear the views of debt investors on Northumbrian Water's ability to raise future finance and the impact of this acquisition on the debt market for water as a whole.***
- 3.1.20 Taking these views into account, Ofwat will need to consider whether it is necessary to require any further licence conditions in order to protect the regulated business following the credit rating downgrades.

3.1.21 In other structures, credit ratings have been supported by the introduction of specific covenants designed to isolate the cashflows of the regulated business and minimise the risk that its financial position could be destabilised by higher risk activities conducted elsewhere in the group or by the instability of its holding company.

3.1.22 Northumbrian Water's licence currently has a condition requiring that it shall declare or pay dividends only in accordance with a dividend policy that will not impair the ability of the regulated business to finance itself. It is for Ofwat to decide if this test has been met. The majority of water companies have this condition.

3.1.23 ***We are asking for views on whether further strengthening of the regulatory ring-fence is required, e.g. to restrict the ability of the regulated business to make its free cashflow available to the wider group, in particular circumstances and hence enhance the protection around the regulated cashflows.***

3.1.24 This restriction of cashflows could be achieved by various means. For example:

- Greater clarity in the company's licence that cashflows are prioritised for the use by the regulated business; or
- The introduction of "cash lock-up" provisions, triggered under particular circumstances.

Such methods mean that in certain circumstances the ability of the holding company to make repayments on its debt (apart from that guaranteed by the regulated business) would be further in doubt. It could therefore have a negative effect on the credit rating of the debt held at the holding company level, although this risk would appear to have been already taken into account by Standard & Poor's in its ratings.

3.1.25 It is also not clear that, on the basis of the published reasoning for the last downgrade, particularly by Standard and Poor's, that this would improve the credit rating of Northumbrian Water. Nevertheless it would provide support for its rating and assist in preventing any further downgrade.

3.1.26 We would also need to consider the licences of other companies, particularly those that are highly geared. However, the possibility of such a condition being introduced in other companies' licences may also have a negative effect on the credit ratings of other holding companies of water and sewerage companies. In the extreme case this might prevent them refinancing existing debt and debt could in the future only be raised at the regulated business itself.

3.1.27 It is our understanding that the rationale underlying Standard & Poor's downgrade of the Ondeo 2006 bond suggests that a negative effect on the credit rating of the holding company would be relatively unlikely in those cases where the regulated businesses retain strong credit ratings in their own right because the risk of regulatory intervention is reduced. The impact of such a new licence condition on new bonds might not therefore, be generally adverse.

3.1.28 ***We would welcome the views of respondents on the imposition of new ring fencing conditions, or modification of existing ring fencing conditions, is required. In particular whether it would improve the ability of Northumbrian Water to secure finance and what would be its impact on the debt market for water as a whole.***

3.2 NWG plc's capacity to be the owner of a regulated water company

3.2.1 We welcome competition for ownership of water companies. It is beneficial because it stimulates 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.

3.2.2 However, we have a duty to ensure that the functions of each 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.

3.2.3 In this case, following the listing of the company on the AIM, the regulated business will be owned by a disparate group of institutional shareholders whose identity is likely to change over time.

3.2.4 Suez will continue to be the largest single shareholder with a 25% stake. The size of its shareholding will not give it the ability to control Northumbrian Water but will give it material influence over the company. It will also have the right to appoint two directors to the board of NWG plc. No other shareholder will have the ability to influence the policy of Northumbrian Water.

3.2.5 It is expected that the executive board of the appointed business will remain broadly the same. This continuity provides comfort about the ability of the regulated business to continue to deliver the services.

3.2.6 The Listings rules for the AIM will impose certain requirements on the owners. However, Northumbrian Water is already required by the conditions of its licence to maintain high standards of corporate governance including maintaining at least three independent non-executive directors and compliance with the principles of corporate governance.

3.3 Management of the regulated water and sewerage business

- 3.3.1 Northumbrian Water's acquisition by NWG plc should not compromise the 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. In this case Northumbrian Water will continue to be operated by its current management as a separate subsidiary.
- 3.3.2 On its acquisition by Suez, Northumbrian Water's licence was amended to strengthen the management independence of the water utility. We are not proposing any further modifications in connection with the management of Northumbrian Water.

3.4 Outsourcing

- 3.4.1 NWG plc has indicated that it has no present intention to further separate the ownership of Northumbrian Water's assets from its operations. 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 its outsourced functions, to enable it to meet its responsibilities as a water and sewerage undertaker.

3.5 Comparative information

- 3.5.1 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 must assess whether NWG plc's prospective ownership of Northumbrian Water might adversely affect our ability to make those comparisons.
- 3.5.2 Northumbrian Water's shares have now been admitted to a listing on the AIM. This is the first acquisition, since privatisation, involving a flotation of new equity. This listing increases the number of water and sewerage companies listed on the London Stock Exchange from 5 to 6. An additional benefit to the regulator comes from the fact that this listing provides information about how investors view the performance of a business whose activities are, predominantly, that of a regulated water company. However, in practice there is likely to be little volume of trading in the new shares, given the small proportion of the company's capitalisation represented by equity, and the overhang of Suez's retained 25% stake. If Northumbrian Water gains a full listing, which is the attention of management, then the availability and utility of the comparative information may be further enhanced.
- 3.5.3 This listing of equity would satisfy our proposed licence modification requiring the Appointee to maintain the listing of a financial instrument and shall use all reasonable endeavours to retain the listing of that financial instrument, whose

market price should react to the financial position of the regulated business, on the London Stock Exchange or another exchange of similar standing. Northumbrian Water also has listed bonds that satisfy this criteria.

- 3.5.4 It is unclear to us whether Suez, with its reduced shareholding, would still be required to comply with its undertaking to the Secretary Of State that shares of a single company which controls the UK enterprises controlled by Suez or any Group Company will be listed on the London Stock Exchange not later than 31 December 2005⁴. However it appears to us that, if this undertaking should stand then, it would be satisfied by the listing.
- 3.5.5 Because this acquisition does not involve the merging of two or more enterprises, there will be no loss of any comparative information as a result of what is simply a change of ownership.

3.6 Incentives for efficiencies

- 3.6.1 It is important that there is adequate pressure for efficiency from the equity shareholders and that incentives for efficiency are maintained under the new structure.
- 3.6.2 Although the equity will now be listed, the proportion of equity in the capital structure will be much reduced compared with under Suez's ownership. The majority of the finance for the regulated business is debt. Conventional providers of debt are concerned principally with repayment of their interest and capital, and have limited incentives to drive the company to achieve efficiencies.
- 3.6.3 The shareholders in NWG plc appear to be attracted principally by the prospect of high dividend yields rather than capital growth. This should mean that they exert pressure on management to make continuing efficiency savings in order to sustain these dividend yields.
- 3.6.4 ***We would welcome views on whether the incentives for efficiency under the new ownership structure are changed from those under the previous ownership structure.***

3.7 Prices and service standards

- 3.7.1 Customers will look to Ofwat to ensure that Northumbrian Water is able to provide proper standards of service at appropriate prices irrespective of its ownership. Northumbrian Water will continue to have the obligations imposed upon it by legislation (especially the WIA91) and the conditions of its licence. We will continue to regulate Northumbrian Water under those provisions.

⁴ Required as a result of the acquisition of Northumbrian by Suez in 1996.

3.7.2 Its 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. 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 exercise our powers to that end.

3.8 The need for additional licence modifications

3.8.1 Except for the issues discussed in Section 3.1 and the changes to bring the ring-fencing provisions in Northumbrian Water's licence (as detailed in Annex 1) into line with other companies, Ofwat is not proposing any further licence modifications to deal with the regulatory issues raised by the proposed acquisition. However, we would like to hear the views of others on whether they believe further licence modifications are necessary.

4. How to respond to this paper

4.1 On the basis of responses to this consultation we will decide whether any regulatory action is necessary to protect the interests of the customers of Northumbrian Water following this acquisition.

4.2 Please send responses to this paper 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

4.3 Responses must arrive no later than 5.00pm on 1 July 2003.

4.4 We will place all responses in the Ofwat library unless they are clearly marked "confidential". We will publish our conclusions in a position paper.

The ring-fencing conditions

Ring-fencing provisions already present in Northumbrian Water's Licence:

- The Appointee shall, at all times, conduct the Appointed Business as if it were substantially the Appointee's sole business and the Appointee were a separate public limited company. The Appointee should have particular regard to the following in the application of this condition:-
 - (a) the composition of the Board of Appointee should be such that the Directors, acting as such, act independently of the parent company or controlling shareholder and act exclusively in the interests of the Appointee;
 - (b) the Appointee must ensure that each of its Directors must disclose, to the Appointee and the Director, conflicts between the duties of the Directors as directors of the Appointee and other duties;
 - (c) where potential conflicts exist between the interests of the Appointee as a water and sewerage undertaker and those of other Group Companies, the Appointee and its Directors must ensure that, in acting as Directors of the Appointee, they should have regard exclusively to the interests of the Appointee as a water and a sewerage undertaker;
 - (d) no Director of the Appointee should vote on any contract or arrangement or any other proposal in which he has an interest by virtue of other directorships. This arrangement should be reflected in the Articles of Association of the Appointee;
 - (e) the Appointee should inform the Director without delay when:-
 - (i) a new Director is appointed;
 - (ii) the resignation or removal of a Director takes effect; or
 - (iii) any important change in the functions or executive responsibilities of a Director occurs.

The Appointee should notify the Director of the effective date of the change and, in the case of an appointment, whether the position is executive or non-executive and the nature of any specific function or responsibility;

- (f) the dividend policy adopted by the Appointee in the light of paragraph 6.12; and
 - (g) the Principles of Good Governance and Code of Best Practice (or any successor document having a similar purpose and content) as may from time to time be incorporated into or approved for the purposes of the Listing Rules of the Financial Services Authority.
- The Appointee shall procure from Northumbrian Water Group PLC legally-enforceable undertakings in favour of the Appointee in a form specified by the Director and expressed to remain in force for as long as the Appointee retains the Appointment and the giver of the undertaking is a holding company or the ultimate holding company of the Appointee.

The undertakings shall provide that:

- (a) those companies providing the undertakings will, and will procure that each of their subsidiaries (other than the Appointee and its subsidiaries) will, give to the Appointee all such information as may be necessary to enable the Appointee to comply with the requirements of the Conditions of the Appointment;
 - (b) those companies providing the undertakings will, and will procure that each of their subsidiaries (other than the Appointee and its subsidiaries) will, refrain from any action which would or may cause the Appointee to breach any of its obligations under the Act or the Conditions of the Appointment; and
 - (c) those companies providing the undertakings will ensure that at all times the Board of the Appointee contains not less than three independent non-executive directors, who shall be persons of standing with relevant experience and who shall collectively have connections with and knowledge of the areas within which the Appointee provides water and sewerage services and an understanding of the interests of the customers of the Appointee and how these can be respected and protected.
- The Appointee shall not, without the consent of the Director, enter into any agreement or incur any commitment incorporating a cross-default obligation, or continue or permit to remain in effect any agreement or commitment incorporating a cross-default obligation, whereby its financial liabilities are increased or accelerated because of a default of any other company.
- The Appointee shall, at such times and in such ways as may from time to time be required by the Listing Rules of the Financial Services Authority, publish such information about its annual interim and final results as is by those rules required to be announced by a company whose shares are for the time being listed on the London Stock Exchange.

- The Appointee shall declare or pay dividends only in accordance with a dividend policy which, in the written opinion of the Director, will not impair the ability of the Appointee to finance the Appointed Business.

Proposed new ring fencing provisions for Northumbrian Water's licence

- The Appointee shall use all reasonable endeavours to ensure that it, or any Associated Company as issuer of corporate debt on its behalf, maintains at all times an issuer credit rating which is an Investment grade rating.
- Appointee to maintain the listing of a financial instrument and shall use all reasonable endeavours to retain the listing of that financial instrument, whose market price should react to the financial position of the Appointee's Appointed Business, on the London Stock Exchange or another exchange of similar standing.