

**The Completed Acquisition of South East Water plc by
Macquarie Bank Limited**

A Consultation Paper by Ofwat



November 2003

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1. Purpose of this document

1.1 This document:

- describes the completed acquisition of South East Water plc and its affiliated businesses by Macquarie Bank Limited;
- describes the proposed long-term structure, which includes the transfer of South East Water plc to the Macquarie European Infrastructure Fund;
- explains the statutory position on mergers; and
- sets out the regulatory issues and our initial assessment of these issues.

1.2 We invite views on the issues discussed in this paper including Macquarie Bank's capacity to be the owner of a regulated water business, the current arrangements for the ring fencing of the licensed water business and the need for modifications to South East Water's licence. Respondents may also comment on any other issues relating to the acquisition which they believe are relevant.

1.3 Responses to this paper are required by no later than 5.00pm on 28 November 2003.

2. Details of the acquisition

- 2.1 On 1 October 2003, Macquarie Bank Limited (Macquarie) announced that it had acquired from French group Bouygues all of the equity of South East Water plc (South East) and its affiliated businesses for £386 million. South East is a licensed water undertaker. The acquisition has been funded by a combination of debt and equity with Macquarie contributing £111 million of equity.
- 2.2 South East is the second largest of the 12 water only companies in the UK, with an average (regulatory) capital base of £423 million in 2002-03. It supplies 400 million litres of water per day to approximately 1.5 million people in the South East of England, in a catchment area that covers some 3600km² of Kent, Sussex, Surrey, Hampshire and Berkshire.
- 2.3 The Macquarie Bank Group provides specialist investment, advisory and financial services in targeted markets around the world. The Group consists of Macquarie, the Australian investment bank, and its worldwide affiliates. Macquarie Bank Group has a market capitalisation of approximately £2.6 billion. It has over £20 billion of funds under management, and manages in excess of £5 billion of equity invested in infrastructure assets and businesses around the world including toll roads, airports, communications, water, rail and power assets. Macquarie's European regional base is London. Macquarie is authorised and regulated by the Financial Services Authority. Macquarie and Bouygues are joint venture partners in a number of projects around the world.
- 2.4 Macquarie has acquired South East as the seed asset for its planned Macquarie European Infrastructure Fund (MEIF). The fund will target European infrastructure assets, potentially including electricity and gas transmission and distribution networks, water and sewerage companies, and other infrastructure assets in the transport and telecommunications sectors. Once the initial equity is raised the fund will acquire South East. Subject to completion of the necessary regulatory processes it is expected that South East will be transferred from Macquarie to the MEIF within the next 12 months, with Macquarie retaining an (indirect) equity stake.

3. The statutory position on mergers

- 3.1 Prior to the acquisition Macquarie did not control any water companies in England & Wales. Therefore, the Secretary of State for Trade & Industry is not required to refer the acquisition to the Competition Commission as a merger of water companies under Sections 32 to 34 of the Water Industry Act 1991 (WIA91).
- 3.2 The Office of Fair Trading (OFT) must investigate mergers which meet either the 'turnover test' or the 'share of supply test' as set out in the Enterprise Act 2002 (Enterprise Act). The turnover test is met if the target company has a UK turnover of £70 million. South East had a UK turnover of £88m in 2002/03. 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 must consider whether the merger may be expected to result in a 'substantial lessening of competition'.
- 3.3 Should the acquisition give rise to a qualifying merger situation under the Enterprise Act, the (OFT) may invite views on whether there are any competition concerns arising from the merger.
- 3.4 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.
- 3.5 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 South East's licence.

4. Regulatory issues arising from the acquisition

Macquarie's capacity to be the owner of a regulated water company

- 4.1 Ofwat accepts that competition for ownership of water companies may be beneficial because it can stimulate existing owners to become more efficient in the provision of water services as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.
- 4.2 However, Ofwat has a duty to ensure 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.
- 4.3 Macquarie is active in managing infrastructure assets funds. Its infrastructure advisory business advised on £24 billion of transactions completed in the past year, £8 billion of which was in Europe. It also has in excess of £5 billion of equity in infrastructure assets under management located throughout Europe as well as Canada, the United States, Chile, Korea, South Africa and Australia. These assets include toll roads, airports, communications, water, rail and power assets. Its largest fund is the Macquarie Infrastructure Group; a listed infrastructure fund targeting equity investments in toll roads in OECD countries.
- 4.4 Furthermore, Macquarie believes it will bring experience to the water industry from other sectors and countries that may be beneficial in improving the performance of South East.
- 4.5 Macquarie has said that its investment fund intends to hold a long-term investment in South East. The water industry is a long-term business requiring stable ownership and management and we welcome this approach.
- 4.6 Macquarie will provide management and advisory services to South East on an arms length basis. This will continue after South East is transferred to the MEIF. Ofwat will seek to ensure that any services are provided on an arms length basis and in compliance with our Regulatory Accounting Guideline 5.03 (RAG 5).

Long term ownership structure

- 4.7 It is planned that ownership of South East will be transferred to the MEIF. Macquarie will retain an investment interest in MEIF and will act as fund manager. The fund strategy is to seek substantial stakes in individual infrastructure companies, and to actively manage investments through management appointments and Board representation.

- 4.8 Ofwat will be conducting its own investigations into the capacity of Macquarie/MEIF to be the owner of a regulated water company, but we would also like to hear the views of others on this issue, before forming an opinion.
- 4.9 Under Condition P of South East's licence, it is required to seek undertakings from its owners that they will:
- Give to the Appointee (South East) all information necessary to enable it to comply with the conditions of its licence;
 - Refrain from any action which may cause a breach of the Appointee's legal obligations or licence conditions; and
 - Maintain a minimum of three independent non-executive directors on the board of South East.

Financing

- 4.10 An important aspect of our assessment will be to ensure that South East, under Macquarie's ownership and under its long term ownership structure, remains able to finance its functions as a water undertaker.
- 4.11 Macquarie is one of Australia's largest companies with a market capitalisation of £2.6 billion. Macquarie has credit ratings of A and A2 from Standard & Poors and Moodys (the two largest credit rating agencies) respectively. Their annual net profits have increased year on year for the past decade. Its net profit for 2002-03 was around £120m.
- 4.12 The acquisition of South East was financed with a mixture of equity contributed by Macquarie and an acquisition loan facility. In addition Macquarie has arranged the refinancing of an existing inter-company loan to South East that was provided by its former UK parent company, Saur Water Services plc (Saur).
- 4.13 MEIF will be equity funded, predominantly by long-term pension fund investors and Macquarie. Following the transfer to MEIF, Ofwat must be satisfied that South East remains able to finance its functions as a water undertaker.

- 4.14 At present the capital structure of South East remains as it was pre-acquisition. The acquisition facility, however, will need to be refinanced or extended within the next 18 months, its current maturity. At this time Ofwat may need to review the proposals, particularly if they lead to a material increase in the level of debt in South East. As the ratio of debt to equity is increased, the financial flexibility of the company and its ability to raise new debt is more limited. Ofwat therefore would need to be content that any future proposals for South East would be sufficiently flexible to withstand any cost shocks and that it would enable South East to access additional debt if necessary to finance its capital investment requirements, the size of which are not currently known.
- 4.15 Any activities of the parent company, be it Macquarie or MEIF, that could prejudice the financial viability of the regulated business would be of concern to Ofwat. These 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. Ofwat modified South East's licence to contain many of these ring fencing provisions as part of the 1999 periodic review process.
- 4.16 South East's current ring-fencing provisions:
- require it 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 the new owner to give a legal commitment to facilitate the proper performance of South East's functions;
 - prohibit cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other company;
 - require it to maintain a minimum of three independent non-executive directors;
 - require it to publish its results as if it were listed on the London Stock Exchange; and
 - require it to ensure that its dividend policy avoids any adverse effect on the company's ability to finance its functions as a water undertaker.
- 4.17 Similar modifications have been made for a number of other companies that have been involved in corporate activity, including refinancing. Most recently this includes modifications for Anglian Water upon its financial restructuring, for Mid Kent Water upon its acquisition by Swan Capital Group and for Portsmouth Water upon its acquisition by South Downs Capital. In addition to the provisions set out in paragraph 4.16, above, these companies are required to maintain an investment grade corporate credit rating.

- 4.18 In the past we have required the condition to maintain an investment grade corporate credit rating from larger companies and those that have introduced highly geared financial structures. We have used the condition as an indicator that companies remain in a position to finance their functions. In South East's case, there is a cost associated with this requirement as, at present, South East neither has nor requires a credit rating, under its current financing arrangements.
- 4.19 An alternative would be to modify South East's licence such that should Ofwat require the company to obtain a credit rating in the future, because of its financing strategy, that the company will use all reasonable endeavours to ensure that it maintains this rating at the investment grade level. The circumstances under which Ofwat would require South East to obtain a credit rating would be if:
- South East seeks to issue public debt; and/or
 - The leverage of South East moves above the level assumed in setting price limits.
- 4.20 We invite views on the form in which the investment grade credit rating condition should be introduced into South East's licence. We will be consulting later in the year on introducing standard ring-fencing provisions for all companies.
- 4.21 In addition to the licence issues above, a number of very limited amendments have been made to the ring-fencing provisions for some other companies since the modifications adopted by South East in 1999. We also intend to incorporate these limited amendments into the South East licence.
- 4.22 We invite views on whether the ring-fencing conditions described are adequate or whether further conditions are required to ensure that the regulated business remains ring-fenced within the Macquarie Bank group.

Management of the regulated water business

- 4.23 Macquarie intends to retain South East's existing management. Macquarie has appointed four representatives to the Board of South East and a further non-executive director. It is expected that some of the existing independent directors will also remain. It proposes to retain a single Saur board member to assist with the transitional arrangements.
- 4.24 Ofwat wish to ensure that South East's acquisition by Macquarie does not compromise 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.

- 4.25 Ofwat understands that under Macquarie's ownership and as part of the MEIF, South East will continue to be operated by its current management as a separate subsidiary, but with Macquarie representatives on the Board.
- 4.26 Furthermore, as fund manager Macquarie plans to establish 'strategy groups' dealing with the key issues and decisions facing the regulated business. Ofwat will wish to understand better the role of these groups in overseeing South East's activities and the extent to which they influence the decisions of the regulated business. We must be satisfied that there is no confusion over who is responsible for key decisions.
- 4.27 We are not proposing any further modifications in connection with the management of South East.

Outsourcing

- 4.28 South East still has some services provided by its former UK parent, Saur Water Services plc, and its associates. Macquarie has indicated that these arrangements will continue materially on their pre-acquisition terms. Macquarie also entered into transition arrangements at the time of the acquisition. These relate to South East staff who will temporarily undertake some services for Saur, shared accommodation and IT services. As part of the transition process South East is looking pragmatically at how all these services are provided for in the future. We would expect South East to keep us informed as this process develops. As noted above, they propose to retain a single Saur board member to assist with the transitional arrangements.
- 4.29 Macquarie has not indicated any present intention to separate the ownership of South East'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 undertaker.

Comparative information

- 4.30 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 will assess whether Macquarie's prospective ownership of South East might adversely affect our ability to make those comparisons.
- 4.31 Because Macquarie has no other water interests in the UK, the initial acquisition does not involve the loss of an independently owned comparator for use in making regulatory judgements about efficiency and standards of services.
- 4.32 South East was not listed on any stock exchange before the acquisition and there is therefore no loss of market information. South East is already required to publish results as if it were listed on the Stock Exchange.

Prices and service standards

- 4.33 Customers will look to Ofwat to ensure that South East is able to provide proper standards of service at appropriate prices irrespective of its ownership. South East 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 South East under those provisions.
- 4.34 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. Ofwat will monitor this and, where appropriate, we will exercise our powers to that end.

Conclusions on the need for licence modifications

- 4.35 Except for a requirement, in some form, relating to investment grade credit rating status, and other very limited changes to the ring-fencing provisions in South East's licence, 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.

5. Responses to this consultation paper

5.1 Ofwat will discuss with Macquarie the issues noted above and we will seek appropriate commitments from Macquarie about our proposals for the modification of South East's licence.

5.2 Responses to this consultation should be made in writing by no later than 5.00pm on 28 November 2003 to:

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Birmingham
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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".