



# **THE PROPOSED TAKEOVER OF SOUTHERN WATER SERVICES LTD BY FIRST AQUA HOLDINGS LTD**

**A CONSULTATION PAPER BY THE OFFICE OF WATER SERVICES**

**March 2002**

## **Background and Purpose**

### **The proposal**

1. On 8 March 2002, First Aqua Holdings Ltd (First Aqua) announced that it had made an agreement to acquire Southern Water plc, which is wholly owned by Scottish Power plc (Scottish Power) for a total consideration of £2,050 million.
2. Southern Water plc is the holding company of Southern Water Services Ltd (Southern Water). Southern Water is one of the ten water and sewerage companies operating in England and Wales and it serves more than four million customers in south east England.
3. First Aqua is a company formed specifically to undertake the proposed acquisition. It is a newly incorporated company owned by Citicorp Banking Corporation (a wholly owned subsidiary of Citigroup) and private investors as shown in annex 1. Debt financing for the acquisition will be underwritten by The Royal Bank of Scotland (RBS).
4. Following completion of the transaction Vivendi Environnement (Vivendi) may, within six months, be offered the opportunity to buy Southern Water from First Aqua at an enterprise value equal to that underlying First Aqua's purchase of Southern Water. If Vivendi were to accept, this transaction would result in a mandatory reference to the Competition Commission under the Water Industry Act 1991 (WIA), due to Vivendi's existing interest in a number of water companies in England and Wales.
5. Vivendi has also entered a two-way option with private and institutional investors who have agreed to subscribe for non-voting preference shares for First Aqua. Such an option cannot be exercised until completion of the proposed acquisition of Southern water by first aqua. If First Aqua offers Vivendi the opportunity to purchase Southern Water within six months of completion, those preference shares can be sold to Vivendi under this option on the third anniversary of the completion of First Aqua's acquisition of Southern Water, assuming Vivendi has not chosen to purchase the preference shares before that time. However if First Aqua does not offer Vivendi the opportunity to buy Southern Water the private and institutional investors will not have the right to use their option. However, Vivendi may opt to purchase the preference shares should they wish. It is for OFT to assess any material influence which might be gained over Southern Water by Vivendi through the purchase of preference shares. Ofwat would consult at the relevant time and therefore this is not discussed further in this paper.
6. Once the initial acquisition by First Aqua of Southern Water is completed, First Aqua may propose to refinance Southern Water. The nature of the refinancing is dependent upon whether Vivendi subsequently decides to acquire Southern Water from First Aqua.

7. First Aqua has indicated that it has no present intention to separate the ownership of Southern Water's assets from its operation.

## **The need for licence modifications and remedies to regulatory concerns**

8. In November 2001, Scottish Power announced that it had, at that time, decided to pursue a capital restructuring of its subsidiary Southern Water. This proposal would have resulted in a significant increase in the gearing of Southern Water. We consulted on the proposal and the modifications to Southern Water's licence that may be appropriate to remedy regulatory concerns.
9. Respondents to the consultation broadly accepted that the licence modifications were appropriate. We believe that if First Aqua's offer were to be successful, those licence modifications, which raise the ring-fence around Southern Water's core business and assets to the current new standard, would be equally appropriate in this case.
10. The consultation on Scottish Power's proposal to refinance Southern Water raised two further issues; whether highly geared, thin equity structure are sufficiently flexible; and whether reduced equity investment results in significantly weaker incentives on the company's management for continuing efficiency improvements. These issues remain relevant for First Aqua's proposals.
11. **We invite views on whether the proposed modifications to Southern Water's licence (which bring its licence up to the current standard) are appropriate. Furthermore, we wish to know whether the issues of management incentives and financial flexibility require additional or alternative measures to safeguard the interests of customers and the regulator's ability to discharge his functions.**

## **The regulation of mergers and takeovers**

### **The European Commission dimension**

12. Under the European Communities Merger Regulation<sup>1</sup> ("the Regulation"), a merger having a Community dimension should be appraised by the Commission of the European Union ("the EU") with a view to establishing whether or not it is compatible with the common market. Because of the parties' combined worldwide and EU turnover, the proposed acquisition of Southern Water plc by First Aqua appears to meet the relevant criteria for a merger having a Community dimension. The EU has one month from the date of receipt of a complete notification to decide whether the

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<sup>1</sup> Council Regulation 4064/89 as amended by Council Regulation 1310/97

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**

13. The relevant authorities of the Member State (i.e. the Office of Fair Trading (OFT) and the Department of Trade and Industry (DTI)) can make an application under Article 9 of the Regulation on national competition to request the EU to refer a merger to it, setting out their reasoning for the request. It can also, under Article 21, apply for recognition of a legitimate interest such that the UK regime should apply to the merger.
14. It is for the OFT and DTI to assess whether the criteria for repatriation on competition grounds, under the Article 9 provisions, are met in this case. Similarly the DTI must decide whether there is a legitimate interest under Article 21. One such legitimate interest would be compulsory reference to the Competition Commission under the WIA. However, First Aqua has no current interests in the UK water industry and hence a mandatory reference under sections 32 and 34 of the WIA would be unlikely.
15. **However any respondent wishing to register their concerns under the provisions of Article 9 or Article 21 should notify us by 3 April 2002. This will enable us to inform the respective authorities within the very tight deadlines set out in the Regulation.**
16. Regardless of whether the case is returned to the UK or not, Ofwat can seek licence modifications. The aim of these Licence modifications is to address the regulatory issues raised by this proposal. This dispensation by the EU has been granted in previous mergers with a European dimension, including the acquisition of Hyder Plc by Western Power Distribution and Thames Water plc by RWE.

## **Duties of the regulator**

17. The duties of the Director General of Water Services (the Director) are set out in the WIA and in competition legislation. The primary ones are to act in the manner he considers best calculated 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; 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 Southern Water. These powers have been strengthened by the Competition Act 1998.

18. 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.
19. 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.
20. First Aqua is a company consisting of financial investors and has no directly relevant experience of the provision and financing of UK water and sewerage services. First Aqua has stated that a sale to a company with such experience is a possibility. However this is only a possibility and First Aqua has stated that, should it remain the owner, Southern Water's management will remain in place and the company will continue to be governed by its existing standards of efficiency and customer services. In addition, Citigroup, one of the financial investors in First Aqua, is a substantial financial institution with significant financial resources. Citigroup has assured Ofwat that it will assist Southern Water in the promotion of its financial security through its influence in financial markets.
- 21. Before the Director forms an opinion about First Aqua's standing as an owner of a water and sewerage company, he invites the views of others.**

## **Regulatory issues**

22. Previous examples of takeovers like this one from outside the water and sewerage industry include the purchase of Wessex Water plc by Enron Corp, the purchase of Thames Water plc by RWE and, on a smaller scale, the purchase of Mid Kent Water by Swan Capital Investments. We consider that the current proposal presents similar issues to these cases and we invite comments on the proposed measures, which are set out below.

## **Ring-fencing of the regulated business and assets, including management resources and access to information**

23. Ofwat is considering whether First Aqua's prospective ownership of Southern Water Group (and therefore, its control of the regulated business) calls into question the adequacy of the ring-fencing arrangements around the core water and sewerage businesses. Ring-fencing arrangements are seen as necessary to enable effective regulation of the water utility in a wider group.

24. Southern Water accepted a number of modifications to its licence in 1995 following its acquisition by Scottish Power; those modifications strengthened the ring fence between Southern Water and its parent and associated companies.
25. Since that time a number of transactions, such as the acquisition of Wessex Water plc by Enron Corp, Mid Kent Holdings plc by Swan Capital Investments and the acquisition of Dŵr Cymru (Welsh Water) by Glas Cymru, have resulted in a new standard of ring fencing licence conditions. The modifications that would bring Southern Water's licence in line with the current standard are discussed in the relevant sections below.

## **Financing of functions**

26. First Aqua is a new company formed solely for the purpose of acquiring Southern Water. However, in the future, they may become involved in other operations. This exposure to other ventures may mean that, if they suffered a sufficiently severe reverse elsewhere, their response might impede or diminish Southern Water's financial capacity. Anything that could prejudice the financial viability of the regulated business would be of concern to the Director.
27. Therefore we propose that Southern Water should be prohibited from continuing or assuming any commitment which includes a "cross default obligation" (whereby Southern Water's financial liabilities are increased or accelerated because of default outside the regulated business).
28. First Aqua has agreed in principle to this licence modification.
29. The initial debt finance for the acquisition will be provided entirely by the Royal Bank of Scotland. The longer term capital structure put in place for Southern Water will have a greater proportion of debt than currently but the precise structure will depend upon the outcome of any future bid for Southern Water which may be made by Vivendi. If First Aqua remains the owner it proposes to refinance Southern Water by issuing bonds to achieve gearing of about 85% of its Regulatory Capital Value<sup>2</sup>.
30. 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 needs to be content that the proposed financing structure will be sufficiently flexible to withstand any cost shocks and that it will enable Southern Water to access additional debt if necessary to finance its capital investment requirements, the size of which are not currently known.
31. This issue was raised in our consultation paper on Scottish Power's proposal to refinance Southern Water. Respondents to the consultation shared our concern over the long-term uncertainties. Our view remains that it is up to the company and its

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<sup>2</sup> The Regulatory Capital Value is the capital base used in setting price limits. It represents the initial market value including debt plus subsequent net new capital expenditure.

investors and lenders to judge for themselves the risks and benefits of a company's financial structure. They should not expect customers to bear any undue risk either now or in the future. Ofwat would continue to monitor the performance of the regulated business and take appropriate action to respond to adverse developments that might threaten its ability to discharge its functions or comply with the conditions of its appointments.

32. We propose that Southern Water should be required to use all reasonable endeavours to ensure, at all times, that it maintains an investment-grade issuer credit rating. This issuer rating, if it is in the investment-grade range, should demonstrate that the refinancing transaction does not create undue strain. The requirement to maintain an investment-grade issuer credit rating into the future should assist with raising capital in the future. Any adverse changes in the rating would provide Ofwat with an early signal that the company's ability to raise future finance was at risk.

33. Once the detail of any refinancing plan is known, Ofwat would have to consider, whether further consultation would be necessary at that time. For example, should First Aqua be unable to successfully refinance Southern Water before the maturity of the RBS loan, then the position in relation to Southern Water may change. Ofwat, together with the OFT would then undertake the relevant consultation processes in light of these circumstances.

**34. Ofwat invites views on the proposed licence modification and on the issues associated with highly geared financial structures.**

### **Incentives for ongoing efficiency**

35. Under this proposal First Aqua's equity investment in the company will be significantly less than is the case for a conventional equity model company. We need to consider whether there will be adequate pressure for efficiency from shareholders and whether incentives for efficiency are maintained under these proposals.

36. The issue of incentives for efficiency has been raised in the context of Glas Cymru's acquisition of Dŵr Cymru (Welsh Water) and subsequent consultation involving similar proposals. We concluded that, in principle, incentives for efficiency are unlikely to be as strong in the absence of shareholders. In this case, First Aqua will be an equity owner, but its investment will be small in relation to the total capital employed in the business. We have some concerns that incentives for efficiency are diminished compared to the conventional equity model with a greater degree of equity investment because First Aqua's exposure is limited. These concerns were shared by a number of respondents to our consultation papers on the proposed refinancing of Southern Water and the proposed refinancing of Anglian Water Services Ltd. However First Aqua would benefit from a higher return on its

investment should Southern Water outperform. This should provide some incentive for First Aqua to drive Southern Water to be efficient.

37. In recognition of the importance of incentives for efficiency, First Aqua have proposed that the remuneration of Southern Water's management should be linked to the financial and service performance of Southern Water. We welcome any proposal that links the remuneration of the management of Southern Water to both its financial and service performance.
38. **Ofwat invites views on the issue of incentives for efficiency in thin equity structures.**

### **Management of the water and sewerage business**

39. Southern Water's acquisition by First Aqua should not compromise effective management of the regulated business. 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 mergers.
40. The shareholders of First Aqua will each appoint a director of First Aqua. We understand that First Aqua will be required to unanimously approve the annual budget and business plans of its subsidiaries (including Southern Water) as well as the appointment of senior executives in those subsidiaries.
41. 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 First Aqua that, following the takeover of Southern Water plc, the regulated business will remain a separate subsidiary.
42. On its acquisition by Scottish Power, Southern Water's licence was amended to strengthen the management independence of the water utility. We propose a further modification of the Appointee's licence to require Southern Water to maintain a minimum of three independent non-executive directors. First Aqua has agreed in principle to this licence modification.
43. **Ofwat invites view on whether the proposed licence modification is appropriate.**

## **Access to information**

44. Ofwat 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.
45. Scottish Power, on its acquisition of Southern Water, gave an undertaking to the Secretary of State to issue and retain a financial instrument whose market price should react to the performance of the regulated business. Should First Aqua become the new owner of Southern Water, Scottish Power's undertaking would lapse. Therefore, we propose to modify Southern Water's licence to include that requirement as a condition of its licence.
46. In addition, we consider that the appointee should be required to publish information about its final and interim results as if it were a company whose shares are listed on the London Stock Exchange.
47. First Aqua has agreed in principle to these licence modifications, subject to adequate time to be allowed to list the financial instrument.
- 48. Ofwat invites view on whether these licence modifications are appropriate.**

## **Prices and service standards**

49. Customers will look to the Director to ensure that the regulated business continues to provide requisite standards of service at appropriate prices. Irrespective of the ownership of Southern Water and the way in which it is financed, it will continue to have the obligations imposed upon it in primary legislation (especially the WIA) and the conditions of its Appointments as a water and a sewerage undertaker. The Director will continue to regulate the company under those provisions. Southern Water'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 and financial structure makes no difference. The Director will exercise his powers to that end.

## **Responses to this consultation paper**

50. The Director will discuss with First Aqua the issues noted above. He will seek from First aqua appropriate commitments about his proposals for the modification of Southern Water's licence, to deal with his concerns, as noted earlier in this paper.
51. Responses to this consultation paper should be sent to Keith Mason, Director of Regulatory Finance, Office of Water Services, Centre City Tower, 7 Hill Street, Birmingham B5 4UA (keith.mason@ofwat.gsi.gov.uk or fax 0121 625 3609) by Wednesday 17 April 2002. Each response will be placed in Ofwat's Library for public inspection, unless it is clearly marked "in confidence".
52. A copy should also be sent to Mr P Fraser at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX (Fax: 0207 211 9160).

## Annex 1

### Names of First Aqua's shareholders

Name of Investor
Citigroup
Martin Naughton
Tavistock Investments Capital Inc (Bahamas)
TBH Investments Limited
Marquis Trust
Morgan Ventures Limited

Note:

The individual and investment trusts noted above are clients of Citibank group.