



**PROPOSALS FOR THE MODIFICATION OF THE  
CONDITIONS OF APPOINTMENT OF SOUTHERN  
WATER SERVICES**

A position paper by Ofwat

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## 1. CONCLUSIONS

We have considered carefully the responses to Ofwat's consultation on proposals by Scottish Power to restructure the capital of its subsidiary Southern Water Services Ltd (Southern Water).

**The consultation showed broad acceptance that the licence modifications are appropriate. In the light of this and the considerations explained in this paper, we conclude that we should not object to the proposals and that Scottish Power should be allowed to proceed to test whether it can secure the financing required at credit ratings consistent with the financing plan underpinning the proposals. This is on the condition that:**

- **Southern Water implements the licence modifications described in Section 6;**
- **Southern Water confirms that the rights proposed for bondholders do not impede the Director General's duties under the Water Industry Act 1991;**
- **Southern Water obtains an investment-grade issuer credit rating before the transaction is brought to the market and maintains it subsequently; and**
- **Southern Water links its management's remuneration to the performance of Southern Water.**

## 2. THE PROPOSAL

Scottish Power announced on 7<sup>th</sup> November 2001 that it had decided to pursue a capital restructuring of its subsidiary Southern Water. Subject to market and other conditions, this will result in approximately £1.9 billion of ring-fenced borrowings in Southern Water. This would represent a significant increase in the gearing of Southern Water. Its indebtedness will rise to around 90% as measured against its regulatory capital value (£2.1 billion at 31 March 2001).

## 3. CONSULTATION

We issued a consultation paper on the proposals on 11 December 2001<sup>1</sup>. That document set out proposed modifications to the licence of Southern Water (as required by Section 13 of the Water Industry Act 1991) and highlighted the key issues arising from the proposals.

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<sup>1</sup> Proposals for the modification of the conditions of appointment of Southern Water Services.

We invited views by 25 January 2002. This paper sets out our assessment of the proposals following the consultation.

We received 13 responses to the consultation paper. Respondents did not identify any significant new issues not already considered in the context of other restructuring proposals. Most concerns were similar to those identified in Ofwat's consultation paper, albeit with different groups emphasising different aspects more strongly than others.

Most, including the Southern Customer Service Committee, broadly welcomed our proposed licence conditions. In relation to other issues, a range of views were expressed but the majority focused on the two key questions identified in our paper:

- (i) **Financing of functions** - Would a highly geared, thin equity structure be sufficiently robust to withstand cost shocks and the consequences of poor management and so protect customers from additional risk?
- (ii) **Incentives for ongoing efficiency** - Would the owner's reduced equity investment result in significantly weaker incentives on the company's management for continuing efficiency improvements?

#### **4. OFWAT'S ASSESSMENT FOLLOWING CONSULTATION**

##### **Ofwat's position on restructuring**

Although Scottish Power's proposals for Southern Water do not result in a change of ownership, or the complete removal of an equity stake, it does represent a significant change to the financial structure of Southern Water.

We welcome innovation directed at improving the efficiency and effectiveness of a water company. It remains the responsibility of shareholders and those that lend to the company to judge the financial and business risks associated with highly geared, thin equity structures. Ultimately the market will decide whether to provide the financial support required to implement the proposals.

Ofwat's consultation paper set out what we considered to be the key issues and concerns arising from the proposals. In our consultation paper, we gave our preliminary view that the proposals did not, on balance, give rise to any insurmountable issues, provided that the package of licence modifications is fully implemented and that the appropriate investment-grade issuer credit rating is secured and maintained.

Since then, Ofwat have further considered the issues in the light of responses to the consultation. Our assessment of the key issues is set out below.

Respondents mainly focused on the questions regarding the robustness and flexibility of a highly geared, thin equity structure and the change in incentives on management resulting from Scottish Power's reduced equity investment.

These questions highlight the key risks in the proposals. These risks cannot wholly be avoided. Some of these risks arise because the long-term performance of companies that rely substantially on debt finance has not, as yet, been tested in the water industry in England and Wales. However, we consider that companies should be free to choose and take to the market their own preferred capital structure provided:

- customers are protected from taking on undue risks; and
- the company remains able to access the capital markets at reasonable rates to finance both present and prospective capital programmes.

This approach was supported by respondents to the consultation.

### **The financing of Southern Water**

Ofwat needs to be satisfied, as far as is practicable, that the current financing plan is robust. We have had extensive discussions with Scottish Power and Southern Water, the credit rating agencies and other City institutions both during and since the consultation, and have taken advice from our financial advisors Deloitte & Touche.

In the short-term the financing plan appears to be satisfactory. If Southern Water achieves the plan, it would be able to provide for a level of reserves designed to manage cost shocks. These reserves come in the form of liquidity facilities and cash accumulation accounts. In addition, the equity holding by Scottish Power provides a further buffer.

The arrangements, as specified in the current financing plan and draft bond documentation, do not appear to compromise Southern Water's ability to issue new debt to fund its capital investment requirements in the period 2000-05.

Respondents shared our concern over the longer-term uncertainties. There were a range of views on whether Southern Water's structure will provide sufficient flexibility to respond efficiently to future developments in the water industry or in financial markets. No conclusive assessment can be made at this stage. Our view remains that it is up to the company and its investors and lenders to judge for themselves the risks and benefits of the structure. They should not expect customers to bear any undue risk either now or in the future. Ofwat will continue to monitor the Appointee's performance and position 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.

We will require Southern Water to obtain an investment-grade issuer credit rating prior to the completion of its restructuring proposals. This issuer rating, if it is in the investment-grade range, should demonstrate that the refinancing transaction does not create undue strain. Southern Water will be required to maintain an investment-grade issuer credit rating into the future. This 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.

### **Incentives for efficiency**

Scottish Power will retain full ownership of Southern Water, but its investment will be small in relation to the total capital employed in the undertaking. This "thin equity structure" has given rise to concerns that incentives for efficiency are diminished, compared to the more conventional equity model because the owner's exposure is limited. Opinion is divided. Some argue that Scottish Power would continue to provide some pressure for efficiency savings. Some have suggested that the incentives would be improved if Southern Water were required to link the remuneration of its management to the financial and service performance of Southern Water and that it should publish the detail of its incentive schemes. This was required of Glas Cymru on its acquisition of Dŵr Cymru Welsh Water and is relevant here.

We have noted that there will be external monitoring from the debt insurers (MBIA) and of course the independent non-executive directors will help to ensure a proper commercial focus for Southern Water.

### **The future**

Respondents, especially those water companies that are proponents of the conventional equity model, expressed concerns that these highly geared structures may be seen as the model for the industry as a whole.

We are clear that it is for a company to decide on the most appropriate capital structure and the appropriate balance for shareholders and lenders. Our concern is to protect customers. Future market developments will have a bearing on the assessment of the efficient level of gearing at the next and future periodic reviews. Very high levels of gearing are not necessarily efficient. Efficiency is not only a matter of reducing running costs, it is also about diversifying risk. The setting of the cost of capital at the next price review will not simply be guided by the most highly geared companies. It cannot be assumed that the current market conditions will persist indefinitely. Highly geared structures entail significant financing risk, especially refinancing risk. Companies which are genuinely efficient should not have to fear that the ways in which the cost of capital allowances are made at future periodic reviews will push them into over-risky structures. On the other hand, companies that choose to skew these risks, in pursuit of out-performance, will get no special treatment. Such skewed risks, by definition, increase the risk of under-performance and investors must understand they have to bear this risk.

If higher levels of gearing are consistent with credit ratings comfortably within the investment-grade envelope and are sustainable in the long-term, there could be long-term benefits for customers. Ofwat will consider the evidence at the next periodic review. To date there is no compelling evidence to indicate

that highly geared structures, such as that proposed for Southern Water, represent an appropriate model for the water industry as a whole.

## **5. THE REGULATORY FRAMEWORK**

If Scottish Power's proposal for Southern Water goes ahead, Southern Water will receive no special or preferential treatment from Ofwat. Southern Water will continue as the Appointee with all the licence obligations of a water and sewerage undertaker. It will be regulated in the same way as other companies.

Its performance in terms of efficiency and customer service will be assessed in exactly the same way and compared against other companies. Price limits will be set using an industry-wide methodology. Efficiency assumptions derived from comparative performance will be used to inform price limits. Southern Water will, therefore, need to ensure that it retains flexibility to respond to future changes in price limits. There can be no expectation that costs incurred will be passed on to customers. This applies equally to financing, operating and capital costs. Ofwat has issued a statement, setting out how it approaches its duties, in an open letter to the Managing Directors of all water companies (MD166; 31 January 2001).

Ofwat will ensure that customers' interests continue to be protected through the provisions in the Water Industry Act 1991 and the Director General will not hesitate to act in the interests of customers. As for all companies this includes, in the last resort, powers to apply for the appointment of a Special Administrator.

## **6. LICENCE MODIFICATIONS**

Ofwat must be satisfied that the interests of customers are protected. 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.

We consulted on further modifications in our paper on 11 December 2001. Southern Water has agreed to these modifications and the response to the consultation did not give rise to any material changes to them.

The licence modifications will:

- (1) require Southern Water to use all reasonable endeavours to ensure, at all times, that it maintains an investment-grade issuer credit rating;
- (2) prohibit Southern Water 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 elsewhere in the group);

- (3) require Southern Water to maintain a minimum of three non-executive directors independent of the Scottish Power Group; and
- (4) require Southern Water to publish information about its final and interim results as if it were a company whose shares are listed on the London Stock Exchange.

In order to compensate for the loss of its stock exchange listing, and the information that listing provided, 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 position of the Appointed Business. The Director General will modify Southern Water's licence to include that requirement as a condition of its licence.

## **ANNEX A: RESPONSES TO THE CONSULTATION**

### **Main themes emerging from Ofwat's consultation paper**

We received thirteen responses to our consultation paper. A list of respondents is given at the end of this Annex and copies of the responses (except those marked confidential) have been placed in the Ofwat library. The views expressed by different groups of respondents are summarised below.

#### Financial institutions

Respondents recognised the potential for reductions to financing costs but indicated that there may be risks associated with the proposed structure that may only be exposed over time.

It was suggested that, if Corporate Credit Ratings or their equivalent, are important for regulatory purposes, then these ratings should be publicly available.

It was suggested that the remuneration of Southern Water's management should be linked to its performance, and in particular its credit quality. In addition, concern was raised over bondholders taking on additional risks as Scottish Power has little to lose by putting its capital at risk under stressed circumstances.

Concern was raised that the reduction of Scottish Power's interest may lead to the holding company placing less importance on the operating company than they did before.

However, it was felt that Scottish Power's retention of some financial interest would exert pressure on the water company to perform.

It was suggested that although bonds are less actively traded than stocks, they do trade, and their values change in response to companies performance. Debt-holders are not merely focused on the payment of interest and the principle.

#### Customers and consumer groups

The Southern Customer Service Committee expressed no objection to Scottish Power's plans, provided that the refinancing proposals will not undermine the company's efforts to deliver high quality service to customers. However they would like to see customer issues and concerns represented at board level by stipulating that one of the non-executive directors has regard for the interests of the customers.

One customer expressed concern that Scottish Power would benefit from the special dividend, but would leave Southern Water financially vulnerable.

### Other regulators and government

The National Assembly for Wales hoped that Ofwat would guard against Scottish Power shifting too much debt onto Southern Water. It was felt that it would be unfair to do this and then try to sell Southern Water to a non-profit making company or other regional undertaking in the South East region.

### The regulated water companies in England

A variety of views were expressed on the most appropriate structure for a water company. A number of companies continue to believe that the existing equity model has its place in the water industry. It was stressed that no alternative structure should be forced upon any company.

Two companies expressed concern that there is little prospect of raising additional equity, should the thin equity structure prove unsustainable. Others believed that the structure of the financing would ensure the long-term flexibility of the company and its access to the capital markets.

One company felt that the regulatory framework including pressure from the CSCs will provide an incentive for the Southern Water to improve performance.

### Others

One respondent with an interest in the regulated utilities considered that Scottish Power's retention of financial interest would exert pressure on Southern Water to perform as Scottish Power would be the first to lose out, before bondholders, should it perform badly.

## **List of respondents to the consultation paper**

### Financial Institutions

Two responses were received, both were marked as confidential.

### Customers and consumer groups

A.J. Caudle  
Campaign Against Monopoly Abuse  
Southern Customer Services Committee

### Other regulators and government

The National Assembly for Wales

### The water companies in England & Wales

Anglian Water Services Ltd	Southern Water Services Ltd
Severn Trent Water Ltd	United Utilities PLC
South West Water Ltd	South Staffordshire Water PLC

### Others

Energy Information Centre