

**The Proposed Acquisition of Wessex Water Limited by  
YTL Power International Berhad**

**A Consultation Paper by Ofwat**



**April 2002**

## **Contents**

- 1. Introduction**
- 2. Details of the proposed acquisition**
- 3. The statutory position on mergers**
- 4. Regulatory issues arising from the proposed transaction**
  - YTLPI's capacity to be the owner of a regulated water company
  - Financing
  - Refinancing of Wessex Water
  - Management of the regulated water and sewerage business
  - Outsourcing
  - Comparative information
  - Prices and service standards
  - The need for additional licence modifications
- 5. Responses to this consultation paper**

# 1. Introduction

## Purpose of this document

1.1 This document:

- describes the proposed acquisition of Wessex Water Limited by YTL Power International Berhad (YTLPI);
- explains the statutory position on mergers; and
- sets out the regulatory issues and our assessment of these issues.

1.2 We invite views on the issues discussed in this paper including YTLPI'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 further modifications to Wessex Water's licence. Respondents may also comment on any other issues relating to the acquisition which they believe are relevant.

1.3 We will make recommendations to the Director General of Fair Trading (DGFT) on this merger on the basis of the comments received. In order to allow comments to be considered by us, responses to this paper are required by no later than 5.00pm on 3 May 2002.

## **2. Details of the proposed acquisition**

- 2.1 On 25 March 2002, YTLPI announced that it had made a recommended cash offer to acquire the entire issued share capital of Wessex Water Limited, the owner of Wessex Water Services Ltd (Wessex Water). Wessex Water is a licensed water and sewerage undertaker.
- 2.2 Wessex Water supplies water and sewerage services to approximately 2.4 million customers in the counties of Somerset, Wiltshire and Dorset in the South West of England. Wessex Water is based in Bath and is currently a subsidiary of Azurix Europe Limited (Azurix), which is controlled by Enron Corporation of America. As well as its water business, Wessex Water Limited owns a number of small unregulated businesses.
- 2.3 YTLPI is a Malaysian company listed on the Kuala Lumpur stock exchange. It is owned 60% by YTL Corporation Berhad, with the remaining shares being held by institutional shareholders and the public. YTL Corporation is also listed on the Kuala Lumpur stock exchange. YTLPI's principal investments are in the power sector in Malaysia. However it also owns a one-third share of ElectraNet SA, a regulated power transmission company in Australia. Neither YTLPI nor YTL Corporation has any existing European activities.

### **3. The statutory position on mergers**

- 3.1 YTLPI does not currently control any water companies 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).
- 3.2 The offer by YTLPI 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 the YTLPI 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 Wessex 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**

### **YTLPI'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 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.
- 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 YTLPI is predominantly active in the power market. It operates two large electricity generating stations in Malaysia under a licence granted by the Malaysian government as part of the privatisation of its electricity industry. It is looking at further developments in the Malaysian power sector and also owns a one-third stake in a regulated electricity transmission company in South Australian.
- 4.4 It has no directly relevant experience of the provision and financing of UK water and sewerage services. Less than 1% of its revenues in 2001 were derived from outside Malaysia and it has no experience of operating in Europe.
- 4.5 Nonetheless, the experience that YTLPI will bring to the water industry from other sectors and countries may be beneficial to improving the performance of Wessex Water.
- 4.6 YTLPI has said it is committed to a long-term investment in Wessex Water. The water industry is a long-term business requiring stable ownership and management and we welcome this commitment to the long-term.
- 4.7 Furthermore, YTLPI intends to retain Wessex Water's existing management, which provides some comfort about its ability to continue to deliver the services.
- 4.8 Ofwat will be conducting its own investigations into the capacity of YTLPI 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.

### **Financing**

- 4.9 An important aspect of our assessment will be to ensure that Wessex Water, under YTLPI's ownership remains able to finance its functions as a water and sewerage undertaker.

- 4.10 YTLPI is one of Malaysia's largest companies and it has significant cash reserves and a stable revenue stream from its power generation interests in Malaysia. Nonetheless, YTLPI is slightly smaller than Wessex Water and the only published credit rating (from Standard & Poor's a leading credit rating agency) for the company is at the bottom of the investment grade range.
- 4.11 If it suffered a sufficiently severe reverse in Malaysia, its response might impede or diminish Wessex Water's financial capacity. Anything that could prejudice the financial viability of the regulated business would be of concern to Ofwat.
- 4.12 These concerns have in the past been addressed by licence modifications and when Wessex Water was acquired by Azurix in 1998 Ofwat modified its licence to ensure that the water company was ring-fenced from the other activities of the group. These ring-fencing provisions have demonstrated their value following the collapse of Azurix's US parent company Enron Corporation.
- 4.13 Similar modifications have been made for a number of other companies that have been involved in corporate activity, including for Thames Water upon its acquisition by RWE, for Mid Kent upon its acquisition by Swan Capital Group and for Portsmouth Water upon its acquisition by South Downs Capital.
- 4.14 The ring-fencing provisions:
- require Wessex Water 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 Wessex Water's functions;
  - require Wessex Water to maintain an investment grade credit rating;
  - 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 Wessex Water to ensure that its dividend policy avoids any adverse effect on the company's ability to finance its functions as a water undertaker.

- 4.15 We believe these licence conditions remain appropriate and are sufficient to protect the regulated business. A number of minor amendments have been made to the ring-fencing provisions for some other companies since Wessex Water was acquired by Azurix and we intend to incorporate these minor amendments into the Wessex Water licence. In particular, the requirement to maintain an investment grade credit rating will be modified to require a corporate investment grade rating, rather than such a rating for all issued debt.
- 4.16 We invite views on whether the current ring-fencing conditions are adequate or whether further conditions are required to ensure that the regulated business remains ring-fenced within the YTLPI group.

### **Refinancing of Wessex Water**

- 4.17 The initial acquisition will be financed partly out of YTLPI's cash reserves and an acquisition facility from Dresdner Kleinwort Wasserstein. In the longer-term YTLPI may wish to refinance Wessex Water.
- 4.18 A number of water companies, including Anglian Water, Mid Kent Water and Portsmouth Water have recently carried out or announced plans to refinance their regulated businesses by replacing equity (shareholders funds) with debt. 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 any refinancing plan will be sufficiently flexible to withstand any cost shocks and that it will enable Wessex Water to access additional debt if necessary to finance its capital investment requirements, the size of which are not currently known.
- 4.19 Once the detail of any refinancing plan is known, Ofwat will have to consider whether further consultation would be necessary at that time.

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

- 4.20 Wessex Water's acquisition by YTLPI should 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.
- 4.21 Furthermore, Ofwat needs to know where key decisions are taken and to maintain a close relationship with the Board who will be taking those decisions. This in turn raises the question of where the licence is held. Ofwat 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 that under YTLPI's ownership, Wessex Water will continue to be operated by its current management as a separate subsidiary.

- 4.22 On its acquisition by Azurix, Wessex 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 Wessex Water.

### **Outsourcing**

- 4.23 Although Wessex Water recently entered into a joint billing agreement with Bristol Water and a joint venture with Montgomery Watson Harza for the delivery its capital programme, YTLPI has indicated that it has no present intention to further separate the ownership of Wessex Water 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**

- 4.24 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). When advising DGFT, we will assess whether YTLPI's prospective ownership of Wessex Water might adversely affect our ability to make those comparisons.
- 4.25 Neither Wessex Water nor Azurix's shares are currently listed on a public stock exchange. However, when Azurix first acquired Wessex Water, Ofwat modified its licence to require it to maintain a listing of a financial instrument whose performance was related to the performance of the regulated business. This requirement will remain and provides some limited information to Ofwat about the market's ratings of Wessex Water, in place of a stock market listing.
- 4.26 Wessex Water is also required to publish results as if it were listed on the stock exchange and therefore the proposed merger would not involve the loss of a comparator for use in making regulatory judgements about efficiency and standards of services.

### **Prices and service standards**

- 4.27 Customers will look to Ofwat to ensure that Wessex Water is able to provide proper standards of service at appropriate prices irrespective of its ownership. Wessex 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 Wessex Water under those provisions.

- 4.28 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.

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

- 4.29 Except for minor changes to bring the ring-fencing provisions in Wessex Water's licence 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.

## **5. Responses to this consultation paper**

- 5.1 Ofwat will discuss with YTLPI the issues noted above and we will seek appropriate commitments from YTLPI about our proposals for the modification of Wessex Water's licence.
- 5.2 On the basis of those discussions and responses to this consultation paper, we 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 5.00pm on 3 May 2002 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

- 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 Andrew Hobbs at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX (Fax: 020 7211 8504; E-mail: andrew.hobbs@oft.gov.uk).