The completed acquisition of Northumbrian Water Ltd

A position paper by Ofwat

August 2003

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SUMMARY AND CONCLUSIONS

On 17 May 2003, Aquavit plc announced that it had agreed to purchase Northumbrian Water Ltd (Northumbrian Water), a water and sewerage company regulated by Ofwat. Aquavit plc completed the acquisition on 23 May 2003 and changed its name to Northumbrian Water Group plc (NWG plc). We consulted on this acquisition in June 2003. This section sets out Ofwat's conclusions following our consultation and further analysis of the proposed financial structure.

Respondents to our consultation raised concerns that given its current credit rating, Northumbrian Water may not readily be able to raise finance in the future. Respondents also voiced concern that a credit rating of BBB is not appropriate for water companies generally, where the expectation is that these companies will continue to be required to finance substantial capital expenditure. A number of investors have questioned whether a credit rating of BBB would ensure ongoing access to the capital markets.

Financing the continuing capital requirements of the water industry in England and Wales is of critical importance and we note the views of investors. We consider that a credit rating of BBB for the industry as a whole is unlikely to be sustainable in the long term because of the companies continuing capital requirements. It would not be consistent with our views on the credit quality of water companies as outlined in 'Setting prices for water and sewerage services 2005-10 – framework and approach', published in March 2003. Such companies must have ready access to the capital markets. A credit rating of BBB might mean that a company would have to pay a disproportionate premium to maintain access to the debt market or at worst find access to the bond markets closed.

In respect of Northumbrian Water, we have considered carefully whether any immediate regulatory action might have a positive impact on the company's credit quality and financial position. In addition we have considered whether any immediate action is required to protect Northumbrian Water's customers from any potential future deterioration in the company's credit quality and financial position.

Northumbrian Water appears to have sufficient cashflows to support its debt. The regulated company has informed us that it has no need to raise money via the debt market until after the current price review[1]. In addition, the company believes that the successful syndication of its Deutsche Bank loan facility indicates the debt market's appetite to invest in the company.

The company is currently reviewing a number of options that might improve its credit quality and financial position. These options include:

[1] Price limits will be determined in November 2004 for the period 2005-10

- raising debt against the revenues generated by Kielder reservoir (a non-regulated asset) and using the proceeds to repay existing debt guaranteed against the shares of Northumbrian Water; and
- obtaining from the European Investment Bank (EIB) a waiver to its right to redeem its current loans (amounting to £376 million) on any change of ownership of Northumbrian Water. (We understand that the EIB has agreed to this until April 2004 when it will review its position.)

It seems unlikely that any immediate regulatory action, at least on its own, would benefit customers materially or achieve an early improvement in the credit rating of Northumbrian Water. We take account here of the views taken by the credit rating agencies including the “stable outlook” assessment that Standard & Poor’s attached to its current confirmed credit rating.

We will, however, modify the licence of Northumbrian Water to bring the regulatory ring fencing up to the current standard. This includes a requirement to maintain an investment grade credit rating. This provides a “floor” to the credit rating of the regulated company – although not necessarily for the group as a whole.

The credit ratings of Northumbrian Water reflect the cash flows required to service all of the group debt i.e. they take account of the debt held outside the regulatory ring-fence. This includes two parent company bonds, a £200 million bond repayable in 2006 and a £350 million bond repayable in 2023.

The latter is guaranteed by Northumbrian Water and indeed the proceeds were used by the regulated business. The proceeds from the former bond were not, but its holders are many of the same institutions. Furthermore, in the event of default on the 2006 bond, the 2023 bond may become repayable and hence the two are linked. This weakens the ring fence and we have told the company it must take all reasonable steps to break the links between the debt guaranteed by the regulated entity and the non-guaranteed debt raised by the parent company. The company is exploring ways in which this can be achieved.

The effect of the final proposals from the Board of Northumbrian Water cannot be fully assessed at this stage, but the position should be clearer within a relatively short time.

The onus is now on Northumbrian Water to take all reasonable steps that might be necessary to enable it to demonstrate to the market and to Ofwat that is has the ability to continue to finance itself into the future. We regard this as a matter of priority for the company.

Should the company not be able to demonstrate that all reasonable steps have been taken by June 2004 then we will need to consider whether further licence modifications, might be appropriate. These may include a “cash lock-up” licence modification that would restrict the ability of the regulated water company to make cash flows available to the wider group in the event of a deterioration in the company's financial position. Such a licence modification was believed by some respondents to be appropriate.

We will keep under review the desirability of such a condition for all companies and the extent to which it might clearly improve the quality of the regulatory ring fence.

1. BACKGROUND

Details of the acquisition

1.1 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 Ltd (Northumbrian Water), the company regulated by Ofwat. The former owner of Northumbrian Water, Suez, has retained the remaining 25%. Aquavit plc completed the acquisition on 23 May 2003 and changed its name to Northumbrian Water Group plc (NWG plc).

1.2 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 under a long-term agreement. Kielder is not part of the regulated business. As well as its water business, NWG plc owns a number of small non-regulated businesses.

1.3 NWG plc is a company formed for the purposes of this acquisition that initially comprised 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.

1.4 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 intends to seek a full listing on the London Stock Exchange in due course. The shares of NWG plc are currently trading at approximately 14% above the issue price of £1.00 per share.

1.5 Since completion of the acquisition Standard & Poor's has confirmed a downgrade to the corporate credit rating of Northumbrian Water and the rating of debt issued by the parent company, albeit with a stable outlook. Fitch Ratings has announced provisional credit ratings that also represent a downgrading, (a less severe one than that made by Standard & Poor's) of both the corporate credit rating of Northumbrian Water and the debt issued by the parent company.

Consultation

1.6 We issued a consultation paper on 10 June 2003. We invited views on any issues resulting from the acquisition and specifically invited views on:

- the financing of Northumbrian Water;
- the current arrangements for ring fencing of the regulated business;
- the new owner's capacity to control a regulated water business; and
- whether incentives for efficiency have changed.

1.7 The consultation closed on 1 July 2003 and on the basis of responses and further analysis of the proposed financial structure, we have considered whether licence modifications are required. The responses are briefly summarised in Annex A.

1.8 The merger did not qualify for investigation under the Water Industry Act 1991 merger provisions and the Office of Fair Trading has confirmed that the merger did not give rise to any competition concerns under the Fair Trading Act 1973.

2. OFWAT'S ASSESSMENT

2.1 This section assesses the responses to the consultation and considers whether the transaction raises issues that could be addressed by modifications to the licence of Northumbrian Water or other regulatory action.

The financing of Northumbrian Water

2.2 Ofwat must consider whether the acquisition results in a financing structure that affects the ability of the regulated water company to finance its functions.

2.3 The listing of shareholder equity in the new business was a significant part of the initial transaction. However, as a result of the acquisition, the bulk of the finance for the group comes from debt, with the total group net debt (£1.7 billion) being equivalent to around 80% of Northumbrian Water's Regulatory Capital Value (RCV). The change of ownership led to an additional £536 million of net debt at the group level. However, the gearing of the regulated business has not increased significantly (being around 63% of the RCV).

2.4 This increased level of debt within the group led to a sharp downgrade in the corporate credit ratings of Northumbrian Water and the rating of the bonds issued by its parent company.

2.5 Where debt is raised outside the regulatory ring fence, the credit rating agencies take into account the amount of parent company debt when rating the regulated water company. Both Standard & Poor's and Fitch Ratings have said that the absence of enhanced creditor protection has been key to the credit rating decision. Such covenants have supported the credit ratings of other highly geared structures. Standard & Poor's confirmed corporate credit rating for Northumbrian Water is BBB. Fitch Ratings has announced a provisional credit rating for Northumbrian Water of BBB+. Northumbrian Water was rated as A- by both ratings agencies prior to the transaction.

2.6 Furthermore Standard & Poor's has downgraded the credit rating of a bond issued by Northumbrian Water's parent company Northumbrian Services Ltd (the NSL 2006 bond) by three notches to BB+. Fitch Ratings have announced a provisional credit rating of BBB- for this bond.

2.7 In the consultation paper we asked for views, in particular from debt investors, on Northumbrian Water's ability to raise finance in the future and the impact of this acquisition on the debt market for water as a whole.

2.8 For water companies with significant current and future investment requirements, the ability readily to access finance from either the equity or debt markets is crucial if they are to finance their functions and fulfil their obligations as water and sewerage undertakers. One of the key issues for lenders is the credit quality of the company.

2.9 Respondents to our consultation from the lending community raised concerns that, at the current credit ratings, the company may not readily be able to raise finance in the future. Some of these respondents appeared not to distinguish between the regulated company, Northumbrian Water, its parent and the holding company. Respondents also voiced concern that a credit rating of BBB could, in their view, erroneously be perceived as appropriate for water companies generally.

2.10 We have set out in 'Setting prices for water and sewerage services 2005-10 – framework and approach' our views on credit quality and our approach to setting prices in 2004 will underpin this. When setting price limits we will not assume credit ratings that lie on the edge of investment grade category but ones that are comfortably within the investment grade range. A long term credit rating of BBB, which is only two notches within investment grade, would not be consistent with our approach. Our approach to credit quality should help prevent a downward spiral in credit ratings, which was a concern to some debt investor respondents.

2.11 Northumbrian Water has confirmed that it has sufficient cash flows to support its debt and the company has informed us that it does not need to raise money from the debt market until after the current price review. In addition, the recent syndication of its Deutsche Bank loan facility was significantly over subscribed. The company believes this demonstrates the debt market's appetite to invest in the company.

2.12 We will, however, modify the licence of Northumbrian Water to bring the regulatory ring fencing up to the current standard. This will include a condition that requires Northumbrian Water to maintain an issuer credit rating that is investment grade. This would provide a "floor" to the credit rating of the company. Northumbrian Water would not be in breach of this condition at its current credit ratings by either Standard & Poor's or Fitch Ratings.

2.13 The company is reviewing a number of options that might improve its credit quality and financial position. These options include:

- raising debt against the revenues generated by Kielder reservoir (a non-regulated asset) and using the proceeds to repay existing debt currently guaranteed against the shares of Northumbrian Water; and,
- obtaining from the European Investment Bank (EIB) a waiver to its right to redeem its current loans (amounting to £376 million) on any

change of ownership of Northumbrian Water. (We understand that the EIB has agreed to this until April 2004 when it will review its position).

2.14 The onus should properly be on the company to take all reasonable steps that might be necessary to enable it to demonstrate to the market and to Ofwat that is has the ability to continue to finance itself into the future. The company is best placed to decide the appropriate steps. Such steps may not be capable of being completed immediately but we regard them as a matter of priority for the company.

2.15 Should the company not be able to demonstrate by June 2004 that all reasonable steps have been taken then we will need to consider whether regulatory action including further licence modifications, might be appropriate.

2.16 Some respondents suggested that a licence modification that restricted the ability of the regulated water company to make its cash flows (primarily dividend payments) available to the wider group would be appropriate. This licence condition would be triggered in the event of deterioration in the company's financial position (measured by reference to some external indicator). They considered a precedent for this exists in the measures applied to Aquila Networks plc by Ofgem.

2.17 We do not consider at present that such a licence modification would benefit Northumbrian Water's customers materially or ameliorate Northumbrian Water's current position, particularly since the ratings recognise all the cash flows to which it is exposed. The financial position of Northumbrian Water appears to be far more stable than that of Aquila Networks plc where group debt was significantly greater than the value of regulatory asset base.

2.18 The need for such a licence modification will be considered again when we review the company's position in June 2004.

2.19 A number of respondents suggested that, in future cases, we should request formal pre-bid credit ratings for transactions prior to any announcement. We will explore this suggestion with the credit rating agencies.

2.20 In addition some respondents from the debt market suggested that a variety of bond covenants that might enhance creditor protection. We regard this as matter for the company.

The current arrangements for ring fencing of the regulated business

2.21 Northumbrian Water's existing licence has ring-fencing provisions that are designed to protect customers from the risks associated with the activities of other companies within the group and from the risks associated with the overall financing structure. These licence conditions were introduced when the licences of Northumbrian Water and Essex & Suffolk Water were merged in 2000. These conditions include provisions that prohibit Northumbrian Water from guaranteeing the debt of other group companies or entering into cross-default arrangements without the written consent of Ofwat.

2.22 When these conditions were introduced the company sought consent to arrangements already in place whereby it had guaranteed a bond issued by the parent company (the 2023 bond), the proceeds of which were for the sole use of the regulated business. Ofwat granted consent to this since it considered that Northumbrian Water would be in no different position had it raised the funds itself.

2.23 Bond investors have pointed out in their responses that, in addition to the guarantee provided by Northumbrian Water, the conditions contained in the bond documentation of the 2023 bond require repayment in the event of default of another bond in the NWG group – a "cross-default" clause. This means that there is a direct link between the regulated company and the now sub-investment grade (based on the credit rating of Standard & Poor's) 2006 parent company bond, in the event of default.

2.24 In light of the link between the debt of the regulated business and its parent and the fact that changes to the overall structure have resulted in a negative impact in the credit rating of Northumbrian Water, it is our view that a continuation of the cross-default clause in the debt guaranteed by Northumbrian Water would undermine the strength of the existing regulatory ring-fence.

2.25 To remedy this and improve the stability of the regulated business we believe that Northumbrian Water must take all reasonable steps to remove the current links between the 2006 parent company bond and the debt of the regulated business. We will discuss the options with the company as they develop their financing options and review the position in June 2004 in conjunction with our review of the company's financial position.

The new owner's capacity to control a regulated water company

2.26 When a water company has a change of ownership, we must consider whether the new owner has the capacity to be the owner of a regulated water business.

2.27 Since the acquisition the executive board of Northumbrian Water has remained broadly the same and is expected to continue to do so. This continuity provides comfort about the ability of the regulated business to continue to deliver the regulated services.

2.28 The Listings Rules for the AIM impose certain requirements on the owners. NWG plc is aiming to achieve a full London Stock Exchange listing by the end of September 2003, which will impose greater disclosure and corporate governance requirements. 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 Good Governance of the Listing Rules of the Financial Services Authority.

2.29 Respondents have not raised any issues in relation to the new owner's capacity to be the owner of a regulated water company, other than in relation to the financing issues discussed elsewhere in this paper.

2.30 Therefore, we have no particular concerns purely in relation to the change of ownership and we are not proposing any specific regulatory action other than seeking licence modifications consistent with the current ring fencing standard for other companies involved in recent merger or corporate finance activity.

Incentives to efficiency

2.31 This acquisition has been partly financed by the issuing of listed equity. In our consultation paper we noted that shareholder equity can play an important role as a spur to greater efficiency and as a cushion against external events.

2.32 Respondents to the consultation did not raise any concerns over the effect of the structure on Northumbrian Water's incentives for efficiency.

2.33 Ofwat does not consider that this structure results in a material change to the incentives for efficiency and therefore we are not proposing any specific regulatory action on this aspect.

3. LICENCE MODIFICATIONS

Proposed new ring fencing provisions for Northumbrian Water's licence

3.1 We will modify Northumbrian Water's licence to bring the regulatory ring-fence up to the current ring standard of other companies recently involved in merger or corporate finance activity[2]. New conditions will be introduced to require Northumbrian Water to:

- use all reasonable endeavours to ensure that it, or any subsidiary as issuer of corporate debt on its behalf, maintains at all times an investment grade corporate credit rating; and

- 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.

3.2 As the structure of the water industry evolves, Ofwat will continue to review the adequacy of all companies' existing licence conditions. As part of this process we will consider whether modifications that restrict the ability of the regulated business to make its free cash flow available to the wider group in particular circumstances, might enhance the protection currently provided by existing licence conditions.

[2] Subject to responses to a statutory consultation required under section 13 of the Water Industry Act 1991.

ANNEX A: CONSULTATION RESPONSES

Ofwat received seven confidential responses from the debt investment community plus responses from WaterVoice Northumbria, WaterVoice Eastern, Ecofin and the Environment Agency.

Main themes emerging from Ofwat's consultation paper

The company's structure and its ability to raise future finance

A number of respondents from the debt market expressed concern that, due to its capital structure, the company's ability to raise finance in the future via the debt capital markets was in doubt. Respondents also pointed out that the cross-default arrangements means that a default on the parent company 2006 bond could ultimately lead to a default in the parent company's 2023 bond, which is guaranteed by the regulated business.

Acceptable credit ratings for water companies

Some respondents from the debt market believed that A- is the lowest credit rating that would enable a water company to gain access to the capital markets. There was also concern that, should other companies be able to raise debt with a credit rating of BBB then this would lead to a further downward spiral in water companies' credit ratings.

Some debt investors took the view that a cash lock-up licence condition should only be introduced once all of the holding company's bonds were amended so that they were guaranteed by Northumbrian Water.

One respondent suggested that covenants should be offered to existing bondholders that restrict dividend payments in order to reduce the amount of debt in the company over time. Again it was suggested that this should be done prior to any licence modifications being made.

Another respondent from the debt market took the view that debt issued by regulated water companies might contain a covenant that allowed investors to redeem the bond on change of ownership.

A respondent from the debt market suggested that Ofwat should seek a formal pre-bid credit rating or make acceptance of a merger conditional upon strong credit ratings. They believed that this would allow licence modifications to be made to a company's licence prior to, rather than after completion of, a take-over.

Changes to the regulatory framework

One respondent suggested Ofwat should have the power to block a merger if it threatened the credit quality of the company.

Service to Customers

Both WaterVoice Eastern and WaterVoice Northumbria wishes to see a continuity of management at Northumbrian Water and stressed that the acquisition must not have a negative impact on the ability of the regulated business to deliver service to its customers.

Ecofin, a shareholder in NWG, believes that the existence of listed equity might provide an increase in the incentives for efficiency to the benefit of cutomers.