



**The acquisition of AWG plc by Osprey Acquisitions Limited and its impact on Anglian Water Services Limited**

**A position paper by Ofwat**

May 2007

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## 1. Background

On 2 October 2006 the boards of Osprey Acquisitions Limited (Osprey) and Anglian Water Group (AWG) announced that they had agreed the terms of a recommended cash offer by Osprey for AWG. AWG is the owner of Anglian Water Services Limited (Anglian Water), an appointed water undertaker regulated by Ofwat. On 24 November 2006, Osprey declared the offer wholly unconditional.

We issued a consultation paper on 15 December 2006 in which we invited views on:

- the capacity of Osprey and its owners to be the owner of a regulated water business and which entities should provide Condition P undertakings to the Company;
- the financing arrangements; and
- the need for modifications to the Company's instrument of appointment (its 'licence') to ensure that, whoever its owners, it has sufficient financial and managerial resources to carry out its functions as a water company and is appropriately ring-fenced from the rest of the Osprey group.

This note sets out our position on these issues, taking into account the views of respondents to our consultation paper. A list of respondents provided in Annex 1.

## 2. The capacity of Osprey and its owners to be the owner of a regulated water business and which entities should provide Condition P undertakings.

### Corporate governance

Osprey was formed at the direction of a consortium comprising:

- 3i Group plc;
- Canada Pension Plan Investment Board (CPPIB);
- Colonial First State Global Asset Management (CFSGAM) the asset management division of Commonwealth Bank of Australia (CBA); and
- Industry Funds Management (Nominees) Limited (IFM) in its capacity as trustee of the Industry Funds Management (International Infrastructure) Wholesale Trust.

Osprey has stated that each investor is looking for long-term secure returns with each investor committed to the long-term ownership and continued stability of Anglian Water's business.

The existing Board has 9 members in total, 6 executive directors and 3 independent non executive directors. Osprey has the right to appoint 4 new non-executive directors to the board of Anglian Water (one representing each investor), although initially intends not to make any changes to the Board.

The investors recognise that the board of Anglian Water is required by its licence to be able to act independently of any parent company or controlling shareholder and to act exclusively in the interests of Anglian Water. In representations to us, Osprey has stated that its investors will ensure that the composition of the board of Anglian Water complies with the requirements of the licence, and will reflect a broad range of relevant skills and experience.

The directors of the board of Anglian Water have responded to our consultation. They have considered the Board's ability to be capable of acting independently, as required by Anglian Water's licence. They were satisfied with the assurances given by Osprey.

The existing independent non-executive directors responded separately to our consultation paper. They note the rights reserved by Osprey to appoint four additional directors to the board of Anglian Water. They are reassured that Osprey does not currently intend to exercise that right but the existing independent directors have concerns that, should these rights be exercised, the newly appointed directors would not be independent. This would, in their view, change the balance of the board of Anglian Water. In such an event the independent directors would wish to review their ability to influence effectively as independent directors.

We acknowledge the issues raised by the Anglian Water's independent non-executive directors. The board structure of each company is different and the onus must be on each company to ensure it is effective. On balance, we consider that no regulatory intervention is necessary at this time.

#### Role of the new owners

The Company needs the active co-operation of its owner in carrying out its functions as a water and sewerage undertaker and complying with its licence.

Anglian Water currently has Condition P in its licence that required it to obtain legally enforceable undertakings from its previous owners. The companies giving the undertakings are required to:

- give the regulated business any information it needs to comply with its licence;
- refrain from any action that could cause the regulated business to breach its licence; and
- maintain a minimum of three independent non-executive directors on the board of the regulated business.

The company's existing Condition P will be amended to require Anglian Water to obtain these undertakings from its Ultimate Controller and where its Ultimate Controller is not the UK holding company, from the UK holding company. The condition will also be amended to include a successor clause that requires Anglian Water to obtain new undertakings in the event of a change of ownership.

Osprey has suggested that the following entities should provide Condition P undertakings to Anglian Water:

- 3i Group plc as a joint ultimate controller;
- CPPIB as a joint ultimate controller;
- CBA as a joint ultimate controller;
- IFM as a joint ultimate controller; and
- Osprey itself as Anglian Water's UK holding company.

In light of the information presented to us (and explained in our consultation paper) and in the absence of any dissenting view from respondents to our consultation paper, we see no reason to dispute Osprey's view of which entities should provide the Condition P undertakings.

However ultimately it is the responsibility of Anglian Water to ensure that it complies with its licence by procuring Condition P undertakings from the appropriate entities.

### **3. Financing**

Whilst the consortium currently intends to retain Anglian Water's existing financing arrangements, Anglian Water's gearing will increase (on a net debt:Regulatory Capital Value basis) from around 78% up to a maximum of 83% as a result of a dividend payment to the consortium members by Anglian Water. A dividend of £215m was paid to the consortium members by Anglian Water on 7 March to facilitate achieving the increase in gearing. A move to gearing of around 83% would leave some headroom against the covenanted level of gearing (85%) that would trigger a dividend lock up at Anglian Water under its securitised structure.

Ofwat has been clear that capital structures are essentially a matter for companies and the markets. However to the extent that capital restructuring may bring about tax efficiencies these would, as part of the established incentive based regulatory regime, be passed to customers at the next price review.

The Consumer Council for Water Eastern has responded to our consultation. They consider that the increase in the level of gearing transfers risk to customers whilst enhancing Anglian Water's return to its owners. They state that the increased gearing will bring financial benefit to the company and as such, they consider that customers should receive their fair share of these benefits, and these should be provided in advance of the next price review.

When we set prices in December 2004, Anglian Water was geared in excess of 80%. It is the tax charges associated with this level of gearing that are reflected in Anglian Waters price limits for 2005-10.

The credit rating agencies have not changed their ratings for Anglian Water as a result of their respective reviews of Osprey's proposals. For example, Moody's Investor Services give Anglian Water a "corporate family" rating of Baa1. The rating provides headroom above the floor for investment grade credit quality. Ofwat considers headroom above this floor important as a safeguard against future uncertainties.

The Consumer Council for Water Northumbria, which represents the customers served by Anglian Water its Hartlepool region, responded to our consultation. They stated they would not accept any change in levels of service as a result of the change of ownership and expect to continue to work closely with staff of Anglian Water and Hartlepool Water to ensure the existing high levels of service are maintained. In addition, one respondent raised concerns over Osprey's ability to give an unconditional guarantee to establish and maintain adequate water and sewerage services.

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 from their regulated water company. Anglian Water will continue to have the obligations imposed upon it by legislation (especially the Water Industry Act 1991) and the conditions of its licence. We will continue to regulate Anglian Water under those provisions. Price limits for 2005-10 have been determined and accepted by Anglian Water. Anglian Water must now deliver the outputs underpinning those price limits. We will monitor this and, where appropriate, we will exercise our powers to that end.

#### **4. Conclusions and the need for modifications to Anglian Water's licence**

We do not consider that the acquisition raises significant regulatory issues. Anglian water's ring-fencing licence conditions are already broadly consistent with those of other water undertakers of a similar size and structure.

However as stated above we will modify Anglian Water's licence to replace the company's existing Condition P with the new generic Condition P.

We will also require Anglian Water to maintain a listed instrument to ensure the continued existence of a helpful financial comparator in the absence of the full equity listing lost as a result of this acquisition.

In addition, we signalled in MD218<sup>1</sup> our conclusion, following consideration of responses to the Financing Networks discussion paper, that there is merit in the gradual adoption by water companies of cash lock-up provisions similar to those already applied to energy companies. We indicated that whilst we saw no grounds for urgent change we would seek to introduce cash lock-up provisions into licences as and when suitable circumstances arise. The change of ownership of Anglian Water, through the acquisition of AWG by Osprey, represents such a circumstance.

We are drafting a cash lock-up provision designed to accommodate the diversity of capital structures in the water industry. Anglian Water has, in principle, accepted this for inclusion in its licence.

These changes will be made following a notice under section 13 of the Water Industry Act 1991.

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<sup>1</sup> Notification of intent to introduce a cash lock-up provision to condition f of companies' instruments of appointment, September 2006

## **Annex 1**

List of respondents:

- Consumer Council for Water, Eastern Division
- Consumer Council for Water, Northumbria
- The Board of Anglian Water Services Limited
- The independent non-executives of Anglian Water Services Limited
- Mr Calthorpe