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The Trafalgar House Takeover Bid for Northern Electric - a Case Study in the Impact of Regulatory Intervention

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Abstract

Trafalgar House's takeover bid for Northern Electric, the first for a privatised utility, was notable in retrospect for the regulatory intervention which it evoked, although it had not been expected that regulatory intervention would play a major role in its outcome. This paper presents a case study of this takeover bid. Its principal focus is on the impact of regulatory intervention by the MMC and the Office of Electricity Regulation and it uses event study methodology to assess the impact of this on shareholders' returns.

1. Introduction

This case study on the Trafalgar House takeover bid for Northern Electric adopts a basically chronological approach, focusing principally on the impact of regulatory intervention on the part of OFFER (Office of Electricity Regulation) and the Monopolies and Mergers Commission (MMC) on the progress and eventual outcome of the bid and on shareholders' returns. The case uses event study methodology to analyse the impact of announcements made during the course of the bid.

It has long been recognised that the possibility of MMC referral can have a significant impact on takeover bids, although in reality relatively few mergers are actually referred (Fairburn 1993 p.253). This case shows that other forms of regulation in the privatised utilities also have the potential to have a significant impact on the outcome of takeovers and can have a significant impact on shareholders' returns.

2. Methodology

The impact of the events investigated is assessed by calculating abnormal returns, using the market model (Sharpe 1963) to estimate normal returns:

$$r_{i,t} = a_i + b_i r_{m,t} + e_{i,t}\ ,\ \mathrm{E}(e_{i,t}) = 0,\ \mathrm{Var}\ (e_{i,t}) = \sigma_e^2$$

where $r_{i,t}$ = return for firm i in period t, $r_{m,t}$ = return on the market in period t, $e_{i,t}$ = error term and a_i, b_i, σ_e^2 are the parameters of the market model.

The values of a_i and b_i were calculated by OLS regression of the logarithm of daily returns on the security against the logarithm of returns on the *Financial Times* - Stock Exchange 100 (FTSE 100) share index - the measure of the market return. The FTSE 100 index did at that point contain a number of regulated companies, which ought perhaps to have been removed from the index (see Dnes and Seaton 1995), but no adjustment was made for this on the grounds of materiality. Appleyard and McLaren (1996) found that the FTSE 100 without regulated companies had at this time a 97 per cent correlation with the FTSE 100 including them. The estimation period was the 60 days prior to the month of the first event (up to 31/07/94 for the regional electricity companies (RECs) and the FTSE 350 Electricity Index and up to 30/11/94 for Trafalgar House). It was felt that returns during the period under review were so affected by the large number of events often following in quick succession that it would not be sensible to recalculate a_i and b_i values for each event, as no uncontaminated estimation period could be found. The abnormal return is the difference between the actual daily return and the normal return generated by the market model.

Generally four-day event windows (t-1 to t+2) were used (Dnes and Seaton (1995) found these were the best) but in the case of the announcement of the Trafalgar House bid a longer event window (t-5 to t+5) was used, because rumours were rife before the formal announcement and on day t+3 the bid terms were announced, adding further information.

The impact of the selected events is tested on the returns of the protagonists, Northern Electric and Trafalgar House, but also on two other RECs, Yorkshire Electricity and Manweb (Merseyside and North Wales Electricity Board), and on the FTSE-350 Electricity Index. Yorkshire and Manweb were selected as RECs of similar size to Northern, so that the impact of these events on other RECs could be assessed. The FTSE-350 Electricity Index covers all electricity distribution and generation companies in the top 350 UK companies and has been used to test the impact of the events on the electricity industry as a whole, not just the distribution companies.

3. Background

When the electricity industry in England and Wales was privatised in 1990 the Government separated the distribution companies from the generators in order to prevent vertical integration. The RECs, the distribution companies, were effectively established as regional monopolies, although provision was made for the introduction of competition later on. OFFER, under its Director-General, Professor Stephen Littlechild, was set up to regulate the industry.

Although the regulatory mechanisms vary from one privatised utility to another, there are a number of common strands in UK utility regulation:

a) the regulator is a single regulator independent of government and of other regulators, although still accountable to government.

b) the system of regulation is based upon RPI - x% price increases rather than on any particular rate of return. The price caps should be set periodically and without retrospective clawback, providing an incentive for the companies to improve their efficiency, in particular by cutting costs (Helm 1994; Vass 1995). However, the differences between the two approaches can be exaggerated, as price cap regulation still requires some notion of what is a fair return in order to set the price caps. Bishop, Kay and Mayer (1995) argue that price cap regulation is essentially similar, but with longer time lags. Laffont and Tirole (1993) regard price cap regulation as the best approach for encouraging cost reduction, as the firm is the residual claimant, but not the best way of preventing rent extraction. Furthermore to set effective price caps the regulator requires good knowledge of cost and demand conditions. In this case there is clear evidence of information asymmetry limiting the regulator's effectiveness and forcing him to revise price caps to correct a perceived error. According to Laffont and Tirole (op.cit.p. 619) commitment to the regulatory contract encourages investment, but is difficult for regulators, since short commitments allow wrong policies to be corrected.

c) the system of regulation can become highly politicised because of the issues involved and regulation takes place in a political environment, despite the *independence* of the regulators (Vass 1995). Laffont and Tirole (1993) comment that UK price capping reviews have not in practice been exogenous, because governments find it difficult not to intervene when pressured to reduce prices. In principle, levels of profit or rates of return should not precipitate an unscheduled adjustment to the price caps, but some degrees of rent extraction are politically unacceptable. This case shows how OFFER revised previously set price caps because of the emergence of information which showed the RECs to be more profitable than OFFER had believed.

On privatisation the Government retained a golden share, which effectively gave ministers a veto over changes in the memorandum and articles of the RECs. The latter limited any shareholding to 15 per cent and thus effectively protected RECs against takeover. The golden shares were due to expire on 31 March 1995 and it was widely expected that a flurry of merger and takeover activity would ensue. RECs' low-risk and predictable cashflows made them attractive targets. Another important factor was the RECs' collective ownership of the National Grid, which they hoped to be able to float as a separate company in the course of 1995. In the 1990 privatisation prospectus it had been valued at £780m, but it was thought that its value on flotation might be £4-5bn. This could give the RECs a huge cash bonanza to pass on to shareholders and made the RECs much more attractive takeover targets.

4. The Events Analyzed

Table 1 sets out the key events in this case study in chronological order, indicating those for which abnormal returns have been calculated.

4.1 Event 1 - OFFER's announcement of price caps - August 1994

This first distribution price review since privatisation (OFFER 1994a) was more lenient than expected and was followed in the next two months by big share price rises. It combined one-off cuts specific to each REC with general annual caps thereafter. Northern Electric was to reduce its distribution prices by 17 per cent in April 1995 and increases thereafter were limited to 2 per cent below the rate of inflation, as shown in Table 6. This was one of the more severe caps, as most other RECs only faced decreases of 14 or 11 per cent in 1995. However, the pricing formula was believed to be fixed for five years and left plenty of scope for strong cashflows and increasing rewards for shareholders.

Table 2 shows the impact of Event 1 on shareholders' returns. The initial market reaction to the price caps was for positive abnormal returns, presumably because they were not as bad as expected. In the cases of Yorkshire, MANWEB and the FTSE-350 Electricity Index the abnormal return on the event day was statistically significant. However, it would seem that the market may have taken some time to realise the full implications of the price caps, as prices rose considerably in the following month. Figure 1 provides a graph of Northern Electric share price movements at this time.

Table 1: Chronology of events

Date	Event	Abnormal returns calculated
11 August 1994	OFFER announces price caps to apply to RECs from 1 April 1995	Event 1
14 December 1994	Swiss Bank Corporation announces that Trafalgar House is considering a takeover bid for Northern Electric	Event 2
19 December 1994	Formal bid announcement	
20 December 1994	OFFER issues a consultation paper on the bid	
9 January 1995	Trafalgar House launches its formal offer document	
14 February 1995	Michael Heseltine, President of Board of Trade, announces that the bid will not be referred to the MMC	Event 3
17 February 1995	Northern Electric issues final defence document	
23 February 1995	Trafalgar House increases its offer	
7 March 1995	OFFER announces that the price caps set in August 1994 are to be reviewed again	Event 4
6 July 1995	OFFER renounces revised price caps for RECs	Event 5
10 July 1995	Southern Company of the US makes a dawn raid on South Western (SWEB) followed by a formal bid	
24 July 1995	Scottish Power mounts a hostile bid for Manweb	
31 July 1995	Hanson announces an agreed bid for Eastern Electricity	
4 August 1995	Trafalgar House announces that it will not renew its bid for Northern Electric	

Table 2: Abnormal returns around the announcement of price caps, August 1994 (%)

Date / Companies	Northern Electric	Yorkshire Electricity	Manweb	FTSE 350 Electricity Index
t-1	-1.57	-1.58	-0.94	-1.32
t	2.84	*5.14	*4.31	*3.65
t+1	1.72	0.88	3.98	0.73
t+2	*-3.18	-2.72	-0.13	0.81
Cumul. *t*-2 to *t*+2	0.30	1.55	*7.29	2.20

t = 11 August 1994 * significant at the 5% level (2-tailed test)

Figure 1: Northern Electric share price movements 01/08/94 - 16/08/95
Source:Datastream

Broken line shows price relative to FTSE-100 Index

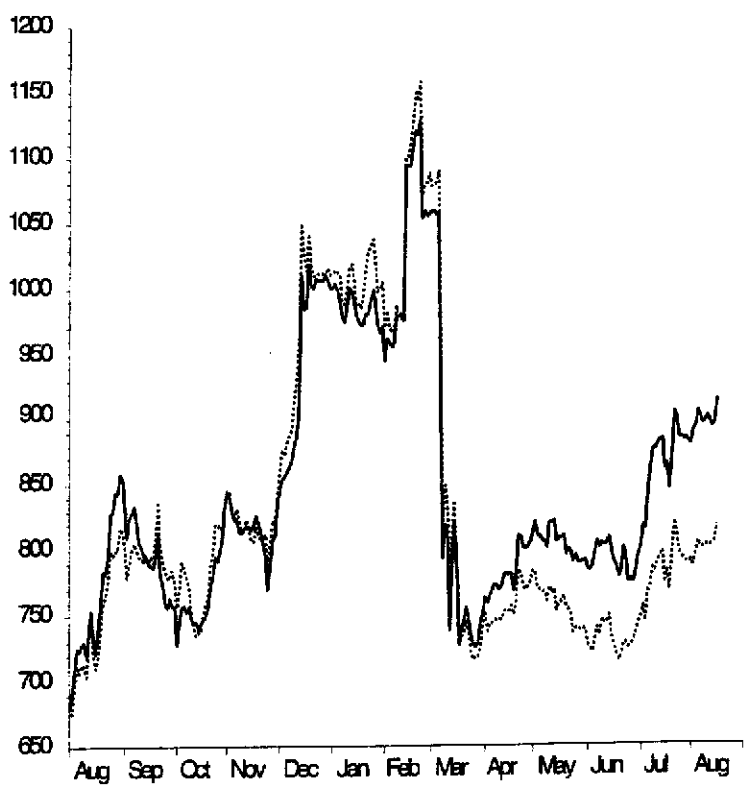

Table 3: Abnormal returns in response to Trafalgar House's bid for Northern Electric (%)

Company Date	Northern Electric	Yorkshire Electricity	Manweb	FTSE 350 Electricity Index	Trafalgar House
t-5	0.31	-1.73	-0.72	-2.42	-1.89
t-4	0.34	-0.18	0.49	0.13	2.89
t-3	1.87	-0.83	-0.40	-0.88	1.38
t-2	1.02	-0.44	-0.57	-0.02	-1.18
t-1	2.29	2.71	0.86	0.32	*-4.07
t	*9.64	2.84	*5.73	*2.34	-1.37
t+1	-2.71	0.69	2.81	0.39	0.32
t+2	-0.78	1.72	-0.22	-0.67	2.45
t+3	2.74	-0.91	0.63	0.55	-0.60
t+4	-2.19	-1.00	-2.08	-1.16	-1.95
t+5	-0.62	-1.42	-2.19	-0.87	0.68
Cumul. *t*-5 to *t*+5	*12.47	1.72	3.08	-2.29	-2.47

t = 14 December 1994 * significant at 5% level (2-tailed test)

Notes: SBC announces Trafalgar's intention to bid 14/12/94. Bid terms announced 19/12/94

4.2 Event 2 - Trafalgar House launches its bid - December 1994

Table 3 shows abnormal losses for Trafalgar House shareholders around the announcement date, which is quite plausible for a bidder company, but abnormal gains for Northern Electric and other RECs because of the prospect of shares being acquired at a premium. It seems that the market felt at this stage that Trafalgar House shareholders were unlikely to benefit from the bid, perhaps because too high a price would have to be paid to secure control or because of costly regulatory obstacles.

These findings are not inconsistent with general findings about how the gains from takeovers are shared between target and predator (e.g. Jensen and Ruback 1983).

It seems probable that financial benefits in the form of lower taxes and less volatile earnings were the most important motives for Trafalgar House. Northern's defence circular valued the tax benefits at £2 per share (Northern Electric 1995a) and in addition the capital gain arising on the sale of the National Grid could be offset against Trafalgar's tax losses. However, the main benefit to Trafalgar was of being able to balance its cyclical earnings stream with Northern's more stable and cash-generating businesses. Another probable motive was the need of Hong Kong Land, 25 per cent shareholder and effective controller of Trafalgar House, and its ultimate parent, Jardine Matheson, to reduce exposure to the politically sensitive area of Hong Kong.

Trafalgar House could have obtained the benefits of steady profits and tax offset from any REC, not necessarily Northern Electric. Publicly Trafalgar House claimed that it already had substantial interests in the North of England, where it employed almost as many people as Northern. In reality the reasons may be Northern Electric's size as one of the smaller RECs and the scope for cost cutting indicated by the regulator's decision to impose the biggest class of price cut on Northern Electric (OFFER 1994a).

4.3 Event 3 - MMC referral - February 1995

It has long been government policy that referrals to the MMC should only be made on competition grounds (Tebbitt Doctrine, House of Commons 1984). This bid did not raise any significant competition issues, as there was no vertical integration and no reduction in the number of RECs. Thus logically the Government should not have made a referral, although there were certain regulatory issues raised by this first bid for a privatised utility. Professor Littlechild's consultation paper on the regulatory issues (OFFER 1994b) shows his concerns about the removal of the share price quotation, which 'removes a source of information about investors' views of comparative performance and the effects of market factors, including regulatory actions' (Op. cit.p.2). He also voiced concern about the potential loss of information if the licence holder was a subsidiary. There was some fear that information from the parent and other subsidiaries might not be so easily obtained. These concerns are in line with Laffont and Tirole's (1993) analysis of cost padding and accounting manipulation. It was reported in the press (*Financial Times* 1995) that OFFER had wanted an MMC referral and that it had suggested that 25 per cent of Northern Electric should be refloated on the stock exchange. This would have provided a share price, but would have made the acquisition enormously more expensive for Trafalgar House, which would have had to buy Northern Electric at a premium and then refloat 25 per cent of it at a discount. Such a solution hardly seems realistic, especially as the planned removal of the golden share so clearly opened up RECs to takeovers and mergers.

In order to pre-empt action Trafalgar House had built a £20 rebate for customers into its bid terms, taking up a hint by Professor Littlechild that it would be easier to clear a bid which benefited customers. At the same time it also showed that £26m could easily be found from Northern Electric to return to customers. Trafalgar House also undertook to maintain Northern Electric as a separate company with its headquarters in Newcastle.

Despite OFFER's preference for an MMC referral, on 14 February 1995, Michael Heseltine, President of the Board of Trade announced that he would let the bid go ahead. It looked at that point as if the major regulatory obstacle had been overcome. Table 4 shows that abnormal gains were made on the announcement with success in the bid being anticipated. The decision also resulted in positive abnormal returns to shareholders in other RECs, as the decision increased the likelihood of further takeovers in the sector. The lack of significant abnormal returns on the FTSE-350 Electricity Index is probably because this includes generators as well as RECs, thus diluting the effect.

Table 4: Abnormal returns on announcement of non-referral of bid to the MMC (%)

Company Date	Northern	Yorkshire	Manweb	FTSE 350 Electricity Index	Trafalgar House
t-1	-0.27	-0.80	-0.40	0.14	-0.39
t	*11.18	*8.53	*6.53	2.70	*4.92
t+1	0.28	0.40	-1.00	-1.30	1.45
t+2	-0.16	0.10	-0.53	0.12	-0.49
Cumul.	*10.96	*6.50	4.50	1.64	5.51

t = 14 February 1995 * significant at 5% level (2-tailed test)

4.4 Northern Electric's defence package
Northern Electric's final defence document (Northern Electric 1995b) announced a package worth £560m for its shareholders. The Board promised a £1.50 special dividend, a £1 bonus preference share and distribution to shareholders of Northern Electric's share of the proceeds of National Grid flotation, which it valued at £2.57 per share. This was worth over £5 per share and would result in the company becoming temporarily very highly geared, 225 per cent on an historic cost basis, declining to 100 per cent by the year 2,000, although Northern Electric (1995b) claimed that cover for interest and preference dividends would remain healthy. Northern Electric also promised fat dividend increases. This bold defence certainly put Trafalgar House on the spot and forced it to increase its offer. However, the Northern Board remained liable to criticism for only acting under external pressure. They could also with the benefit of hindsight be criticised for taking the regulatory regime too literally, assuming that with price caps set until the year 2,000 their action in returning so much value to shareholders would not trigger any regulatory reaction.

Trafalgar House responded with a revised offer (Trafalgar House 1995), which was widely reported in the press as being finely pitched and by no means a knockout blow. Without OFFER's last minute intervention, it is far from certain what the result of the bid would have been.

4.5 Event 4 - OFFER's last minute intervention
OFFER's announcement on 7 March 1995 (OFFER 1995a), three days before the offer closed, that it would look again at the price caps for the period 1995 - 2000, effectively scuppered Trafalgar House's bid by creating so much uncertainty about RECs' future profitability. Professor Littlechild's timing was also extraordinary because his announcements coincided with first trading for the last tranche in the privatisation of the generators' (PowerGen and National Power) shares. The announcement wiped millions off the prices of these shares and lead to questions being asked about why the offer had been allowed to go ahead with a highly price-sensitive announcement in the offing.

The Northern Electric Board felt in the circumstances obliged to recommend Trafalgar House's offer, but Trafalgar House let it lapse at the last moment after it attracted over 80 per cent acceptances. Trafalgar House then made a lower bid of £9.50, but the Northern Electric Board refused to allow it to be put to shareholders.

Table 5 shows the significant negative abnormal returns caused by the regulator's announcement, which made the bid less desirable and less likely to succeed, as well as threatening to reduce all RECs' future profits. At this point it was not certain that the price caps would be revised and whether any changes would be implemented in the form of a general adjustment across all RECs or in the form of reductions in the price caps of specific RECs. The market reaction was to anticipate an across the board reduction with all the three RECs here examined suffering negative abnormal returns of roughly the same size.

Even if one believes that the takeover bid was not the main reason for OFFER's decision to review the price caps again, (although OFFER claims that it was (OFFER 1995b)) it gave Professor Littlechild an excuse to intervene. He justified his action on the grounds that new information had emerged since the price caps were set the previous August. This was:

a) the share price reaction to the August 1994 price cap announcement;

b) the terms of Trafalgar House's bid for Northern Electric;

c) information in the bid and defence documents (OFFER 1995b).

He also mentioned widespread public concern about the fairness of the price caps. This was an admission that the earlier price caps had been wrong and that OFFER had relied too uncritically on information presented to it by the RECs. It also was an action which further politicised the regulatory process and which went against the spirit of the regulatory regime. Instead it was becoming obvious that only a certain level of profitability could be allowed. This illustrates Laffont and Tirole's (1993) proposition that commitment to a price capping agreement is problematic for regulators, as it prevents the correction of mistakes before the next price review.

It appears that the information Northern Electric supplied to OFFER in relation to the price caps was in some ways out of line with that released during the takeover. Perhaps this was only to be expected. Forecasts provided for a price capping regulator are likely to be more conservative than those used to fight off a hostile takeover and maintain the loyalty of shareholders. Helm (1995 p.20) states that the regulatee's objective is to maximise profits and to ensure that it faces the weakest regulatory constraints. Business plans are therefore likely to overstate costs and understate demand.

In the OFFER press release of 24 March 1995 (OFFER 1995b p. 3) the Director-General says in reference to Northern Electric's second defence document:

> This contained information about planned operating costs and capital spending, special payments to shareholders and a forecast of substantially rising dividends, all of which were formulated subsequent to the discussions which informed my August proposals. This could have implications for the ability of other companies to implement reductions in operating costs and capital spending, make payments and dividends to shareholders and to increase gearing.

Table 5: Abnormal returns on announcement of intention to revise price caps, 7 March 1995

Date \ Companies	Northern Electric	Yorkshire Electricity	Manweb	FTSE 350 Electricity Index	Trafalgar House
t-1	0.07	-0.60	0.30	0.15	0.94
t	*-16.03	*-23.85	*-16.71	*-11.46	*-6.40
t+1	*-12.79	*-7.15	*-8.66	*-3.51	0.46
t+2	2.97	*6.54	1.66	1.52	0.32
Cumul. t-1 to t-2	*-24.55	*-25.11	*-22.43	*-13.15	-4.78

* significant at 5% level (2 tailed test)

Table 6: Present and proposed price controls for electricity distribution charges (relative to inflation)

REC	Initial price reduction in 1995/96	Proposed reduction in 1996/97	X factors 1997-2000	Aggregate reduction 1994/95 to 1999/2000
Eastern	11	10	3	27
East Midlands	11	13	3	29
London	14	11	3	30
Manweb	17	11	3	33
Midlands	14	11	3	30
Northern	17	**13**	**3**	**34**
NORWEB	14	11	3	30
SEEBOARD	14	13	3	32
Southern	11	10	3	27
SWALEC	17	11	3	33
South Western	14	11	3	30
Yorkshire	14	13	3	32
Average	**14**	**11.5**	**3**	**31**

Source: OFFER (1995c)

4.6 Event 5 - OFFER sets new price caps - July 1995

The proposals involved further price reductions as of April 1996 ranging from 10 per cent to 13 per cent. Northern Electric received a 13 per cent cut. This was to be followed in the three subsequent years by RPI - 3 per cent, rather than RPI - 2 per cent as originally proposed. Table 6 shows that Northern Electric received the biggest price reductions in both reviews and was the only REC so to do. The review combined across the board reductions in annual price caps with some differentiation between RECs for the initial reduction in April 1996.

The share price reaction to the announcement was wild, with shares rising on rumours of a lenient settlement, then falling back as some features of the review became known. However, the net change by the end of day *t* was upwards, suggesting that the review was not overly severe and left scope for dividend increases. Table 7 shows positive abnormal returns which are not statistically significant, so the conclusion must be that the announcement had no significant effect on returns. It would seem that the reductions in the price caps had already been discounted into the price.

Trafalgar House itself had meanwhile reported half year losses exacerbated by the £12m net costs of its takeover attempt and announced a swingeing cost cutting programme. On 4 August 1995 it announced that it would not be bidding for Northern Electric, claiming that recent bids for other RECs had pushed prices up too high. However, a stream of bad news about Trafalgar House's performance had cast doubt on its management's control of the business and lead to a dramatic fall in its share price. Since then Trafalgar House's problems have continued, culminating in its takeover by Kvaerner in April 1996.

5. Conclusions

A number of tentative conclusions can be drawn from this case study, which would in some cases need to be confirmed by further research on a more systematic basis.

a) It could be argued that the takeover process is helpful to the regulator because it reduces the information asymmetry between regulator and regulated utility (Robinson 1995). New information is likely to emerge during a bid, which was not available before. This is certainly what OFFER claimed, although some might feel that it had not been sufficiently sceptical of the data supplied to it to help it fix the original price caps.

b) On the other hand mergers may create problems for the regulator by making the results of the regulated company less visible and because of the loss of the share price. OFFER certainly put forward this view (OFFER 1994b p.2) and the case certainly supports the view that shareholder returns provide useful signals to the regulator.

c) It appears difficult for regulators to set prices for fixed time periods and refrain from intervention throughout the period of the price cap. Although in theory RPI - x per cent price caps should avoid problems about setting an acceptable rate of return, the political reality is that returns over a certain level are unacceptable in privatised utilities. Regulators seem likely to intervene on an ad hoc basis to adjust prices. As Helm (1995 p.37) notes, five years is a long time to wait to correct errors.

d) The evidence from this case lends support to the notion that regulatory risk is the main type of risk faced by shareholders in privatised utilities, which are fundamentally of low business risk. More systematic research is needed to test and measure this and to assess the extent to which regulatory intervention in one industry affects others.

Endnotes

1. Department of Accounting and Finance, University of Newcastle upon Tyne. I am grateful to my colleagues Professor Tony Appleyard and Josie McLaren for comments on the paper and for advice on methodology. Helpful comments were received from participants to the British Accounting Association Northern Accounting Group Conference at the University of Northumbria in September 1995 on an earlier draft of this paper. My thanks also go to two anonymous referees for their helpful comments on the paper.

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