



THE PROPOSED CHANGE OF OWNERSHIP OF SOUTH DOWNS CAPITAL LIMITED

A CONSULTATION NOTE BY OFWAT

1. Purpose

This note describes the proposed acquisition by Abbey National Treasury Services Overseas Holdings (ANTSOH) of substantially all of Drummond Capital's stake in South Downs Capital Ltd (South Downs) and invites comments on the proposal. On the basis of responses to this consultation paper, we will formulate our advice to the Director General of Fair Trading (DGFT). To meet the DGFT's timetable, responses to this consultation should be made in writing by no later than 5.00pm on 16 April 2002 to:

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At the end of the consultation period, we will place each response in Ofwat's Library for public inspection, unless it is clearly marked "in confidence". You should also send a copy to Andrew Hobbs at the Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX (Fax: 020 7211 8916; E-mail: andrew.hobbs@oft.gov.uk).

2. The proposal

On 14 March 2002, the Royal Bank of Scotland (RBS) announced that its subsidiary Drummond Capital had reached agreement for the sale to ANTSOH of substantially all of its equity interest in South Downs, the ultimate holding company of Portsmouth Water plc (Portsmouth Water). Following the transfer, South Downs will be owned 15% by its management, 40% by the South Downs Employee Benefit Trust, 36% by ANTSOH and 9% by Drummond Capital.

Portsmouth Water is a licensed water undertaker regulated by Ofwat. It supplies water to approximately 285,000 customers in and around the city of Portsmouth in the south of England. As well as its water business (which contributes over 95% of the group's turnover), South Downs also owns a number of unregulated businesses.

ANTSOH is a wholly owned subsidiary of Abbey National Treasury Services plc (ANTS). ANTS is the wholesale bank of the Abbey National Group (the Group) and also the Group's treasury. The company is a wholly owned subsidiary of Abbey National plc.

The proposed transfer does not effect the proposals for the future structure and financing of South Downs, which Ofwat consulted on in October 2001¹. Under these proposals, ownership of the company would have passed over time to the South Downs Employee Benefit Trust through the redemption of the stake held by Drummond Capital. It was expected that this redemption would take approximately 15 years. This remains the case and the stakes held by ANTSOH and Drummond Capital will be redeemed on a pro-rata basis.

3. The statutory position on mergers

ANTSOH does not currently control any water enterprises in the UK and hence the Secretary of State for Trade and Industry (Secretary of State) is not required to refer this offer to the Competition Commission. However, the transfer does give rise to a qualifying merger under the Fair Trading Act 1973 (FTA). Under the FTA, the Secretary of State may refer a proposed merger or acquisition to the Competition 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.

The DGFT is responsible for advising 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 that 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 that would impact on our ability to regulate the water company.

If the Secretary of State refers the transfer to the Competition Commission, the Commission must consider whether the take-over is likely to have effects adverse to the public interest. If it so concludes, the Secretary of State may either prohibit the transfer, or seek remedies. If it makes no adverse public interest finding, the transfer may proceed.

4. Duties of the regulator

The regulator's duties are set out in the Water Industry Act 1991 and in competition legislation. His primary duties are to act in the manner he considers best calculated to ensure that water companies properly carry out their functions and that they can finance the proper provision of those services. He also has duties to protect customers, to promote efficiency and economy by regulated businesses and to promote the efficient use of utility services by consumers. He has further duties to facilitate effective competition in the provision of utility services and (concurrently with the DGFT) to investigate and deal with anti-competitive behaviour by licensed utilities such as Portsmouth Water. The Competition Act 1998 has recently strengthened these powers.

¹ The proposed acquisition of Brockhampton Holdings plc by South Downs Limited: a consultation paper by Ofwat (October 2001)

An important aspect of competition is in the market for ownership and control of those utilities. Competition in ownership may stimulate existing owners to be more efficient in the services provided as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.

Therefore, Ofwat accepts in principle that changes of ownership following takeovers may be beneficial. At the same time, because we are concerned that the functions of water undertakers should be properly carried out, we wish to be satisfied, in each particular case, that the prospective owner has the probity and operational and financial capacity to assume that role. Before forming an opinion about ANTSOH's standing, we would like to know the views of others in this respect.

5. Licence modifications

When South Downs acquired Portsmouth Water last year Ofwat consulted on the regulatory issues involved in the new structure of the company. We proposed a set of licence modifications to deal with the regulatory issues and these are currently in the process of being made. They remain relevant and Ofwat will make these licence modifications regardless of the share transfer. Portsmouth Water has given an undertaking to Ofwat that it will act as if these licence modifications had been made.

These modifications are designed to ensure that the regulated business is firmly ring-fenced within its new group. They:

- require Portsmouth 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 Portsmouth Water's functions;
- require Portsmouth Water to maintain an investment grade corporate credit rating;
- prohibit cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other companies in the South Downs Capital group;
- 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 Stock Exchange;
- Portsmouth Water's dividend policy must avoid any adverse effect on the company's ability to finance its functions as a water undertaker.

The licence modifications also require Portsmouth Water to obtain from its owners, undertakings that they and other group companies provide information and avoid actions that might interfere with Portsmouth Water's obligations as water undertaker. ANTSOH will be required to provide these undertakings in place of Drummond Capital.

The transfer does not in Ofwat's view raise any new regulatory issues that might require further licence modifications. However we would welcome views from any interested parties on the proposal.

6. Effect on customers of the proposals

Ofwat is satisfied that there will be no deterioration in the quality of service provided to Portsmouth Water's customers as a result of the transfer. ANTSOH appreciate the need for adequate ring fencing of Portsmouth Water and for independent local representation on Portsmouth's Board.

The obligations imposed by the Water Industry Act 1991 and the licence issued under it would continue to apply and Ofwat believes that the proposed takeover should not adversely affect customers in any way.

**Office of Water Services
26 March 2002**