

POSITION NOTE ON THE ACQUISITION OF SOUTH STAFFORDSHIRE PLC BY ARCAPITA BANK B.S.C. (C) (FORMERLY FIRST ISLAMIC INVESTMENT BANK E.C.)

First Islamic Investment Bank E.C., through its acquisition vehicle AqualInvest Acquisitions Limited (AqualInvest), announced on 18 November 2004 that its offer to acquire South Staffordshire plc (South Staffordshire) for £142.6 million had been declared fully unconditional. South Staffordshire is the immediate owner of South Staffordshire Water plc (SSW), a regulated water company, and also owns a number of non-regulated businesses.

On 29 November 2004, the Office of Fair Trading cleared the acquisition without referring it to the Competition Commission. On 17 December 2004, we issued a consultation paper, "*The completed acquisition of South Staffordshire plc by First Islamic Investment Bank E.C.*" The purpose of the paper was to consult on any regulatory issues arising from the acquisition and whether any modifications should be made to SSW's instrument of appointment (its "appointment").

On 15 March 2005, Bahrain-based First Islamic Investment Bank E.C. changed its name to Arcapita Bank B.S.C. (c) (Arcapita).

This note sets out the issues raised by respondents and our position on those issues. Annex 1 lists the respondents.

Remoteness of the new owners

WaterVoice Central, which represents SSW's customers, was concerned that the new structure resulted in opaque and distant owners with no real relationship with the interests and concerns of either customers or employees of SSW. Other respondents also believed that remoteness of the owners and de-listing of South Staffordshire's shares could reduce the company's accountability and make it more difficult for stakeholders to access information on the company.

Many regulated water (and water and sewerage) companies are part of larger groups. In each case we regulate the water undertaker itself ("the appointee"), which remains locally managed. It is the appointee, rather than its owners, which is directly responsible for complying with its appointment. The appointee's responsibilities include delivering the required levels of service to its customers and providing the information submissions required by Ofwat as its economic regulator and by other regulators including the Environment Agency and Drinking Water Inspectorate.

We will modify Condition F of SSW's appointment to bring it into line with the current standard for companies with similar ownership structures. This will ensure that customers are protected from risks outside the appointed business, including any risks that may be faced by its owners, and that the

company makes the same information publicly available as a listed company would.

To ensure that SSW has the co-operation of its parents in carrying out its functions, we are also proposing to insert Condition P into the company's appointment. This condition requires the water company to obtain legally enforceable undertakings from its UK holding company and 'ultimate controller', where:

Ultimate Controller means any person (including, without limitation, a corporate body) who or which (alone or jointly with others and whether directly or indirectly) is (in the reasonable opinion of Ofwat) in a position to control, or to exercise material influence over, the policy or affairs of the regulated business or of any holding company of the regulated business.

The undertakings state that the companies will:

- give SSW any information it needs to comply with its appointment;
- refrain from any action that could cause SSW to breach its appointment; and
- maintain a minimum of three independent non-executive directors on SSW's board.

SSW has agreed to act as if our proposed modifications to its appointment conditions F and P were already in place. As part of this agreement, it has obtained condition P undertakings from its new ultimate controller (Arcapita) and new UK holding company (AqualInvest).

We believe this should reassure customers that SSW's parent is committed to helping the water company continue to act in its customers' best interests.

Complexity of the new ownership structure

Two respondents were concerned that the complexity of the new structure might mean that SSW's true ownership was unclear.

As set out above, under appointment condition P we will require SSW to obtain undertakings from its ultimate controller that it will co-operate with SSW in carrying out its functions. SSW has given us assurances that Arcapita is its ultimate controller.

As described in our December consultation paper, the relatively complex new structure arises principally from a requirement, under Arcapita's constitution, that this transaction be compliant with Islamic law. A number of other water companies also have complex ownership structures including those owned by companies funded by private equity and/or passive investors.

We have examined the proposed structure and are comfortable with SSW's conclusion that Arcapita is its ultimate controller. Ultimately, however, it is for the company to ensure that it obtains Condition P undertakings from the

correct body. SSW understands that, were this not the case, it would be in breach of its appointment and we would have to consider taking appropriate action. If its ultimate controller changed at any time in the future, the new ultimate controller would be required to provide SSW with a new undertaking at the same time as this change.

Ownership by overseas companies

A number of respondents were opposed to overseas interests acquiring water companies in England and Wales.

It is not for Ofwat to dictate the nationality of water companies' owners. The possibility of a takeover acts as a stimulus to managements to run their companies more efficiently. Preventing non-UK organisations from buying water companies could lessen this pressure and reduce the efficiency gains, ultimately leading to higher bills for water customers. Any purchaser (UK or non-UK) should however be 'fit and proper' to be the owner of a regulated water company. We have seen no evidence to suggest that Arcapita does not meet this requirement.

Arcapita is licensed and regulated by the Bahrain Monetary Agency (BMA). It is subject to a similar set of rules to UK-based investment banks that are regulated by the Financial Services Authority. The BMA's licensing conditions take into account a bank's reputation and financial standing, its track record and probity, as well as consideration of the 'fit and proper' nature of its controllers and management. The BMA has told us that it has no information to suggest that Arcapita does not meet these licensing conditions.

Our proposed modifications to SSW's appointment will ensure that, whoever its owner, it will continue to have sufficient financial and managerial resources to perform its functions, and that it will operate with the interests of its customers uppermost. As mentioned above, the regulated water company will remain locally managed and able to respond to the needs of its local customers.

We have been made aware of allegations regarding a specific individual, who was in the past a member of a body advising Arcapita on the compliance of its investments with Islamic law. We have ascertained that this person left the advisory body in 2002 and has never been an employee, director or officer of Arcapita. As this is the case, we have not attached any weight to these allegations in coming to our 'fit and proper' conclusions on Arcapita. Our own investigations have not indicated any areas of concern in relation to Arcapita's current management.

Bid price

WaterVoice Central believed that the high price paid for South Staffordshire relative to the underlying value of the company's assets indicated that investors in water companies were prepared to accept lower returns than we have allowed for in setting the cost of capital.

There are many factors that influence the bid price in acquisitions. Arcapita has said that it was attracted by South Staffordshire's strong management and record of making efficiency savings, as well as the potential for growth of its non-regulated businesses. In addition, there is normally a premium paid for control of any company. Consequently, we do not believe that the premium paid by the company indicates that we have set the cost of capital at too high a level.

Views of other regulators

The Drinking Water Inspectorate and Environment Agency did not believe that SSW's change of ownership would affect their ability to monitor the company's operations.

Next Steps

In accordance with Section 13 of the Water Industry Act 1991, we have issued a formal notice of our intention to modify SSW's appointment by varying condition F and inserting condition P. As explained above, these changes will further protect SSW's customers from risks outside the appointed business. We are not proposing any appointment modifications in addition to those highlighted in our December 2004 consultation paper.

ANNEX 1 – LIST OF RESPONDENTS

WaterVoice

WaterVoice Central

Mike Jensen, Member, WaterVoice South West

Regulators

Drinking Water Inspectorate

Environment Agency

Members of the public

10 responses