

**The Proposed Acquisition of
Brockhampton Holdings plc by
South Downs Limited**

A Consultation Paper by Ofwat

November 2001

1. Introduction

Purpose of this document

1.1 This document:

- Describes the proposed acquisition of Brockhampton Holdings plc (Brockhampton) by South Downs Limited (South Downs). Brockhampton is the owner of the regulated water business, Portsmouth Water plc (Portsmouth).
- Describes South Downs' proposals for the financing of the company and the creation of an Employee Benefit Trust which, in the medium term, will assume control of South Downs.
- Explains the statutory position on mergers.
- Sets out the regulatory issues, possible licence modifications required, and requests comments on Ofwat's assessment of these issues.

1.2 Ofwat will make recommendations to the Director General of Fair Trading (DGFT) in relation to this merger including the need for modifications to Portsmouth's licence. In order to allow comments to be considered by Ofwat, responses to this paper are required by no later than 5.00pm on 21 November 2001.

2. Details of the proposed acquisition and new structure

Summary of the proposals

- 2.1 Brockhampton will be acquired by South Downs, a new private company.
- 2.2 South Downs is wholly owned by South Downs Capital, which will initially be owned by its employees, through an Employee Benefit Trust (40%), its management (15%) and Drummond Capital, a subsidiary of the Royal Bank of Scotland (45%). It will be largely financed by debt.
- 2.3 Over time, South Downs' retained profits will be used to acquire Drummond's stake, leaving it under the control of the Employee Benefit Trust, set up to administer the employees' stake.
- 2.4 The new company will not be listed on the London Stock Exchange (the Stock Exchange). Brockhampton will be de-listed.
- 2.5 The operations and business of Portsmouth is expected to be unchanged.
- 2.6 Further details of the proposed acquisition, the financial structure and the role of the Employee Benefit Trust are set out below.

The acquisition

- 2.7 On 24 October 2001, South Downs announced that it had made a recommended offer to acquire all of the issued share capital of Brockhampton, the holding company of Portsmouth, which is a licensed water undertaker. The offer values the shares of Brockhampton at approximately £71 million.
- 2.8 Brockhampton's current share structure is unusual amongst listed companies and unique amongst water companies. Less than 10% of the shares in issue carry any voting rights. The remaining shareholders are entitled to dividends but have no voting rights.
- 2.9 Of the voting shares, more than 80% are owned by four investors. The two largest are Brockhampton's own employee pension scheme and the Brockhampton Employee Share Ownership Trust, who between them hold almost 60% of the voting shares. The Brockhampton board appoints the trustees of the Employee Share Ownership trust. South Downs has received irrevocable undertakings in favour of the acquisition from 86% of the non-voting shares and 52% of the voting shares.
- 2.10 Portsmouth supplies water to approximately 285,000 customers in and around the town of Portsmouth in the south of England. Brockhampton is based in Hampshire, and its shares are listed on the Stock Exchange. As well as its water

business (which contributes over 95% of the group's turnover), Brockhampton also owns a number of unregulated businesses. Following the acquisition, the shares of Brockhampton will be de-listed.

- 2.11 South Downs is a subsidiary of South Downs Capital Limited, which is owned by Brockhampton's management (15%), employees (45%) and Drummond Capital, a subsidiary of the Royal Bank of Scotland (40%).
- 2.12 Drummond Capital will hold subordinated debt of up to £20m in South Downs. This debt will be repaid using South Downs' retained profits. Once it has been redeemed, the shares held by Drummond Capital will be deferred¹ and ownership of the company will be administered by an Employee Benefit Trust. The Trust will be administered by a board of directors which will have a fiduciary duty to secure the maximum economic benefits for the beneficiaries who are the current and future employees of the company.

Financial structure

- 2.13 The initial finance for the acquisition will be provided entirely by the Royal Bank of Scotland. Once the acquisition is completed, South Downs propose to refinance this debt (except the subordinated debt held by Drummond Capital) by issuing bonds up to 85% of Portsmouth's Regulatory Capital Value².
- 2.14 Until its shares are deferred, Drummond Capital will be entitled to a dividend equivalent to 45% of Brockhampton's annual net cash flows after payment of the interest on all debt. South Downs will not pay any other dividends until these shares are deferred.
- 2.15 The remaining profits, which ordinarily would have been used to pay a dividend to the remaining shareholders, will be used to redeem the subordinated debt held by Drummond Capital.
- 2.16 South Downs expects that this debt will be redeemed over a fifteen-year period. However, the better the group performs, the quicker this debt will be repaid and the greater the benefits that will accrue to management and the Employee Benefit Trust. South Downs believes that this will give the management and employees a strong incentive to drive the efficiency of the regulated business.
- 2.17 South Downs has indicated that it has no present intention to separate the ownership of Portsmouth's assets from its operation. Should it choose to do so in future then Ofwat might require further licence modifications, including modifications to ensure that the licence holder retains control of outsourced functions, to enable it to meet its responsibilities as a licence water undertaker.

¹ Deferment of shares means that the shares relinquish all economic and voting rights

² The Regulatory Capital Value is the capital base used in setting price limits. It represents the initial market value including debt plus subsequent net new capital expenditure.

The Employee Benefit Trust

- 2.18 Following the acquisition, the voting rights attached to the employees shareholding will be administered by the management (giving the management effective control of the company with 55% of voting rights).
- 2.19 Upon deferment of Drummond's shares, ownership of South Downs will effectively be split between the employees (73%) and the management (27%). The employees' stake will be administered by an Employee Benefit Trust. A board of five directors will be appointed to run the Employee Benefit Trust.
- 2.20 Three of the Trust's Directors will be independent. Initially the Royal Bank of Scotland or some other independent body will appoint them. When one of the independent Directors resigns, the remaining independent directors will appoint a replacement.
- 2.21 There will also be a management director of the Trust, who is appointed by the board of Portsmouth, and an employee director, appointed by the employees. Each group is able to remove its own director(s) or the board is able to remove any of the directors.

3. The statutory position on mergers

- 3.1 Neither South Downs, nor Drummond Capital currently controls any water companies in England & Wales. Therefore, the Secretary of State for Trade & Industry (the Secretary of State) is not required to refer the offer to the Competition Commission (the Commission) as a merger of water companies under the Water Industry Act 1991 (The Water Act).
- 3.2 However, the offer by South Downs 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 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.
- 3.3 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.
- 3.4 If the Secretary of State refers South Downs' offer to the Commission, it must consider whether the take-over is likely to have effects adverse to the public interest. If the Commission so concludes, the Secretary of State may either prohibit the take-over, or seek remedies. If the Commission makes no adverse public interest finding, the offer may proceed.
- 3.5 If the offer were to proceed, Ofwat would need to consider what modifications might be required to the licence held by Portsmouth, in order to deal with the regulatory issues arising from the take-over. Proposed licence modifications are discussed in this paper.

4. Regulatory issues arising from the proposed acquisition

- 4.1 If South Downs is successful in acquiring Brockhampton, this will be the first example of employee ownership of a water company. However, as previously noted the capital structure of Brockhampton is unusual in that its pension fund and Employee Share Ownership Trust own such a large proportion of its shares.
- 4.2 The proposed acquisition is similar in many respects to the acquisition of Mid Kent Holdings plc by Swan Capital Limited earlier this year, and raises similar regulatory issues. Ofwat considers that the proposal raises concerns about five issues:
- Incentives for ongoing efficiency
 - Financing of Portsmouth's functions
 - Ring fencing of the regulated business
 - Comparative information
 - Management of Portsmouth

Each of these issues is discussed below.

Incentives for ongoing efficiency

- 4.3 The water companies have, since privatisation, become more efficient as a result of the combined pressure from shareholders and the system of incentive-based regulation under which they operate. Portsmouth is currently one of the most efficient companies in the industry on the basis of our efficiency analyses. Ofwat therefore needs to be content that the proposed new structure will retain strong incentives for efficiencies both in the short and medium-term.
- 4.4 In the short-term, the retained profits of South Downs will be used by the Employee Benefit Trust and management to redeem the stake held by Drummond. The better the company performs the more quickly the employees and the management will be able to redeem Drummond's stake.
- 4.5 Only after Drummond's stake has been acquired will the management and employees be entitled to receive any dividends from the company. South Downs believe that this will provide the Trust and management with strong incentives to drive the performance of the company in order to buy out Drummond's stake.
- 4.6 Once Drummond's shares have been deferred, the Employee Benefit Trust will appoint three professional directors to its board. Two other directors will be appointed as representatives of the employees and the management

respectively³. The Trust's directors will have a duty to maximise the economic benefits for all beneficiaries. Its board will have a majority of professional independent directors, so will be independent from the employees and management.

- 4.7 Ofwat has some concerns that, in the short-term, the imperative for the employees and the management to 'acquire' Drummond's stake may not provide equivalent incentives to the pressure from equity shareholders to drive efficiency. However, Ofwat recognises the difficulties of Brockhampton's current capital structure and the pressures to resolve them.
- 4.8 The at-risk capital in the structure will come entirely from Drummond, which will receive dividends until its stake is acquired. Therefore, Drummond's principal concern will be to ensure that the returns made by Portsmouth will be sufficient to cover the interest payment on its subordinated debt, rather than driving the company to make further efficiency savings.
- 4.9 In the longer term, Ofwat remains concerned that there may be a conflict of interest between the Employee Benefit Trust's role in driving the performance of the company to deliver efficiency savings and its obligation to employees.
- 4.10 Ofwat would welcome the views of others on whether the structure proposed by South Downs will provide equivalent incentives to those under the conventional shareholder model.

Financing of Portsmouth's functions

- 4.11 South Downs intends to refinance the initial acquisition financing (except the subordinated debt) by issuing new corporate debt, which will significantly increase Portsmouth's gearing. Following the refinancing, the proportion of debt to Portsmouth's Regulatory Capital Value will be around 85%. As gearing is increased, the financial flexibility of the company and its ability to raise new debt is more limited.
- 4.12 Because it is not publicly listed, South Downs would have very limited recourse to the equity markets as a source of additional finance should it encounter financial difficulties. Ofwat therefore needs to be content that the proposed financing structure will be sufficiently flexible to withstand any cost shocks and that it will enable Portsmouth to access additional debt if necessary to finance its capital investment requirements, the size of which are not currently known.
- 4.13 In a limited company, the shareholders equity provides a buffer to insulate the company against the effects of any cost shocks. South Downs will have very little equity. However, Drummond will be entitled to receive dividends on its

³ Prior to the deferment of Drummond's shares the Trust's board will have just one director appointed by the management.

shareholding in the company. If South Downs does not generate sufficient surplus, Drummond's dividend will be reduced, thereby providing a measure of protection against cost shocks.

- 4.14 In addition, the repayment of the subordinated debt held by Drummond is dependent on the extent to which the company is successful. Repayments on this debt will only be made if the company generates sufficient profits after the payment of dividends to Drummond.
- 4.15 South Downs believes that these two measures will provide an effective 'buffer', protecting customers from risk.
- 4.16 Ofwat would welcome views on whether the proposed financial structure may be expected, over the longer term, to prove sufficiently flexible and robust to enable Portsmouth to continue to finance its functions over the long-term.

Ring-fencing of the regulated business

- 4.17 In mergers involving a change of ownership, Ofwat has sought licence modifications to strengthen the existing ring-fencing provisions in companies' licences. These are conditions designed to enable Ofwat to regulate effectively the water utility within a wider group and to provide re-assurance that it remains able to finance its regulated activities.
- 4.18 Although Portsmouth would not be part of an extended group under South Downs' proposals, its proposed financing structure poses similar potential threats to its financial position.
- 4.19 Ring-fencing arrangements are also seen as important in other regulated industries. For example, it is Ofgem's policy to include standardised financial ring-fencing conditions in the licences of all the principal national and regional energy network companies. Such conditions presently apply to all public electricity suppliers in England & Wales and to Transco's gas transportation business.
- 4.20 Ofwat will therefore expect the board of Portsmouth to agree to licence modifications designed to ensure that a proper ring-fence is maintained around the regulated business. These modifications would prevent Portsmouth from:
 - raising finance for the regulated business on terms that included cross-default provisions between the regulated and non-regulated businesses;
 - holding or acquiring investments of any kind except those connected with the carrying out of its activities as a water undertaker; and would
 - require Portsmouth to use all reasonable endeavours to maintain an investment grade corporate credit rating.

Comparative information

- 4.21 One of the most important tools available to Ofwat for the regulation of water companies is the ability to make comparisons between them (comparative competition). When advising DGFT, we will assess whether South Downs' prospective ownership of Brockhampton might adversely affect our ability to make those comparisons.
- 4.21 Brockhampton's shares are currently listed on the London Stock Exchange. If it is taken over by South Downs, that listing will cease. The de-listing of Brockhampton's shares would also disapply the Stock Exchange's public disclosure rules and remove its performance from scrutiny by the public, City analysts and institutional shareholders.
- 4.22 De-listing would reduce Ofwat's ability to form a judgement about how the financial markets perceive Brockhampton and its operations, of which Portsmouth's activities are a major component. That in turn would remove Ofwat's ability to compare the market's ratings of Brockhampton with other listed owners of licensed water companies. It would also affect our ability to make judgements about an appropriate cost of capital for the water companies. It would further reduce the number of listings of water companies and as listings are lost, the value of those remaining becomes greater.
- 4.23 However, the low frequency of trading in Brockhampton's shares and its current capital structure and closely held ownership means that this is not as great a detriment as in the case of the owner of a larger water and sewerage company. We would require Portsmouth to agree to a licence modification requiring it to publish financial information as if it were listed and subject to the rules of the Stock Exchange.
- 4.24 Apart from the loss of stock market information, the proposed merger would not involve the loss of a comparator for use in making regulatory judgements about efficiency and standards of services.

Management of Portsmouth

- 4.25 It is important that Brockhampton's acquisition by South Downs should not compromise the effective management of Portsmouth. Ofwat consider that the licence for a water undertaker should be held where the key decisions are taken. If the licence holder is a subsidiary company it should be able to demonstrate an adequate degree of independence and its directors should have clear responsibilities for regulatory matters.
- 4.26 In previous mergers we have agreed licence modifications designed to strengthen the management independence of the water company. These are:

- the water company should be required to conduct its core businesses as if it was substantially the sole business undertaken and it was a separate public limited company;
- the composition of the Board should be such that it can act independently of the parent and the directors of the water company should act exclusively in the interests of the water company if conflicts of interest arise. They should not vote on contracts where they have interests by virtue of other directorships;
- the water company's dividend payments should not exceed amounts which would, in Ofwat's opinion, preserve its ability to continue to discharge and finance its functions as a water company;
- the water company should be required to obtain from its ultimate parent company an undertaking to ensure that the water company's Board contains at least three non-executive directors having relevant experience and an understanding of customers' interests and how these can be protected;
- the board of the water company should be required to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the Listing Rules of the UK Listing Authority.

4.27 These modifications reflect current best practice for licence conditions.

Prices and service standards

4.28 Customers will look to Ofwat to ensure that Portsmouth is able to provide proper standards of service at appropriate prices irrespective of its ownership. Portsmouth will continue to have the obligations imposed upon it by legislation (especially the Water Act) and the conditions of its licence. We will continue to regulate Portsmouth under those provisions.

4.29 Its existing price limits will remain unchanged from those determined by Ofwat at the 1999 Periodic Review, which allow it to maintain its service to customers. Future price limits will be set as for all other companies. 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. Ofwat will exercise our powers to that end.

The need for licence modifications

4.30 Ofwat will consider whether it will be appropriate to propose modifications to Portsmouth's licence to incorporate the measures outlined above, or whether additional or alternative measures might better safeguard the interests of customers and Ofwat's ability to discharge its functions. Respondents may believe that there are other matters that require similar treatment.

5. Responses to this consultation paper

- 5.1 Ofwat will discuss with South Downs the issues set out in this paper. We will seek commitments from South Downs about our proposals to modify Portsmouth's licence, to deal with these issues.
- 5.2 On the basis of those discussions and responses to this consultation paper, we will formulate our advice to the DGFT. To meet the DGFT's timetable, responses to this consultation should be made in writing by no later than 5.00pm on 21 November 2001 to:

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Director of Regulatory Finance
Office of Water Services
Centre City Tower
Hill Street
Birmingham
B5 4UA

Fax: 0121 625 3609
E-mail: keith.mason@ofwat.gsi.gov.uk

- 5.3 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).