



**The completed acquisition of South Staffordshire plc by
Alinda Infrastructure Fund**

A consultation paper by Ofwat

March 2008

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1 Purpose

1.1 The purpose of this consultation paper is to consult on any regulatory issues arising from the completed acquisition of South Staffordshire plc by Alinda Infrastructure Fund. South Staffordshire plc is the owner of South Staffordshire Water plc, an appointed water undertaker regulated by Ofwat. Alinda Infrastructure Fund is managed and controlled by Alinda Capital Partners LLC, which is a US independent private investment firm specialising in infrastructure assets.

1.2 Ofwat, as the economic water regulator, itself has no ability to block acquisitions or mergers of water companies. But in the interests of water consumers it looks to ensure that any owner of a water company is 'fit and proper' to provide such an essential public service. Ofwat regulates through the provisions of the Instrument of Appointment (the Appointment) of each company and can impose suitable amendments if necessary, subject to appeal by the company to the Competition Commission in the event of disagreement.

1.3 This document:

Describes the completed acquisition of South Staffordshire plc by Alinda Infrastructure Fund (controlled and managed by Alinda Capital Partners LLC). It;

- explains the statutory position on mergers;
- describes the proposed long-term financial structure for South Staffordshire Water plc and sets out the regulatory issues, including Appointment modifications we propose, and;
- our initial assessment of these issues.

1.4 We invite views on the issues discussed in this paper, including:

- the capacity of Alinda Capital Partners LLC to be the owner of a regulated water business;
- which entities should provide undertakings under Condition P of South Staffordshire Water plc's Appointment;
- the implications of the proposed long-term financial structure
- the impact of these proposals on comparative competition; and
- the need for modifications to South Staffordshire Water's Appointment 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 group.

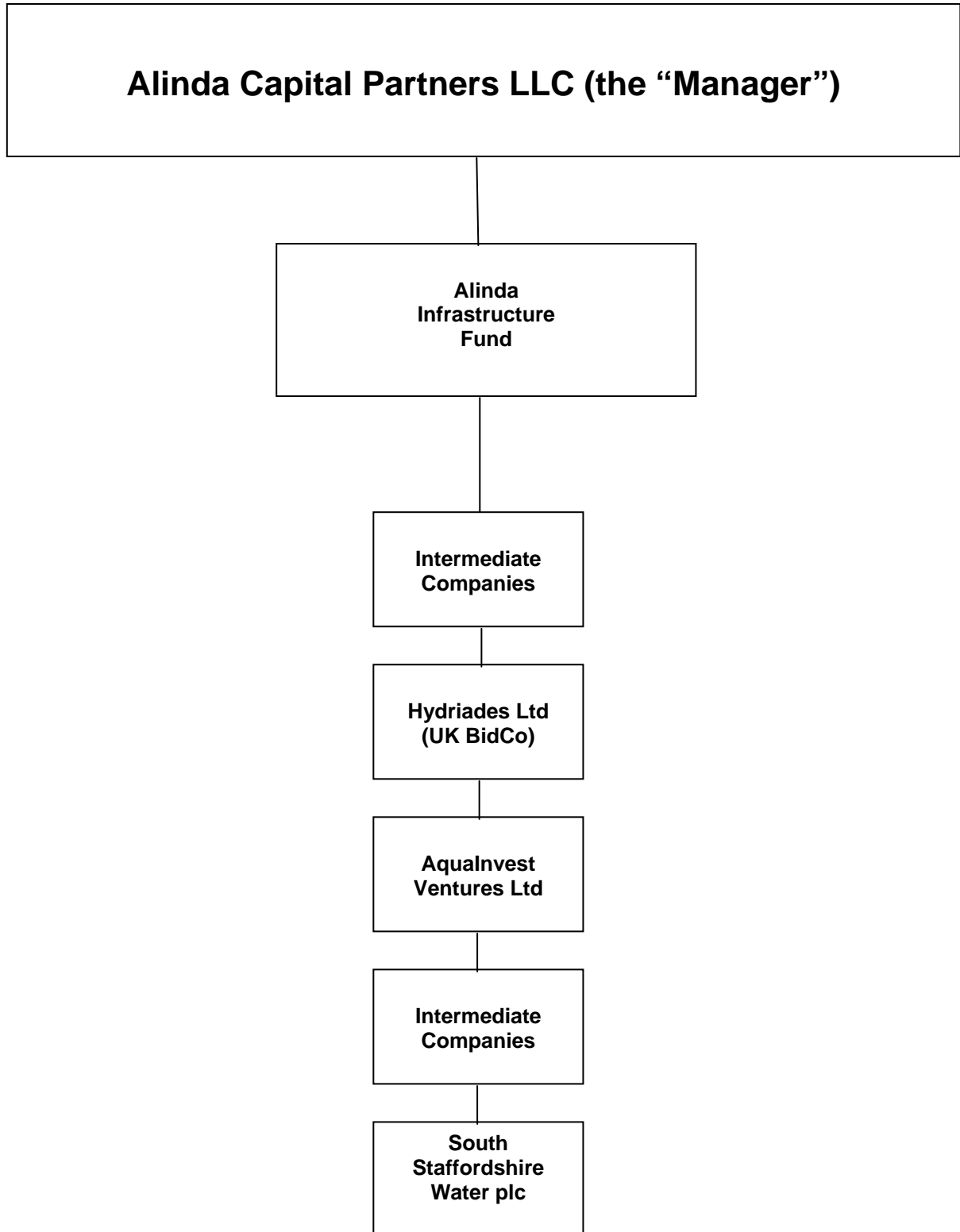
Respondents may also comment on any other issues relating to the acquisition that they believe are relevant.

- 1.5 Responses to this paper are required by no later than **5.00pm 4 April 2008**. We will then consider responses and publish a position paper. We will propose and consult on Appointment amendments as necessary and amend South Staffordshire Water Plc's Appointment accordingly.

2 Details of the acquisition

- 2.1 On 29 October 2007 it was announced that Arcapita and its affiliates sold South Staffordshire plc to the Alinda Infrastructure Fund, an institutional fund managed and controlled by Alinda Capital Partners LLC, an independent private investment firm, for an undisclosed amount. Alinda Infrastructure Fund financed its acquisition with 100 percent equity. South Staffordshire plc is the owner of South Staffordshire Water plc (SSW).
- 2.2 SSW is an appointed water undertaker with a regulatory capital value of £195.3m in March 2007. Currently it is the fourth largest of the eleven water only companies in England and Wales. It supplies 281 million litres of water per day to approximately 500,000 homes and 36,000 business customers in a 1,500km² area covering parts of Staffordshire, the West Midlands and Derbyshire.
- 2.3 Alinda Capital Partners LLC is a US independent private investment firm specializing in infrastructure assets that provide essential services to communities, businesses and governments. They manage and control the Alinda Infrastructure Fund, an unlisted institutional fund with \$3 billion in capital commitments and approximately \$10 billion in purchasing power.
- 2.4 Established in 2005, Alinda Infrastructure Fund targets investments in Europe and North America that provide essential services to communities, governments and businesses.
- 2.5 The investors in the Alinda Infrastructure Fund comprise predominantly European and U.S. pension funds, insurance companies, and charitable and university endowments. The Investors have no right to manage the affairs of their respective investment.
- 2.6 Alinda Capital Partners LLC as controller and manager of Alinda Infrastructure Fund, invests in SSW through Hydriades Ltd (see paragraph 2.7)

2.7 Structure of Ownership



3 The statutory position on mergers

- 3.1 Under section 32 of the Water Industry Act 1991 (WIA91), the Secretary of State for Trade and Industry must refer a merger of any two water or water and sewerage companies in England and Wales to the Competition Commission. Prior to the acquisition, Alinda Capital Partners LLC had no interest in any water or water and sewerage companies in England and Wales. Therefore, the duty under section 32 of WIA91 does not arise.
- 3.2 In addition to the sector-specific merger provisions in WIA91, the Enterprise Act 2002 (EA02) sets out circumstances under which the OFT has a duty to refer a merger in any sector, including water, to the Competition Commission for further investigation of the competition issues arising from anticipated or completed mergers.
- 3.3 There is no obligation on Alinda Capital Partners LLC to notify the OFT of the acquisition of South Staffordshire Plc. At the time of publication we understand that no party to this acquisition has notified the OFT.
- 3.4 These are matters for the company and the OFT but we understand that Alinda Capital Partners LLC has no controlling interest in any other water or water and sewerage company in England and Wales.
- 3.5 The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition in relation to SSW as the appointed water undertaker and whether any modifications should be made to its Appointment.

4 Regulatory issues arising from the acquisition and the need for Appointment modifications

The capacity of Alinda Capital Partners LLC to be the owner of a regulated water company

- 4.1 Competition for ownership of water companies may be beneficial because it can stimulate existing owners to become more efficient in the provision of water services as well as encouraging prospective owners to take advantage of opportunities that may not have been fully exploited by the existing ownership.
- 4.2 However, we have a duty to act in a way which we consider is best calculated to secure that the functions of water and sewerage undertakers are properly carried out. Therefore we must be satisfied, in each particular case, that the prospective owner has the probity and the operational and financial capacity to assume that role.
- 4.3 Alinda Capital Partners LLC has said it is committed to long-term investment in SSW and typically has a 10–20 year investment horizon. The water industry is a long-term business requiring stable ownership and management and we welcome this commitment to the long-term.
- 4.4 We understand that Alinda Capital Partners LLC has experience in roads, water and wastewater, airports, municipal services and natural gas utilities in the United States, UK and other European countries.

We invite views on the capacity of Alinda Capital Partners LLC to be the owner of a UK regulated water company.

Management of the regulated business

- 4.5 We also want to be satisfied that Alinda Capital Partners LLC's ownership of South Staffordshire plc does not compromise effective management of SSW, the regulated business. Previous respondents to our consultation papers on changes of ownership have expressed concerns about the loss of managerial effectiveness as a result of corporate activity.
- 4.6 Alinda Capital Partners LLC considers the continuation of the skills and experience of management and employees to be an important factor in the future success of the business. It therefore intends to retain the existing senior management team. Alinda Capital Partners LLC place great faith in the management and will not be taking an executive role.

Role of Owners

- 4.7 All water companies need the active co-operation of their owners in carrying out their functions. Most water (and water and sewerage) companies have Condition P in their Appointment's that require them to obtain legally enforceable undertakings from their owners. The companies giving the undertakings are required to:
- give the regulated business any information it needs to comply with its Appointment;
 - refrain from any action that could cause the regulated business to breach its Appointment; and
 - maintain a minimum of three independent non-executive directors on the board of the regulated business.
- 4.8 These undertakings help to protect customers by strengthening the ability of the regulated business to comply with the conditions of its Appointment and to maintain its independence from the rest of the group to which it belongs.
- 4.9 SSW currently has a version of Condition P in its Appointment. We intend to modify Condition P of SSW's Appointment. This generic Condition P rather than naming specific entities under its current ownership will still require the Appointee to secure undertakings from its Ultimate Controller (see paragraph 4.10) and, when the Ultimate Controller is not the UK holding company, from its UK holding company. The purpose of this modification is to standardise this ring-fencing condition for all regulated water companies and to ensure that it requires the Appointee to procure undertakings from the appropriate entities under a variety of ownership structures.
- 4.10 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.
- 4.11 SSW propose that Alinda Capital Partners LLC is the right party to provide the Condition P undertaking as the Ultimate Controller. No Investor holds or will hold any control rights with respect to Hydriades. The Investors will have no rights to manage the affairs of Hydriades and as such, the Investors will be purely passive investors. The affairs of Hydriades will be managed by its Board of Directors. It is proposed that Hydriades Limited, the UK bidding vehicle of Alinda Capital Partners LLC, should also give the Condition P for the UK Holding Company.

We invite views on which entities should provide Condition P undertakings to South Staffordshire Water plc

Ring-fencing and Appointment modifications

- 4.12 Any activities of Alinda Capital Partners LLC that could prejudice the financial and managerial viability of the regulated business would be of concern to us. Such concerns have in the past been addressed by Appointment modifications to ensure that the water company is ring-fenced from the other activities of the group.
- 4.13 SSW already has the majority of 'standard' financial ring-fencing Appointment conditions. Amongst other things these conditions:
- require SSW to operate as if it were a separate company, for its Board to be able to act independently of the parent company and solely in the interest of the water company;
 - ensure that there is no cross subsidy between SSW and its associated companies;
 - require SSW to ensure that its dividend policy rewards efficiency and the management of economic risk, and will not impair the company's ability to finance its functions as a water undertaker;
 - require SSW to have sufficient financial and managerial resources to carry out its activities;
 - ensure that SSW's financial affairs can be assessed and reported on separately from other businesses and activities of its group;
 - require SSW to use all reasonable endeavours to maintain an investment grade credit rating for its corporate debt
 - prohibit (without Ofwat's consent) cross defaults, whereby SSW's financial liabilities are increased or accelerated because of a default of any other companies in the group; and
 - require SSW to publish its results as if it were listed on the Stock Exchange.

4.14 We propose to make the following modifications to Condition F

- We will introduce the cash lock-up provision which would prohibit, subject to certain limited exceptions, and without the regulator's prior consent, the transfer of cash or other assets to an associated company in certain circumstances where the company's investment grade credit rating is threatened.
- We will require SSW to maintain a listing of a financial instrument. Although not a substitute for an equity listing, this would ensure the existence of a helpful financial comparator.
- We will require SSW to act at all times in the manner best calculated to ensure that it has adequate systems of planning and internal control to enable it to secure the carrying out of its regulated activities.

We will require the Appointee to submit an annual certificate, accompanied by an independent report from the Reporter or other person as specified by Ofwat, that in the opinion of the Directors the Appointee will, for at least the next 12 months, have available for it systems of internal control which are sufficient to enable it to carry out its functions.

This condition is not being proposed in reaction to any concerns over SSW's current standards, but part of our objective to standardise Appointee's conditions when suitable opportunities arise.

Financing

- 4.15 An important aspect of our assessment will be to assess whether SSW remains able to finance its functions as an Appointee under Alinda Capital Partners LLC's ownership.
- 4.16 Taking the most useful measure of SSW's gearing – its net debt/regulatory capital value (RCV) ratio at 31st March 2007 was 62%¹.

¹ Gearing stated as 69.9% in Financial performance & expenditure of the water companies in England & Wales 2006-2007 report. Overall net debt amounted to £136.4m at 31 March 2007; however this includes a premium of £15.5m in relation to the index-linked loan and therefore for covenant compliance purposes net debt amounted to £120.9m, being 62% of the Company's Regulated Capital Value of £195.3m at 31st March 2007.

- 4.17 SSW currently has a credit rating of “A-” from Standard and Poor’s (S&P) and an ‘Investment Grade’ private credit rating from Moody’s. Alinda Capital Partners LLC target approximately 77% gearing which equates to an increase of c.£25m (net debt) compared to current levels, through the issuance of a 40 to 50 year bond through a private placement, coupled with pre funding and repayment of short term borrowings to enhance liquidity. This level of debt compares to covenants for SSW at 85% of RCV. The intention is to maintain a solid investment grade rating in SSW, with a rating of BBB+ from S&P being targeted. Moody’s have already indicated no change to their current investment grade rating. The current Moody’s rating is on the assumption that the company has gearing at its covenanted level of 85%.
- 4.18 At a Group level, additional debt (in the form of 5 year bank debt) will be raised against both the cashflows of the Group’s non-regulated businesses and the dividend stream from SSW. There will be no recourse to SSW under this debt. Moody’s look solely at SSW in their rating. The targeted S&P rating set out above of BBB+ for SSW takes into account the additional debt at Group level.
- 4.19 The targeted rating outcomes would provide some headroom above the floor for investment grade credit quality. Ofwat considers headroom above this floor important as a safeguard against future uncertainties. One of the ring-fencing provisions outlined above is a requirement for SSW to maintain an investment grade credit rating. We use this condition as an indicator that companies remain in a position to finance their functions. Should the investment credit rating be threatened then this would trigger a cash lock-up. Please see paragraph 4.14.

Comparative Information

- 4.20 An important tool available to Ofwat for the regulation of water companies is the ability to make comparisons between them (comparative competition). We want to ensure that Alinda Capital Partners LLC’s ownership of SSW will not have an undue adverse affect on our ability to make those comparisons.
- 4.21 As stated in paragraph 4.14, SSW’s Appointment does not contain the current standard provision that requires an Appointee to maintain the listing of a financial instrument; we are proposing to introduce this condition into SSW’s Appointment.

We invite views on the impact of these proposals on comparative information.

Prices and service standards

- 4.22 Customers will expect SSW to provide proper standards of service at appropriate prices irrespective of its ownership. SSW will continue to have the obligations imposed upon it by legislation and the conditions of its Appointment. We will continue to regulate SSW under those provisions.
- 4.23 SSW's existing price limits will remain unchanged from those determined by Ofwat, at the 2004 periodic review, which allow it to maintain its service to customers. SSW accepted these price limits. 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. Alinda Capital Partnership LLC has confirmed that the quality of service customers previously received will not be adversely affected.

Conclusions on the need for Appointment modifications

- 4.24 We propose to introduce the following;
- the cash lock-up provision
 - the requirement to maintain a listing of a financial instrument
 - the requirement to certify that adequate systems and internal controls are in place into SSW's Appointment and
 - the amended condition P
- 4.25 Other than this, we do not consider that the acquisition raises significant regulatory issues and we are not proposing any further Appointment modifications at this stage.

However, we would like to hear the views of others on whether they believe further Appointment modifications are necessary.

5 Responses to this consultation paper

5.1 We have discussed with SSW the issues noted above. SSW have agreed in principle to the proposals for the modifications of its Appointment stated in paragraph 4.24

5.2 Responses to this consultation should be made in writing by no later than **5.00pm 4 April 2008**

5.3 Responses should be addressed to:

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Office of Water Services
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5.4 At the end of the consultation period, each response will be placed in Ofwat's Library for public inspection unless respondents specifically request otherwise.