



CHANGE IN THE OWNERSHIP OF A 36% SHAREHOLDING IN SOUTH DOWNS CAPITAL LIMITED

AN OFWAT CONSULTATION NOTE June 2005

1. Purpose

This note describes the completed acquisition by Secondary Market Infrastructure Fund UK LP (SMIF) of a 36% shareholding in South Downs Capital Ltd (South Downs) and invites comments on the proposal. South Downs is the ultimate holding company of Portsmouth Water plc (Portsmouth Water). Portsmouth Water is an appointed water undertaker, regulated by Ofwat.

The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition and whether any modifications should be made to Portsmouth Water's appointment.

This acquisition has not led to any major change in the way Portsmouth Water is financed or managed. Portsmouth Water already has the most up to date conditions in its instrument of appointment (its appointment) that ensure the water business is ring fenced from other companies in its group. Therefore, subject to responses to this consultation note, our initial proposal is that no further significant appointment modifications are needed. More detail on our rationale is given in sections 3 and 4 below.

Responses to this consultation should be made in writing by no later than Thursday 14 July to:

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At the end of the consultation period, each response will be placed in Ofwat's Library (unless it is clearly marked "confidential") and will be available for public inspection.

2. Details of the acquisition

On 23 February 2005, SMIF announced that it had acquired a 36% equity interest in South Downs, the ultimate holding company of Portsmouth Water and a number of small unregulated businesses, from Abbey National Treasury Services Overseas Holdings (ANTSOH). Following the transfer, voting rights in South Downs are held 15% by its management, 40% by the South Downs Employee Benefit Trust, 36% by SMIF and 9% by Drummond Capital (a wholly-owned subsidiary of Royal Bank of Scotland). ANTSOH no longer holds any equity in South Downs. The level of debt in South Downs and its subsidiaries will not change as a result of this transaction.

Portsmouth Water is an appointed water undertaker, regulated by Ofwat. With a regulatory capital value of £92.3m in 2004-5, it is the fourth smallest of the twelve water only companies in England and Wales. It supplies water to approximately 290,000 homes and business customers in Hampshire and West Sussex, including the city of Portsmouth.

The transfer does not affect the proposals for the future structure and financing of the South Downs group, which we consulted on in October 2001¹. As set out in these proposals, the shareholdings currently held by SMIF and Drummond Capital were to be redeemed over a period of approximately 15 years. This remains the case following SMIF's purchase of its 36% shareholding. Once the investments have been fully redeemed, ownership of the company will pass to the South Downs Employee Benefit Trust and South Downs management. Until this point, SMIF and Drummond Capital will retain their original allocation of voting rights.

SMIF is a UK Limited Partnership, established in 2001. It currently owns and controls a portfolio of 35 infrastructure assets with a gross asset value in excess of £250 million. SMIF's investments are predominantly in the UK Government's Private Finance Initiative market, covering education, healthcare, transport and other social infrastructure. In addition, SMIF holds a 50% stake in a gas metering concession let by British Gas covering the North East and North West of England.

SMIF is part of a group of limited partnerships that are managed by STAR Capital Partners Ltd (SCP). SCP is the manager of the STAR fund, a private equity fund set up to acquire and develop capital assets and capital-asset based businesses, either independently or in partnership with existing owners. SCP is authorised and regulated by the Financial Services Authority.

3. The statutory position on mergers

This transaction does not result in any competition concerns under the Water Industry Act (WIA91) or the Enterprise Act 2002 (EA02). The reasons for this are set out below.

EA02 sets out circumstances under which the Office of Fair Trading (OFT) has a duty to refer a merger in any sector, including water, to the Competition Commission for further investigation. This transaction does not meet the tests set out in EA02 and does not therefore give rise to a qualifying merger.

¹ 'The proposed acquisition of Brockhampton Holdings plc by South Downs Limited: a consultation paper by Ofwat' (October 2001). Brockhampton Holdings was Portsmouth Water's listed holding company.

WIA91 contains a special merger regime for mergers between water and sewerage companies. Under section 32 of WIA91 (recently amended by EA02 and the Water Act 2003) the Office of Fair Trading (OFT) must refer a merger of any two water or water and sewerage companies in England and Wales to the Competition Commission where the turnover of each of the water enterprises to be merged exceeds £10 million. Portsmouth Water's turnover was £31.3m in 2004-05.

In coming to a decision on whether a merger has taken place, the OFT must consider whether, as a result of a proposed or completed transaction, a corporate body has or would have control or material influence over two or more water or water and sewerage companies. When examining this transaction, the OFT considered among other things the involvement of the Royal Bank of Scotland (RBS) with SCP as manager of SMIF. Prior to the transaction, RBS already had a 9% shareholding in South Downs through its subsidiary, Drummond Capital, and also held a stake in the parent company of Southern Water, a water and sewerage company. Had the OFT decided that RBS had material influence over both Southern Water and Portsmouth Water following this transaction, it would have been required to refer the matter to the Competition Commission.

The OFT has consulted on whether there are any competition concerns arising from this merger, and considered detailed information submitted by SMIF on its ownership and control. It concluded on 20 May 2005 that the transaction has not resulted in a merger situation, and cleared the transaction without making a reference to the Competition Commission.

The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition and whether any modifications should be made to Portsmouth Water's appointment.

4. Regulatory issues arising from this acquisition

The capacity of SMIF to be the owner of a large shareholding in a regulated water company

We must be satisfied that water companies' owners have the probity and operational and financial capacity to assume that role.

SMIF is managed by a number of professionals with experience in infrastructure finance, including investment in utilities. Three of the five members of the management team were previously employed at Abbey National Treasury Services plc. One of these, William Doughty, was already a director of South Downs when SMIF acquired its shareholding in the company.

SMIF has said that Portsmouth Water's management will not change following the acquisition. This gives us further confidence that Portsmouth Water will continue to have the expertise necessary to conduct its business.

We are conducting our own investigations into the capacity of SMIF to be the owner of a large shareholding in a regulated water company, but we would also like to hear the views of others on this issue before forming an opinion.

Ring fencing

Any activities of SMIF or other companies in its group that could prejudice the financial and managerial viability of Portsmouth Water 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.

When South Downs acquired Portsmouth Water in 2001, we consulted on the regulatory issues involved in the new structure of the company. This included consultation on modifications to Portsmouth Water's appointment condition F, designed to ensure that the regulated business was ring fenced within its new group. As a result, Portsmouth Water currently has the majority of the most up-to-date ring fencing conditions. These conditions:

- 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 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;
- help to ensure there is no cross-subsidy between Portsmouth Water and any associated company;
- require it to publish its results as if it were listed on the Stock Exchange; and
- require its dividend policy to avoid any adverse effect on its ability to finance its functions as a water undertaker.

Portsmouth Water's appointment does not contain the requirement to list a financial instrument. This transaction does not result in the loss of any listing and to introduce this condition would impose disproportionate costs on a company of Portsmouth Water's size.

We are not proposing to make any further modifications to Portsmouth Water's appointment following this latest transaction, but we would like to hear from others whether they think appointment modifications are required, and their reasons for this.

Role of Portsmouth Water's owners

Portsmouth Water's appointment condition P requires it to obtain from its ultimate holding company and ultimate controller², undertakings that they and other group companies will:

- give Portsmouth Water any information it requires to comply with its obligations as a water undertaker;
- avoid actions that might interfere with its obligations; and

² 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.

- ensure that its board contains a minimum of three independent non-executive directors.

Where Portsmouth Water's ultimate controller or ultimate holding company changes, its appointment requires that these undertakings be provided by the new owner/controller.

Following the acquisition of ANTSOH's shareholding by SMIF, it is Portsmouth Water's responsibility to satisfy itself as to the identity of its new ultimate controller. SMIF's ownership structure is complex. Portsmouth Water has told us that SCP is its new ultimate controller. SCP is the manager of SMIF (under a management agreement), its core investor, and also owns the general partner in the fund.

SCP has provided new undertakings as Portsmouth Water's ultimate controller, in place of ANTSOH.

We are discussing with Portsmouth Water whether the other companies currently required to give undertakings under its condition P, South Downs Capital and its subsidiary, South Downs Limited, are the most appropriate bodies to give these undertakings. If necessary, we will modify the company's appointment to ensure that it obtains undertakings from the most appropriate bodies.

Effect on customers of the proposals

SMIF acknowledges the need for adequate ring fencing of Portsmouth Water and for independent local representation on the company's Board. The obligations imposed on Portsmouth Water by its appointment and WIA91 will not change. Ofwat can see no reason why the quality of service provided to Portsmouth Water's customers should deteriorate as a result of the transfer.

**Office of Water Services
June 2005**