



**The syndication of Deutsche Bank's
ownership of Aqueduct Capital (UK)
Limited and its impact on Sutton and East
Surrey Water plc**

A consultation paper by Ofwat

May 2007

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1 Purpose

- 1.1 We published our position note 'The completed acquisition of the East Surrey Holdings Group by Aqueduct Capital (UK) Limited and its impact on Sutton and East Surrey Water Plc' in September 2006 (our 'position note'). The purpose of the position note was to set out our conclusions on the regulatory issues arising from the acquisition of the East Surrey Holdings Group by Aqueduct Capital (UK) Limited ('ACUK') and the modifications to be made to Sutton and East Surrey Water's (SES's) instrument of appointment (its 'licence').
- 1.2 Condition P of SES's licence requires it to procure legally enforceable undertakings from its UK holding company and its ultimate controller(s). The UK holding company undertaking provided by ACUK and the ultimate controller undertaking provided by Deutsche Bank AG London remained in place when we published our position note. Deutsche Bank AG (Deutsche) had the largest shareholding in ACUK at that time but was in the process of syndicating its interest in ACUK.
- 1.3 Deutsche completed the syndication of its stake on 5 January 2007. This consultation considers how the syndication of Deutsche's stake affected the ownership structure of SES and hence which entities SES considers constitute the UK holding company and ultimate controller for the purposes of providing the Condition P undertakings.
- 1.4 We invite views on this paper including:
- the capacity of ACUK under its revised ownership structure to be the owner of a regulated business;
 - which entities should provide ultimate controller undertakings as required by Condition P of SES's licence; and,
 - addition of the cash-lock up licence conditions to SES's licence.
- 1.5 Responses to this paper are required by no later than 5pm on 18 June 2007.

2 Details of the syndication and the investors

2.1 ACUK is a private company incorporated in England and Wales on 12 October 2005 and was formed at the direction of Deutsche. It had not conducted business prior to its acquisition of East Surrey Holdings Limited.

2.2 The ownership structure of ACUK prior to completion of the syndication of Deutsche's stake was described in our previous consultation¹ and updated in our position paper. Deutsche subsequently completed the syndication of its stake in SES (through its ownership of ACUK) on 5 January 2007. We understand that:

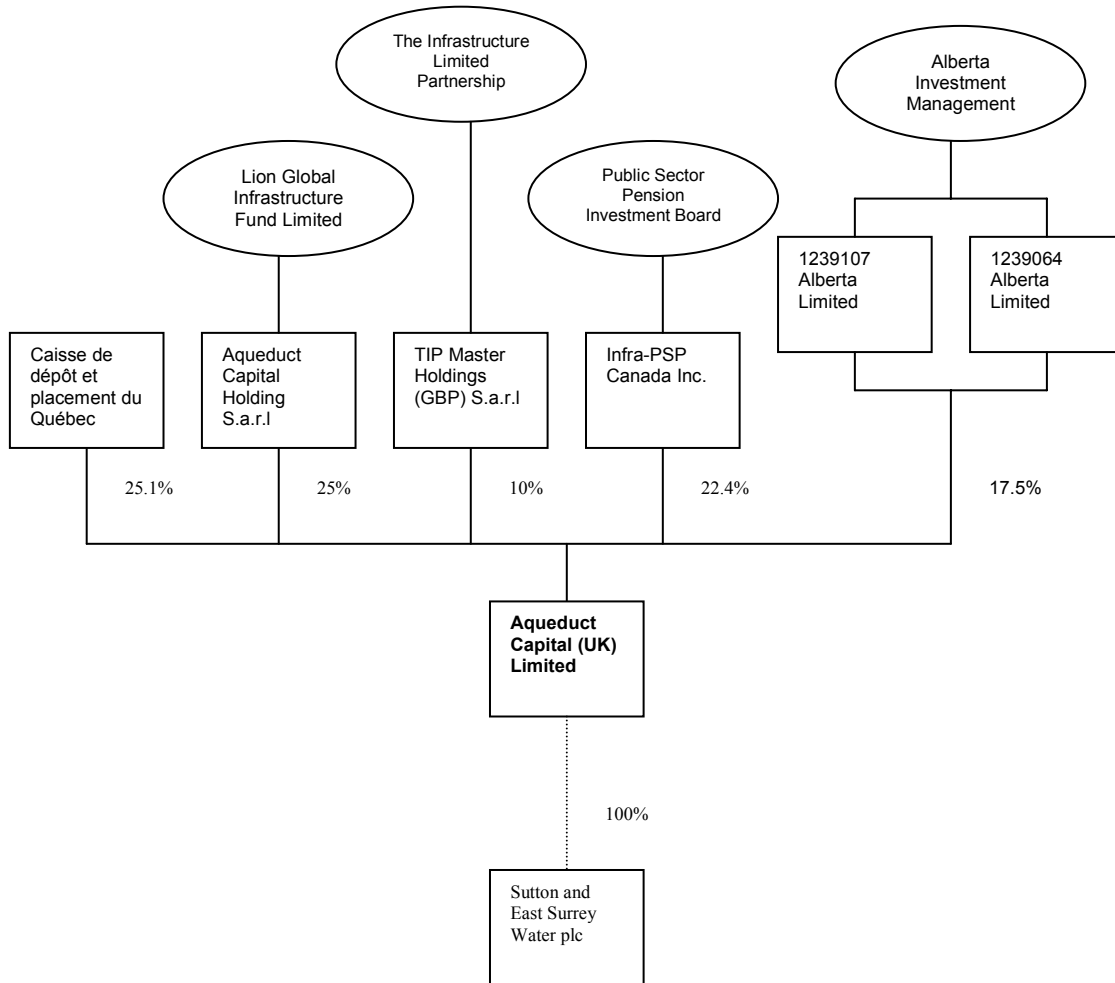
- Caisse de dépôt et placement du Québec (CDPQ) has a 25.1% interest in ACUK. CDPQ is the Quebec public sector investment manager and the largest institutional fund manager in Canada.
- Aqueduct Capital Holding S.a.r.l has a 25% interest in ACUK. Aqueduct Capital Holding is a wholly owned subsidiary of Lion Global Infrastructure Fund Limited (LGIF) (formally Infrastructure Holdings Limited). LGIF is a Guernsey based infrastructure fund managed by Lion Capital Management of Singapore. Although jointly owned by Lion Capital Management and Deutsche, Deutsche's economic interest in LGIF is 20% and Great Eastern Life owns the remaining 80%.
- Alberta Investment Management (AIM) has increased its interest in ACUK by 5% to 17.5% through its two companies 1239107 Alberta Limited and 1239064 Alberta Limited. AIM is a division of the Department of Finance of the Canadian Province of Alberta and manages assets of pension fund and endowment fund clients. AIM also holds an aggregate interest of approximately 4% in the Thames Water group.
- Infra-PSP Canada Inc. (PSP) has acquired a 22.4% shareholding of ACUK. PSP is an investment vehicle of the Public Sector Pension Investment Board, a Canadian crown corporation.
- TIP Master Holdings (GBP) S.a.r.l has a 10% interest in ACUK. TIP Master Holdings is an investment vehicle incorporated on behalf of The Infrastructure Limited Partnership (TIP), a Guernsey limited partnership in which, among others, Deutsche Bank Infrastructure Holdings (UK) No.1 Limited, a wholly owned subsidiary of Deutsche, is a limited partner and holds a one-eleventh interest.

¹ 'Completed acquisition of the East Surrey Holdings Group by Aqueduct Capital (UK) Limited and its impact on Sutton and East Surrey Water plc: A consultation paper by Ofwat', March 2006.

2.3 We understand that Deutsche's interest in ACUK is therefore now approximately 1% through its interest in TIP Master Holdings (GBP) S.a.r.l and it holds a further 5% indirect economic interest through its ownership of LGIF.

2.4 The diagram below shows the updated structure chart of the entities involved in the ownership of SES.

Ownership structure



2.5 SES is an appointed water undertaker, regulated by Ofwat. With a regulatory capital value of around £140m in 2005-06, it is the sixth largest of the thirteen water only companies in England and Wales. It supplies water to approximately 270,000 homes and business customers across the London Boroughs of Croydon, Merton and Sutton, East Surrey and parts of Kent and Sussex.

3 The statutory position on mergers

- 3.1 The Water Industry Act 1991 (WIA91) put in place a special merger regime for mergers between water and sewerage companies. Under section 32 of WIA91 (as amended by the Enterprise Act 2002 (EA02) and Water Act 2003), the Office of Fair Trading (OFT) must refer to the Competition Commission a merger of two or more water enterprises (which includes sewerage undertakings) in England and Wales broadly where the turnover of each is £10 million or more.
- 3.2 In addition to the sector-specific merger provisions in WIA91, the 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 ACUK or the investors to notify the OFT of the syndication of Deutsche's stake². At the time of publication we understand that no party has notified the OFT of the further syndication.
- 3.4 These are matters for the company and the OFT but we understand that neither ACUK nor any of the investors (or their group companies) has material influence or control over any 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 SES as the appointed water undertaker.

² The OFT considered the acquisition of stakes by CDPQ and AIM in ACUK in 2006. On 1 September 2006 and 4 September 2006, the OFT published its decisions that it had found the acquisitions (by CDPQ and AIM respectively) did not qualify for a reference to the Competition Commission under WIA91. It also concluded that neither acquisition gave rise to a relevant merger situation and so did not fall within the OFT's jurisdiction under EA02.

4 Regulatory issues arising from the acquisition and the need for a licence modification

The capacity of ACUK and its investors 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 We have described the ownership structure in section 2. We understand that, collectively, the investors have experience in owning infrastructure assets internationally including but not limited to electricity transmission grids, gas transmission networks, airports and roads. We also understand that the investors are familiar with owning assets in a regulated environment. ACUK have told us the investors understand their responsibilities to all stakeholders, including customers, arising from ownership of public infrastructure.

We invite views on the capacity of Aqueduct Capital (UK) Limited and its investors to be the owner of a regulated water company.

Role of the owners of Sutton and East Surrey Water

- 4.4 All companies need the active co-operation of their owners in carrying out their functions. Condition P came into effect in SES's licence on 22 December 2006 and set out the requirement for SES to obtain legally enforceable undertakings from its owners. The companies giving the undertakings are required to:
- give the regulated business any information it needs to comply with its licence;
 - refrain from any action that could cause the regulated business to breach its licence; and
 - maintain a minimum of three independent non-executive directors on the board of the regulated business.

- 4.5 These undertakings help to protect consumers by strengthening the ability of the regulated business to comply with the conditions of its licence and to maintain its independence from the rest of the group to which it belongs.
- 4.6 SES already has three non-executive directors on its board in recognition of the Condition P requirement.
- 4.7 Condition P requires SES to secure undertakings from its UK holding company and its ultimate controller.
- 4.8 Ultimate controller is defined in SES's licence Condition P to mean 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 any holding company of the regulated business.
- 4.9 Condition P of SES' licence requires it to secure new undertakings following any subsequent change of ownership. Under the previous ownership structure, SES obtained the relevant undertakings from Deutsche Bank AG London as the Ultimate Controller and ACUK as its UK holding company.
- 4.10 The syndication of Deutsche's ownership has not led to any change to the UK holding company, therefore the undertaking from ACUK as the UK holding company will remain in place.
- 4.11 ACUK has made representations to us on complying with the ultimate controller obligation. In coming to their view, the investors have considered the rights and obligations of the investors in ACUK under the shareholder agreement which provides for specific matters being reserved for shareholders and the Board of ACUK.

Shareholder reserved matters

- 4.12 ACUK has informed us that no individual shareholder has the ability to veto strategic decisions at a shareholder level, with the exception of one shareholder who, with their present shareholding can veto the decision to exit (i.e. a sale or listing of ACUK). The investors consider this is not a reason to require that investor to provide an ultimate controller undertaking as circumstances leading to such a blocking decision are unlikely to arise in practice and the nature of the matters reserved for shareholders are not directly relevant for the purposes of the Condition P undertakings.

Board reserved matters

- 4.13 Strategic business decisions such as approval or amendment of business plans and approving regulatory submissions are matters reserved for the Board. The shareholder agreement sets out the director appointment rights for each of the investors.

Current Board structure

- 4.14 For commercial reasons, none of the investors currently plan to exercise their individual rights to appoint directors to the Board of ACUK. We understand that three of the four Deutsche appointed directors to the Board of ACUK resigned in March 2007. The investors have told us that two new directors (both of whom are currently directors of SES and not Deutsche employees) have been appointed to the Board of ACUK. The board of ACUK now comprises three directors.
- 4.15 The director originally appointed by Deutsche that remains on the Board of ACUK is also an employee of Deutsche. However, the investors consider that Deutsche does not have control or material influence over ACUK because (i) the director owes his duties to the Board of ACUK, (ii) his continuing appointment is on behalf of all shareholders, (iii) Deutsche does not own an interest in ACUK sufficient to give it an absolute right to a board seat and (iv) the investors have the right to remove the director at any time by ordinary resolution.

Theoretical Board structure

- 4.16 The investors have explained that at board level, the shareholder agreement has been structured as a “shifting alliance” such that no investor or investor-appointed director has blocking rights.
- 4.17 The shareholder agreement provides that the quorum for board meetings of ACUK is three directors. If shareholders took up their director appointment rights, the shareholder agreement provides that quorum would cease for strategic resolutions (eg approval of business plans, regulatory submissions, budgets) where the number of directors appointed by any one shareholder who are present and entitled to vote would entitle them to cast sufficient votes to block the resolution.
- 4.18 ACUK considers therefore that if the shareholders were to take up their director appointment rights, individual directors would nonetheless owe their primary duty to ACUK and would not individually be empowered (under the ACUK shareholder’s agreement) to veto the strategic business decisions described above.
- 4.19 The investors conclude that no individual shareholder has control or material influence over the strategic business decisions of ACUK under the proposed Board structure or the structure if the investors were to take up

their director appointment rights. The investors suggest that ACUK should provide Condition P undertakings to SES as the ultimate controller of SES.

- 4.20 In light of the information presented to us above, we see no reason to challenge the investors' view that ACUK should provide the ultimate controller undertaking.
- 4.21 Ultimately it is the responsibility of SES to ensure that it complies with its licence by procuring Condition P undertakings from the appropriate entities both now and in the future.

<p>We invite views on which entity or entities should provide an ultimate controller undertaking to SES.</p>
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Ring fencing arrangements

- 4.22 We published our position note on the completed acquisition of the East Surrey Holdings Group by ACUK in September 2006. The position note confirmed the modifications to the licence of SES that we proposed in order to bring the ring fencing licence conditions into line with the 'standard' for companies with similar ownership structures. The licence modifications came into effect on 22 December 2006. These ring fencing licence conditions:
- require SES 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;
 - strengthen the ring fence ensuring that there is no cross subsidy between SES and its associated companies;
 - require SES 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 SES to confirm on an annual basis it has sufficient financial and managerial resources to carry out its activities;
 - ensure its financial affairs can be assessed and reported on separately from other businesses and activities of its group;
 - require SES to maintain an investment grade corporate credit rating;
 - prohibit (without Ofwat's consent) cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other companies in the group; and
 - require it to publish its results as if it were listed on the Stock Exchange.

- 4.23 We signalled in MD218, published on 7 September 2006, our conclusion, following consideration of responses to the Financing Networks discussion paper, that there is merit in the gradual adoption by water companies of cash lock-up provisions similar to those already applied to energy companies³. We indicated that whilst we saw no grounds for urgent change we would seek to introduce cash lock-up provisions into licences as and when suitable circumstances arise. The syndication of Deutsche's ownership represents such a circumstance.
- 4.24 SES has indicated that, in principle, it is willing to accept the cash lock-up licence provisions.

We invite views on whether the ring fencing conditions described are adequate or whether further conditions are required, above the introduction of a cash lock-up provision, to ensure that the regulated business remains appropriately ring fenced within the wider group.

³ We did not include the cash lock up provision in the suite of changes to SES's licence implemented in December 2006 because the changes had been agreed before we published MD218.

5 Next steps

5.1 Responses to this paper should be made in writing no later than 5pm on 18 June 2007. We will then consider responses and publish a position paper.

5.2 Responses should be addressed to:

Emma Cochrane
Head of Corporate Finance
Water Services Regulation Authority
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Fax: 0121 625 3623

E-mail: emma.cochrane@ofwat.gsi.gov.uk

5.3 At the end of the consultation period, each response will be placed in Ofwat's library for public inspection unless respondents request otherwise.