



POSITION NOTE ON THE PROPOSED ACQUISITION OF EAST SURREY HOLDINGS PLC BY KELLEN ACQUISITIONS LIMITED AND ITS IMPACT ON SUTTON AND EAST SURREY WATER PLC

Terra Firma Investments GP (2) Limited ('TFI'), through its acquisition vehicle Kellen Acquisitions Limited ('Kellen'), announced on 8 April 2005 that it planned to acquire the entire share capital of East Surrey Holdings plc ('ESH'). ESH is the holding company of Sutton and East Surrey Water plc ('SES'), a water undertaker regulated by Ofwat.

On 27 May 2005, we issued a consultation paper, 'The Proposed Acquisition of East Surrey Holdings Plc by Kellen Acquisitions Limited and its impact on Sutton and East Surrey Water plc.' The purpose of the paper was to consult on any regulatory issues arising from the acquisition and whether any modifications should be made to SES's instrument of appointment (its "appointment"). On 16 June 2005, the Office of Fair Trading (the OFT) cleared the acquisition without referring it to the Competition Commission under section 33(1) of the Enterprise Act 2002. In its decision the OFT also noted that a mandatory reference to the Competition Commission under section 32 of the Water Industry Act 1991 was not triggered as only one water enterprise is involved in the transaction.

This note sets out the issues raised by respondents and our position on them. There were only two responses to the consultation paper (from the Drinking Water Inspectorate and WaterVoice Thames – which represents SES customers).

The capacity of Kellen to own a regulated water business

On the basis of our work we have no reason to doubt that Kellen is fit and proper to own a regulated water company. The responses to the consultation gave us no reason to change this view.

The DWI had no specific comment on the content of the consultation paper and concurred with the conclusion that the acquisition did not raise any significant regulatory issues, particularly with respect to maintaining quality of drinking water to the requirements specified in the Water Supply (Water Quality) Regulations 2000.

WaterVoice Thames noted the fact that Kellen has no previous experience of operating a water company. It also noted the proliferation of ownership of water companies by financial institutions.

WaterVoice Thames indicated in its response that it understands that there is a real possibility that after the proposed acquisition is completed, further restructuring will result in the divestment of SES within a short space of time.

WaterVoice Thames' expressed its preference for SES to be owned by an organisation with a strategic commitment to the business backed by expertise in the water industry.

Despite this WaterVoice Thames considered that, at least in the short term, customers are not likely to notice any difference in service arising from the acquisition owing to, in its view, the company's excellent track record in providing high quality service from the existing SES team. However, it also considered that there must be a danger that the management would be distracted should SES be sold off within a few months. As regards management Kellen has indicated that it:

- believes that ESH has an effective and capable management team which has consistently delivered operationally; and
- intends to retain the services of the Executive Directors of ESH and SES once the acquisition has been completed.

As a result of its concerns WaterVoice Thames therefore supported our proposals to modify SES's instrument of appointment. Our aims are to ensure that SES is ring fenced from the other activities of the group and that the company has the co-operation of its owners in carrying out its functions. The proposed changes are described in the following section.

Whilst Kellen's offering circular for the shares in ESH indicated that Kellen would undertake a strategic review of the water business, it did not constitute a formal proposal to either sell off or alter the capital structure of SES. We therefore consulted on the regulatory issues arising from the current proposals as they affect SES and its customers. We will consider the implications of any such future strategic review involving the water company at that time.

Proposed licence modifications

Many regulated water (and water and sewerage) companies are part of larger groups. In each case we regulate the water undertaker ("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 propose to modify Condition F of SES'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). It will also require the company to make publicly available the same information a listed company would.

To ensure that SES has the co-operation of its owners in carrying out its functions, we also intend 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 UK holding company and Ultimate Controller will:

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

SES has agreed in principle to the modifications to Condition F and insertion of Condition P and will agree to act as if they are in place once the acquisition completes.

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

Customer dividend

In its response to the consultation WaterVoice Thames suggested that the new owner should return a 'customer dividend' of £40 to each customer of SES. WaterVoice Thames argued that this would allow customers to share in the added value that it expects Kellen to generate.

The price limits we announced for SES in December 2004 for the 2005-10 period were no higher than is necessary for an efficient company to finance its functions. These price limits were agreed by the company and will not, in any way, be affected by this proposed transaction. Customers are not disadvantaged by the sale.

The price Kellen proposes to pay for ESH, as with all acquisitions, reflects the new owner's circumstances and market conditions at that particular point in time. It is difficult to distinguish any premium for SES alone from the different businesses acquired. Terra Firma has said that it was attracted to ESH by its strong management and track record, as well as the potential for growth of its regulated gas and pipeline businesses. In addition it is usual in any industry for the new owners to acquire at a premium.

It is the shareholders that receive the proceeds from any sale, whether it be at a premium or a discount to the RCV. The financial position of SES is essentially unaffected by the purchase price.

We will take account of any new evidence arising from takeovers during the next five years in our assessment of the cost of capital at the next price review.

Financial projections

In our consultation paper we said we would need to assess whether SES remains able to finance its functions as a water undertaker under Kellen's ownership. We also noted the credit rating agencies' comments on the proposed acquisition concerning the creditworthiness of SES and the likelihood of increased gearing at SES.

We have reviewed a set of financial projections provided by Kellen. Amongst other things, they set out forecasts for gearing and cash-based financial ratios. Nothing in these projections has come to our attention to warrant further action by us at this time.

In particular we explained in our consultation paper that Kellen had indicated that it had no plans to change the financial structure of the water company and that the £100m index linked bonds issued in 2001 by SES would be unaffected by the transaction.

As part of the new appointment conditions SES will be required to maintain an issuer credit rating which is an investment grade rating. The purpose of this is to provide reassurance that the appointee continues to be in a position to finance its functions. SES already maintains a credit rating to comply with the conditions of its 2001 bond issuance. Whilst we noted in our consultation paper that Standard and Poors had put SES on "Creditwatch" and Moody's had downgraded the credit rating a notch, the ratings remain comfortably within investment grade. On this basis SES would therefore comply with the proposed change to its conditions of appointment.

We also propose to modify SES' appointment conditions to prohibit SES, without the Director General of Water Service's (the Director) consent, from entering or permitting to remain in force, arrangements that contain cross default provisions (ie where an event within the wider ESH group can have a financial impact on the water company). This is to ensure that no risks beyond those inherent in the appointed business can be imported. However, SES is already subject to cross-default obligations as a result of the arrangements it entered into when it issued its 2001 bond. SES has said that these are designed to facilitate the efficient financing of the water company.

As a result, therefore, the combined effect of the existing cross-defaults and the proposed modification to SES' appointment would, without the Director's consent, technically constitute a breach of its appointment.

SES would have to immediately refinance the 2001 bond without such consent. This may affect the short-term financing and credit quality of the company. It is also the precise consequence we are seeking to avoid through the prohibition of cross-default clauses.

SES argues that the cross-default provisions are designed to facilitate the efficient financing of the water company. This needs to be weighed against our policy preference for prohibition of cross default clauses. Taking all these issues into account the Director considers, in this case, that the existing financing should be continued and that consent should be given to these specific cross default clauses.

Next Steps

We will issue a formal notice of our intention to modify SES's appointment in accordance with section 13 of the Water Industry Act 1991 in due course. The proposed changes will introduce ring-fencing provisions into Condition F and insert Condition P. As explained above, these changes will further protect SES's customers from risks outside the appointed business. We are not proposing any appointment modifications in addition to those highlighted in our May 2005 consultation paper.