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The completed acquisition of the East Surrey Holdings Group by Aqueduct Capital (UK) Limited and its impact on Sutton and East Surrey Water plc

A position note by Ofwat

September 2006

POSITION NOTE ON THE COMPLETED ACQUISITION OF THE EAST SURREY HOLDINGS GROUP BY AQUEDUCT CAPITAL (UK) LIMITED AND ITS IMPACT ON SUTTON AND EAST SURREY WATER PLC

1 Introduction

Deutsche Bank AG (Deutsche), through its acquisition vehicle Aqueduct Capital (UK) Limited (Aqueduct), announced on 16 December 2005 that it planned to acquire the East Surrey Holdings Group (ESH) from Kellen Acquisitions Limited (Kellen). ESH is the holding company of Sutton and East Surrey Water plc (SES), a water undertaker regulated by the Water Services Regulation Authority (Ofwat). Aqueduct subsequently acquired ESH on 27 January 2006.

On 28 March 2006, we issued a consultation paper, 'The completed acquisition of the East Surrey Holdings Group by Aqueduct Capital (UK) 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 licence).

This note sets out the issues raised by respondents and our position on them. There were two responses to the consultation paper from Martin Blaiklock and the Consumer Council for Water Thames (CCWater Thames). CCWater Thames represents SES's customers.

We have delayed publication of this document to allow us to take into account the views of the Office of Fair Trading as to the implications of the subsequent syndication by Deutsche of some of its stake in Aqueduct (see section 2.1).

2 The capacity of Deutsche and Aqueduct to own a regulated water business

Our assessment of whether Deutsche and Aqueduct are fit and proper persons to own a regulated water company is covered in the following subsections.

Both respondents to our consultation paper have commented on:
- the capacity of Deutsche to own a regulated water company; and
- the implications of the syndication of part of Deutsche's stake in Aqueduct.

In summary, on the basis of our work, including our review of responses to the consultation, we have no reason to doubt that Deutsche or Aqueduct is fit and proper to own a regulated water company. We are continuing to review the implications of the syndication of Deutsche's stake in Aqueduct. We understand that this process is not yet complete but at the time of writing Deutsche remains the largest shareholder in Aqueduct.

2.1 Deutsche's syndication of stake in Aqueduct

Since we published our consultation paper Deutsche has sold part of its interest in SES (through its ownership of Aqueduct) to other investors. We signalled in our consultation paper that Deutsche had begun this sale process. We now understand that:

- Caisse de depots et placement du Quebec (CDPQ) acquired a 25.1% interest in Aqueduct on 7 April 2006. CDPQ is the Quebec public sector investment manager and the largest institutional fund manager in Canada. CDPQ already has a 12.5% economic interest in South East Water Limited via its shareholding in Macquarie Luxembourg Water Sarl which owns South East Water. CDPQ also has a 4% interest in Macquarie European Infrastructure LP which owns 50.1% of Macquarie Luxembourg Water Sarl;
- Infrastructure Holdings Limited (IHL), an investment vehicle jointly owned by Deutsche and Great Eastern Life, acquired a 25% interest in Aqueduct on 26 April 2006. Although jointly owned, Deutsche's economic interest in IHL is 20%. Great Eastern Life owns the remaining 80%. IHL was established to facilitate participation of Asian investors in European infrastructure opportunities; and
- Alberta Investment Management (AIM) acquired a 12.5% interest in Aqueduct on 16 May 2006 through its two companies 1239107 Alberta Limited (a 4.75% interest) and 1239064 Alberta Limited (a 7.75% interest). AIM is the Alberta state pension fund and endowment fund manager. AIM already has a 12.5% economic interest in South East Water Limited via its shareholding in Macquarie Luxembourg Water Sarl. AIM also has a 3.3258% interest in Macquarie European Infrastructure LP which owns 50.1% of Macquarie Luxembourg Water Sarl.

As a result of this syndication Deutsche retains a direct interest of 37.4% in Aqueduct (the largest single shareholding) and a further 5% indirect economic interest through its ownership of IHL.

The new investors in Aqueduct did not make any formal notification to the Office of Fair Trading (OFT) of these transactions. We informed the OFT of these developments because of CDPQ's and AIM's interests in other water companies. The OFT published invitations to comment on both CDPQ's and AIM's investments on 25 July 2006.

The Water Industry Act 1991, as amended (WIA91) sets out a special merger regime for mergers between water and sewerage companies. Under section 32 of WIA91 OFT has a duty to refer to the Competition Commission a merger of two or more regulated water or water and sewerage companies (licensees) in England and Wales where the turnover of each is £10 million or more.

The Enterprise Act 2002 (EA02) sets out circumstances under which the OFT has a duty to refer a merger in any sector, including water (when the special merger regime for water does not apply), to the Competition Commission for further investigation of the competition issues when a relevant merger situation has been created.

On 1 September 2006 and 4 September 2006 the OFT published its decisions that it had found that the acquisitions (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 the EA02.

2.2 Capacity to raise resources for SES regulated functions

CCWater Thames indicated that whilst it felt that Deutsche has sufficient access to capital to support SES, there was no guarantee of the financial position of the new owners (following Deutsche's syndication of ownership). CCWater Thames suggested that the syndication should be on terms that provide continuing financial guarantees from Deutsche or its subsidiaries. We explain later in this paper our review of SES's projections, including the credit rating agencies' views. These projections have not changed as a result of the syndication. We do not regard the syndication as potentially inhibiting SES's capacity to raise capital. Furthermore, SES can raise capital in its own right – it is not dependent on Deutsche's facilities.

2.3 Understanding of the industry

CCWater Thames indicated that in its view Deutsche has knowledge of financing of utilities but that there is no evidence of a particular understanding of the requirements placed upon UK water undertakers. CCWater Thames questioned whether such knowledge will be available to the ultimate owners, and will continue to be a strength of the board of the regulated company.

We explained in our consultation paper that Deutsche views existing management as a key feature of its investments. As a result it retained the services of both the executive and non-executive directors of ESH and SES following the acquisition. On this basis we have no concerns about the impact of the acquisition on the regulated company's understanding of the industry.

Martin Blaiklock felt that Deutsche's acquisition of SES was purely financial. He felt that the bank's lack of corporate experience in the water sector put SES at risk of non-compliance with Condition P of its licence (which, amongst other things, requires the licensee's owner to refrain from any action that could cause the regulated businesses to breach its licence or its obligations under the licence). We do not see the relevance of the type of owners in terms of the ability to provide the undertakings required under Condition P. This Condition aims to strengthen the ability of the regulated company to comply with its licence and maintain its independence from the rest of the group to which it belongs. Implications of Deutsche's ownership of SES for Condition P are explained in section 4.

2.4 Probity

Both CCWater Thames and Martin Blaiklock highlighted the fine imposed on Deutsche by the Financial Services Authority (FSA) on 12 April 2006. The fine arose due to breaches of FSA principles 2 (failure to act with due skill, care and diligence) and 5 (improper market conduct) in relation to two transactions in 2004 within the Equity Capital Markets (ECM) group of Deutsche's Global Banking Division.

As a result Martin Blaiklock has challenged whether Deutsche can be considered to have the probity necessary for it to own a regulated water company. CCWater Thames emphasised the need for Ofwat to consider whether the syndication of the bank's ownership of Aqueduct was sufficiently transparent and whether Deutsche is indeed fit to own a regulated licensee.

The FSA's primary purpose when imposing a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefit of compliant behaviour.

In its judgement the FSA noted that Deutsche has the financial resources at its disposal to ensure that its internal arrangements are compliant with the FSA regulations. Furthermore, it acknowledged the significant co-operation and assistance it has received from Deutsche during its investigation. The FSA also noted that Deutsche undertook its own significant internal investigation into the transactions with the assistance of external advisers. In determining the level of fine the FSA took account that Deutsche;

- self-reported the matters to the FSA, and provided the FSA with the results of this investigation;
- has undertaken a review of its ECM group and related sales and trading processes since March 2004;
- has undertaken internal disciplinary action against some of the individuals involved in the matters of concern; and
- enhanced its compliance function.

Furthermore, we understand that Deutsche's Global Markets Division, Structured Capital Markets (SCM) business is handling the current Aqueduct syndication. We understand that SCM is part of a different business unit within Deutsche and has a separate management structure to ECM and was not implicated, in any way, in the disciplinary proceedings instigated by the FSA.

We also understand that Deutsche's Compliance and Legal functions have been involved in reviewing each step of the purchase by SCM of the interest in ESH and the introduction of other investors Aqueduct.

On the basis of the above we have no reason to doubt that Deutsche is fit and proper to own a regulated water company.

2.5 Conflicts of interest

Martin Blaiklock suggested that a conflict of interest arose between Deutsche's ownership of SES and its appointment as adviser to RWE in its disposal of Thames Water (as reported in the Financial Times on 29 April 2006 but not confirmed by Deutsche). In terms of Deutsche's internal procedures and controls, it has five core divisions: Global Banking, Global Markets, Asset Management, Private Wealth Management and finally Private and Business Clients. The Global Banking Division (comprising a number of financing and advisory activities including the Corporate Finance business which incorporates Mergers and Acquisitions advice) operates behind a Chinese wall from the other four divisions including Global Markets (which incorporates Structured Capital Markets which is dealing with the syndication of Deutsche's ownership in Aqueduct).

We understand that the activities of both the SCM, a Global Markets Business, and Corporate Finance, a Global Banking Business, are subject to the bank's conflicts of interest procedures and the bank's Compliance Department independently monitors their activities for conflicts arising between the two divisions. In order to implement an effective corporate governance structure and for the effective management of Chinese Walls and potential conflicts of interest, key members of senior management are above the Chinese wall. These individuals exercise strategic management over the bank's activities but are not involved in day to day sales and trading decisions.

We have no reason to doubt that the safeguards that Deutsche has in place to safeguard against the prospective conflicts of interest that Martin Blaicklock suggests are fit for purpose.

3 Financing

In our consultation paper we said we would need to assess whether SES remains able to finance its functions as a regulated water undertaker under Aqueduct's ownership. We also noted that SES was considering paying out cash reserves from the 2000-01 bond issue in the form of a special dividend in 2006-07. Other than this consideration of a reduction of cash reserves, Deutsche had indicated that it had no plans to change the overall financial structure of the regulated water company as shaped by the covenants set out in its 2001 bond.

We explained in our consultation paper of 28 March 2006 that SES had agreed to act as if the proposed licence modifications that we published on 11 November 2005 are already in place. With regard to dividends the company is therefore effectively operating under a licence Condition which requires its dividend policy to:

- reward efficiency and the management of economic risk, and
- not impair SES's ability to finance its functions as a water undertaker

However, CCWater Thames expressed doubt about the proposal to pay a special dividend owing to concerns it has with the consequent implications for gearing. CCWater Thames indicated that it was not clear whether the proposed special dividend would reward Deutsche for its temporary ownership, or whether it had been offered as an incentive to maximise the price potential owners are willing to pay.

Since we published our consultation paper SES has confirmed that its Board has approved the proposal to pay this special dividend. As we outlined in our consultation paper, a consequence of this special dividend is an increase in

SES’s level of gearing from its current level to closer to its covenant level. Whilst the gearing (net debt:RCV) would remain below the covenanted level of gearing in SES’s bond documentation (80% in relation to dividend lock-up provisions), SES’s projections show its gearing moving closer to the covenanted levels than historically.

As part of the new licence 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. We noted in our consultation paper that whilst 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.

The ratings agencies have since reviewed their credit ratings in the light of the company’s confirmed proposal to pay a special dividend and the impact of this payment for the financial projections. Moody’s has confirmed its rating at Baa1. FitchRatings downgraded its rating a notch to BBB+ on 25 May 2006. Standard and Poors similarly downgraded its rating to BBB+ on 2 June 2006 to reflect its expectation that SES's financial profile and capital structure will weaken as a result of Aqueduct's more aggressive financial policy. All ratings are on stable outlook.

We have reviewed the financial projections provided by SES. Amongst other things, they set out forecasts for gearing and cash-based financial ratios. Nothing has come to light in our review to warrant further action by us at this time. Furthermore, as noted above, the credit rating agencies have reviewed the same projections and have assessed SES’s credit quality. The rating outcomes provide some headroom above the floor for investment grade credit quality. Ofwat considers headroom above this floor important as a safeguard against future uncertainties.

4 Licence modifications

Many licensees are part of larger groups. In each case we regulate licensee which remains locally managed. It is the licensee, rather than its owners, which is directly responsible for complying with its licence. 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.

As we explained in section 3, we published our proposal to modify Condition F of SES’s licence to bring it into line with the current ‘standard’ for companies with similar ownership structures on 11 November 2005 (a copy of this notice is appended to the this note). The proposed modifications to SES’s licence will ensure that customers are protected from risks outside the licensee’s 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.

We have since considered responses to the Financing Networks discussion paper (published February 2006) and as set out in MD218 have concluded that there is merit in the gradual adoption by regulated water companies of cash lock-up provisions similar to those already applied to energy companies. However, we see no grounds for urgent change and will therefore only seek to introduce cash lock-up provisions into licences as and when suitable opportunities arise. We do not believe it would be appropriate to seek to introduce the cash lock-up provision in SES's licence now, which would be retrospective relative to the timing of the transaction.

To ensure that SES has the co-operation of its owners in carrying out its functions, we also published our intention to insert Condition P into the company's licence on 11 November 2005. This condition requires SES 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 must state that the UK holding company and Ultimate Controller will:

- give SES all information it needs to comply with its licence;
- refrain from any action that would or may cause SES to breach any of its obligations under WIA91 and its licence; and
- ensure that SES's Board contains a minimum of three independent non-executive directors.

SES agreed to act as if the modifications to Condition F and insertion of Condition P were in place from 28 October 2005, the date on which Kellen acquired East Surrey Holdings plc. Deutsche has since sold some of its interest to other investors as explained in section 2. We are considering how these new investors affect the ownership structure of SES and hence which entities SES considers constitute the UK holding company and Ultimate Controller(s) under Condition P. If these new investors have no ability to exercise material influence or control on SES through their minority interests in Aqueduct then we would be unlikely to be seeking any additional Condition P undertakings. Furthermore SES's previously provided undertakings from Deutsche Bank AG London (the Ultimate Controller) and Aqueduct (its UK holding company) would remain in place.

Successive changes of ownership

CCWater Thames has questioned whether the licence conditions as a whole provide sufficient protection against a rapid succession of changes of ownership undertaken, in its view, for the sole purpose of taking value out of the company. CCWater Thames has questioned whether we could seek better protection of customers in pursuit of our duty to regulate in such a way as to allow efficient regulated companies to make a reasonable return on capital, and no more.

CCWater Thames accepts that it is in the nature of the licensed water industry that financial requirements are long term while ownership may be transient. However, it believes that the regulator should consider how customers are protected from effects of temporary ownership and that they should be strongly challenged if the likely effect is to reinforce upward pressures on prices. To this end it has suggested amending the licence as follows

In agreeing to act as if the modifications to Condition F were in place from 28 October 2005, SES is required (under paragraph 6A.5A of the Condition) to conduct the Appointed Business as if it were substantially the Appointee's sole business and the Appointee were a separate public limited company. SES is required, amongst other things, to have regard to the following in the application of this Condition:

> *the composition of the Board of the Appointee should be such that the directors, acting as such, act independently of the parent company or controlling shareholder and act exclusively in the interests of the Appointee*

CCWater Thames has suggested that this be amended to:

> *the composition of the Board of the Appointee should be such that the directors, acting as such, act independently of the parent company or controlling shareholder and act exclusively in the interests of the Appointee* ***its obligations to customers, and its ability to comply with the purpose and conditions of its appointment.***

In its submission to Ofwat, CCWater Thames implies that the amendments are aimed at clarifying whether the licence's intention is to protect shareholders of the company or the ability of the company to carry out its duties to customers. The licence provision as it stands is there to protect SES from the activities of the wider group. It aims to protect the financial and managerial capacity of SES and so protect its ability to deliver its services to customers.

We agree that frequent changes of ownership can be disruptive but we do not believe the changes suggested by CCWater Thames would be an appropriate addition to the licence. We believe that the current standard for ring-fencing the appointed business via the licence conditions we impose is fit for purpose. More generally, the ring fencing provisions contained in companies' licences are designed to reduce the risk of financial distress by constraining the conduct of the licensee. Their presence helps to reassure the regulator that companies remain in a position to finance their functions and consumers' interests are not adversely affected by a company's capital structure.

Furthermore, the price limits that we set for the 2005-10 period will in no way change as a result of the acquisition or the decision to pay a special dividend. As a result there is nothing in the SES acquisition that in our view warrants more stringent protections than already agreed as a result of the previous sale to Kellen.

Martin Blaiklock felt that customers of SES had a right to know who the ultimate owner and controllers(s) would be. He suggested that any investor owning more than 3% of the share capital of any UK water company should be disclosed in the notes to the company accounts and their probity publicly established.

Ofwat has no authority with regard to what should or should not be recorded in company's accounts. Where any licensee undergoes a change of ownership we consult on the regulatory issues that emerge including whether the new owner(s) are fit and proper to own a water company. We are still considering which entities in the corporate structure constitute the Ultimate Controller.

On the basis of the information that we have, Deutsche remains the largest shareholder. In view of this we do not consider it necessary to publicly consult on the probity of other small investors at this stage. Should our review of Ultimate Controller issues bring to light any ability by these smaller investors to exert control over SES (which includes the ability to exercise material influence over the policy or affairs of SES or any holding company of SES), we would consider whether to consult on the probity of those investors and the need for SES to procure additional Condition P undertakings at that point.

5 Next steps

We have considered the suggestions made by respondents for what they believe would strengthen the ring-fencing of the regulated business's licence and increase transparency. We regard the current standard for ring-fencing to be fit for purpose and that on the basis of the details of the SES acquisition, further protections are unwarranted for the reasons outlined in this paper. Taking this into account, we are not proposing any additional licence modifications. We will therefore formally modify SES's appointment as we proposed in our announcement on 11 November 2005, which was in accordance with section 13 WIA91. The 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.