

**WATER INDUSTRY ACT 1991, SECTION 13
PROPOSALS BY THE DIRECTOR GENERAL OF WATER SERVICES TO MODIFY
THE CONDITIONS OF APPOINTMENT OF
SUTTON AND EAST SURREY WATER PLC AS A WATER UNDERTAKER**

THE PROCESS

This Notice seeks comments on the proposed modifications described below. Any representations or objections must be sent in writing to the Director General of Water Services, Centre City Tower, 7 Hill Street, Birmingham, B5 4UA (fax, 0121-625 3609 or e-mail keith.mason@ofwat.gsi.gov.uk) to be received no later than 5.00pm on 9 December 2005.

DESCRIPTION OF THE PROPOSED MODIFICATIONS AND THE REASONS FOR THEM

Sutton and East Surrey Water plc (the Company) holds an appointment as a water undertaker under the Water Industry Act 1991.

Terra Firma Investments (GP) 2 Limited (Terra Firma), through its acquisition vehicle Kellen Acquisitions Limited (Kellen), acquired East Surrey Holdings plc on 28 October 2005. East Surrey Holdings plc is the immediate owner of the Company. This acquisition did not result in any major change in the way the Company is financed or managed. In May 2005 we issued a consultation paper on the transaction. The purpose of this consultation paper was to consult solely on any regulatory issues arising from the acquisition and whether any modifications should be made to the Company's appointment. We received no substantive responses.

We propose to make the modifications to bring the Company's appointment into line with the current standard for other water companies. The Company has agreed in principle to the making of these modifications.

Maintenance of comparisons with other water undertakers

We consider that the core business of the Company should be transparent to regulation. To that end, we propose appointment modifications that will require it to operate at arm's length from Terra Firma and its subsidiaries (the Company's Group).

The modifications will:

(1) (i) ensure that payment for any services provided by any company within the Group (Associated Company) does not exceed prices obtained by market testing, or where this is not appropriate, an appropriate proportion of the Associated Company's costs, as agreed by Ofwat; and

(ii) require the Company to obtain from that Associated Company information required by Ofwat about the latter's costs.

Ring-fencing of the Company

We wish to ensure that the Company's regulated business is ring-fenced from the other activities of Associated Companies. The Company must not, whether through its involvement in those other activities or by its dividend policy, put at risk its ability either to carry out its functions as a water undertaker or to finance them. **Appointment modifications will therefore:**

(2) prohibit the transfer of any asset from the Company to any Associated Company except with Ofwat's consent;

(3) require the Company to maintain an issuer credit rating of investment grade;

(4) require the Company to maintain the listing of a financial instrument on the London Stock Exchange or another exchange of similar standing;

(5) prohibit it from giving a guarantee of any liability or making any loan to any other company within the Group except with Ofwat's consent;

(6) prohibit it from entering into or continuing any commitment which includes a 'cross-default obligation' (whereby its financial liabilities are increased or accelerated because of a default elsewhere within the Group) except with Ofwat's consent;

(7) require it to declare or pay dividends only in accordance with a dividend policy which will not impair its ability to finance its functions as a water undertaker and which has been approved by its Board, which rewards efficiency and the management of economic risk; and

(8) require it to publish the financial information that would be required if it were subject to the Listing Rules of the Financial Services Authority.

The Company's Directors are already required to certify annually to Ofwat that the Company has adequate financial and management resources. **Further modifications will require:**

(9) (i) the Directors to certify their opinion that any contracts with Associated Companies include all provisions necessary for the Company to meet its obligations as a water undertaker;

(ii) that certificate to include the main factors which the Directors took into account in giving it;

(iii) the Company to inform Ofwat if the Board becomes aware of any circumstances which might mean that its most recent certificate could not be repeated; and

(iv) the annual certificate to be accompanied by a report to Ofwat from the Company's Auditors, detailing any inconsistencies between the certificate and the statements submitted with it or the findings of their own audit.

Management of the Company

Although the Company is a part of Terra Firma's group, it has its own duties as the water undertaker for its area. **A further appointment modification will:**

(10) require the Company, in carrying out those functions, to behave as if they were substantially its sole business and it were a separate public limited company. In doing so it will be required to have particular regard to the following:

(i) the composition of the Board should allow it to act independently of the parent company or controlling shareholder, and exclusively in the interests of the Company;

(ii) the Company must ensure that each of its directors discloses any conflicts of interest between their duties to the Company and other duties, both to the Company and to Ofwat;

(iii) where potential conflicts exist between the interests of the Company and other companies in the Group, the Company and its directors must ensure that they have regard exclusively to the Company's interests as a water undertaker;

(iv) no director of the Company should vote on any matter where he has an interest by virtue of other directorships and this must be reflected in the Company's Articles;

(v) the Company should inform Ofwat of any important changes in the composition of the Board or the responsibilities of any director;

(vi) the Company's dividend policy; and

(vii) the principles of corporate governance which are from time to time recognised by the Listing Rules of the Financial Services Authority.

The role of the Company's owners

The Company should have the active co-operation of its owners in carrying out its functions as a water undertaker and complying with the conditions of its appointment. **Further modifications will:**

(11) (i) require the Company to obtain from Terra Firma (its Ultimate Controller) and Kellen (its UK holding company), or their successors, legally enforceable undertakings that they and their subsidiaries (apart from the Company and its subsidiaries) will:

(a) give the Company all information it requires to comply with its appointment;

(b) refrain from any action which would be likely to or may cause it to breach any of its obligations under the Water Industry Act 1991 or its appointment as a water undertaker; and

(c) ensure that its board contains not less than three independent non-executive directors.

(ii) require it to inform Ofwat immediately in writing, if it becomes aware that the undertaking has ceased to be legally enforceable, or that there has been any breach of its terms.

(12) prohibit it (except with Ofwat's consent) from making any contract with a member of the Group which is not one of its own subsidiaries, for so long as the above undertakings have not been given or there is an unremedied breach of any of them.

***Office of Water Services
November 2005***