

WATER INDUSTRY ACT 1991, SECTION 13 - PROPOSALS BY THE WATER SERVICES REGULATION AUTHORITY (OFWAT) TO MODIFY THE CONDITIONS OF APPOINTMENT OF THAMES WATER UTILITIES LIMITED AS A WATER UNDERTAKER

THE PROCESS

This Notice seeks views on the proposed modifications described below. Any representations or objections must be sent in writing to Emma Cochrane, Head of Corporate Finance, Ofwat, Centre City Tower, 7 Hill Street, Birmingham, B5 4UA (fax 0121-625 3609 or e-mail emma.cochrane@ofwat.gsi.gov.uk) to be received no later than 5.00pm on 17 August 2007.

DESCRIPTION OF AND REASONS FOR THE PROPOSED MODIFICATION

On 1 December 2006 Kemble Water Limited completed its acquisition of Thames Water Holdings Plc. Kemble Water Limited is 100% owned by Kemble Water Holdings Limited (Kemble) which, in turn is owned by a consortium of investors (the Consortium). Thames Water Holdings Plc has subsequently changed its name to Thames Water Holdings Limited. It is the UK parent and owner of 100% of the issued share capital of Thames Water Limited which in turn owns 100% of Thames Water Utilities Holdings Limited, the UK parent and owner of 100% of the issued share capital of Thames Water Utilities Limited (Thames Water). Thames Water is an appointed water and sewerage undertaker regulated by Ofwat.

We issued a consultation document in February 2007 in which we invited views on:

- the capacity of Kemble and its investors to be the owner of a regulated water business;
- the board structure put in place by the Consortium and its compatibility with good corporate governance of the regulated company;
- which entities should provide parent company and ultimate controller undertakings to Thames Water under Condition P of its Instrument of Appointment (its 'Appointment');
- the implications for Thames Water of the proposed long term financial structure for Thames Water and the Thames Water group; and
- the need for modifications to Thames Water's Appointment to ensure that, whoever its owners, it has sufficient financial and managerial resources to carry out its functions as an appointed water and sewerage company and is appropriately ring-fenced from the rest of the group.

In May 2007 we issued a position paper in which we said we would make the Appointment modifications proposed in our consultation paper. The Appointment modifications we proposed are set out below.

1. The role of the Thames Water's owners

Thames Water should have the active co-operation of its owners in carrying out its functions as a water undertaker and in complying with the conditions of its appointment.

Thames Water's existing Condition P will be replaced with a generic form of Condition P. This will require Thames Water to obtain these undertakings from an Ultimate Controller and where the Ultimate Controller is not the UK holding company, from the UK holding company. The condition will also be amended to include a successor clause that requires Thames Water to obtain new undertakings in the event of a change of control.

2. Comparative information

One of the most important tools available to Ofwat for the regulation of water companies is the ability to make comparisons between them (comparative competition). Thames Water's Appointment already contains the Appointment condition which requires it to use all reasonable endeavours to maintain an investment grade credit rating. This allows us to make comparisons of how the market values Thames Water relative to other listed companies. This type of analysis informs our judgements for example on the appropriate cost of capital for water companies.

However, Thames Water's Appointment condition relates to its corporate debt. Thames Water's new owners propose to implement a securitisation which will involve the transfer of all of Thames Water's existing debt into a securitisation structure and the issuance of new long term bonds ring fenced around the cash flows and obligations of Thames Water. Given the nature of the financing proposals, we proposed that Thames Water's Appointment be amended so that Thames Water be required to maintain an investment grade issuer rating.

The issuer rating reflects the financial capacity of the corporate entity and therefore its ability to raise capital or maintain access to liquidity in the future. Any significant adverse changes to the rating would provide us with an early signal that the company's ability to raise future finance was at risk.

3. "Cash lock-up"

We signalled in MD218¹ our conclusion, following consideration of responses to the Financing Networks discussion paper², that there is merit in the gradual adoption by water companies of cash lock-up provisions similar to those already applied to energy companies. The new provisions make explicit the steps the regulator requires of the regulated company in order that the financial viability of the regulated company is preserved if its investment grade credit quality is threatened.

We indicated that whilst we saw no grounds for urgent change we would seek to introduce cash lock-up provisions into companies' Appointments as and when suitable circumstances arise. We published on the same day as MD218 our conclusions on a capital restructuring undertaken by Thames Water's previous owners and our view that this represented a suitable circumstance to introduce the cash lock up Appointment provision into Thames Water's Appointment.

4. Systems of planning and internal control

In January 2006 Thames Water informed us that it had discovered that it had been failing to meet certain standards of customer service performance under the GSS and had not been making payments due to customers for those failures as it is required to do. We are conducting an investigation into these irregularities and possible misreporting of customer services data. Together with Thames Water we appointed Ernst & Young LLP to work on our behalf, and they have now produced a report for our consideration.

We indicated in our consultation paper that one of the actions we intend to take is to modify Condition F of Thames Water's Appointment:

- To require it to act at all times in the manner best calculated to ensure that it has adequate systems of planning and internal control to enable it to secure the carrying out of its Regulated Activities; and
- To require the appointee to submit an annual certificate, accompanied by an independent report from the Reporter or other person as specified by Ofwat, that in the opinion of the Directors the appointee will, for at least the next 12 months, have available for it systems of internal control which are sufficient to enable it to carry out its functions.

END

¹ Notification of intent to introduce a cash lock-up provision to Condition F of companies' instruments of appointment – 7 September 2006

² Financing Networks: A discussion paper, February 2006