



**The Proposed Acquisition of East Surrey Holdings Plc
by Kellen Acquisitions Limited and its impact on Sutton
and East Surrey Water plc**

A consultation paper by Ofwat

May 2005

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1 Purpose

1.1 This document:

- describes the proposed acquisition by Kellen Acquisitions Limited (Kellen), a company formed at the direction of Terra-Firma Investments GP (2) Limited (TFI), of East Surrey Holdings Plc (ESH). ESH is the owner of Sutton and East Surrey Water plc (SES), an appointed water undertaker regulated by Ofwat.
- explains the statutory position on mergers;
- describes TFI's ownership and structure; and
- sets out the regulatory issues and our initial assessment of these issues.

1.2 We invite views on the issues discussed in this paper, including:

- the capacity of TFI and Kellen to be the owners of a regulated water business;
- which entities in the Kellen group structure should provide the undertakings to SES referred to in Section 4 of this paper;
- the need for modifications to Conditions F and P of SES's instrument of appointment (its 'licence') to ensure that, whoever its owners, it has sufficient financial and managerial resources to carry out its functions as a water company and is appropriately ring-fenced from the rest of the Kellen Group.

Respondents may also comment on any other issues relating to the acquisition that they believe are relevant.

1.3 Responses to this paper are required by no later than 16 June 2005.

2 Details of the acquisition

- 2.1 On 8 April 2005, Kellen announced that it planned to acquire the entire share capital of ESH. Kellen is a company formed at the direction of TFI. ESH is the holding company of Sutton and East Surrey Water plc (SES), a water undertaker regulated by Ofwat.
- 2.2 The acquisition will be effected by schemes of arrangement covering the ordinary and preference shares of ESH. The preference share scheme will be conditional upon the ordinary scheme becoming effective.
- 2.3 Under Kellen's proposals, ordinary shareholders will receive 525 pence for each ordinary share with an entitlement to a 10 pence interim dividend. This ordinary scheme values ESH's existing, issued ordinary share capital at around £453m. Holders of preference shares will receive 125.5 pence for each share. If the scheme of arrangement concerning the preference shares does not become effective Kellen plans to take steps to cancel the preference shares. The offering circular was released on 11 May 2005.
- 2.4 TFI is general partner of the six limited partnerships that constitute Terra Firma Capital Partners II Fund. TFI is advised by Terra Firma Capital Partners Limited (TFCP). TFCP was established in March 2002 and grew out of Nomura's Principal Finance Group. It is an independent private equity organisation but continues to advise Nomura in respect of its existing portfolio of investments. TFCP is authorised and regulated by the Financial Services Authority. The Guernsey Financial Services Commission regulates TFI. The acquisition vehicle, Kellen, will be financed using a combination of debt and equity. The aggregate amount of capital (a mixture of debt and equity) provided from within the TFI Group will be approximately £262m. Kellen also has in place up to £458m of debt facilities.
- 2.5 ESH is a regulated multi-utility infrastructure business in the UK. In addition to SES it comprises Phoenix Natural Gas Limited (which distributes and supplies gas in the Greater Belfast area and is regulated by the Northern Ireland Authority for Energy Regulation (NIAER)) and E.S. Pipelines Limited (which is an independent gas transportation business in the UK). East Surrey Holdings also announced on 19 May 2005 that it had agreed, with Terra Firma, to acquire Centrica plc's gas transportation business, British Gas Connections Limited, for £90m. ESH's consideration for the acquisition is approximately £8m which is being satisfied from its existing cash resources. NIAER issued a consultation paper on the implications of Kellen's proposed acquisition of ESH on Phoenix Natural Gas Limited on 25 May 2005.
- 2.6 SES is an appointed water undertaker, regulated by Ofwat. With a regulatory capital value of around £140m in 2004-05, 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.

- 2.7 The offering circular indicates that whilst Kellen believes that Phoenix Natural Gas Limited and E.S. Pipelines Limited represent highly attractive opportunities, offering growth through the acceleration of the current investment programmes, it will consider the strategic position of SES following the Ordinary Scheme Proposals becoming effective. We will consider the implications of any such strategic review at that time.

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 (recently amended by the Enterprise Act 2002 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 where the turnover of each is £10 million or more. We understand that Kellen does not hold an existing interest in any water or sewerage companies in England & Wales.
- 3.2 In addition to the sector-specific merger provisions in WIA91, the Enterprise Act 2002 (EA02) sets out circumstances under which the Office of Fair Trading (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 The OFT issued an Invitation to Comment on the proposed acquisition on 19 May 2005. It is considering whether the proposed acquisition would create a relevant merger situation under the merger provisions of the Enterprise Act 2002. If it is found to constitute a relevant merger situation, the OFT will consider further whether a substantial lessening of competition results from the merger that warrants reference to the Competition Commission for investigation and report.
- 3.4 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 and whether any modifications should be made to SES's licence.

4 TFI's ownership and group structure

4.1 Kellen is a private company incorporated in England and Wales on 16 February 2005 and has been formed at the direction of TFI for the purpose of acquiring ESH. Kellen has not traded since its date of incorporation, nor has it entered into any obligations other than in connection with this acquisition proposal and its financing. The directors of Kellen are employees of TFCP (which is adviser to TFI).

4.2 All water companies need the active co-operation of their owners in carrying out their functions. Most water (and water and sewerage) companies have a condition in their licence (Condition P) that requires them to obtain legally enforceable undertakings from their 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.

These undertakings help to protect customers 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.

4.3 SES does not have Condition P at present. We propose to include the condition in its licence and to require it to obtain undertakings from:

- its UK holding company; and/or
- its 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. Kellen and SES have no objections to this proposal.

4.4 We are currently in discussions with SES and Kellen as to which are the appropriate entities to provide the Condition P undertakings. For similarly structured transactions (i.e. acquisitions by private equity vehicles) we have required undertakings from both the acquisition vehicle (in this case Kellen) and entities higher up the group structure as ultimate controllers.

Condition P requires new undertakings to be provided on any subsequent change of ownership. We would welcome the views of others.

5 Other regulatory issues arising from the acquisition

The capacity of TFI and Kellen to be the owners of a regulated water company

- 5.1 We accept that 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.
- 5.2 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 operational and financial capacity to assume that role.
- 5.3 TFI has total fund commitments of approximately €2 billion. TFCP has indicated that ESH fits perfectly with its investment strategy of targeting asset intensive businesses with strong and reliable cashflows operating in basic service industries.
- 5.4 An entity in the wider Terra Firma Group previously had an equity interest in Hyder plc but aside from this does not have any previous experience in the water sector. Its current assets include equity interests in UK and Pan-European cinema chains, UK waste management and landfill companies and in motorway service stations in Germany.
- 5.5 TFI believes that ESH has an effective and capable management team which has consistently delivered operationally. It intends to retain the services of the Executive Directors of ESH and SES once the acquisition has been completed. TFI believes it can provide the capital and the complementary operational skills to support the management in growing and developing the businesses further.
- 5.6 We invite views on the capacity of TFI and Kellen to be the owners of a regulated water company.

Ring fencing

- 5.7 Any activities of TFI or its group companies that could prejudice the financial and managerial viability of SES would be of concern to us. Such concerns have in the past been addressed by licence modifications to ensure that the water company is ring fenced from the other activities of the group.
- 5.8 We propose to bring SES' licence Condition F in line with other water companies that have been involved in corporate activity, including refinancing in this regard. The most recent examples include modifications

for Bristol Water and Dee Valley Water following financial restructuring by both companies. We also modified South East Water's licence to bring it up to the current ring fencing standard after its acquisition by Macquarie Bank in 2003. This is in addition to the licence modifications described in Section 4 concerning Condition P. These licence modifications will:

- 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;
- it has sufficient financial and managerial resources to carry out its activities;
- 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.

5.9 The presence of these conditions in companies' licences helps to reassure us that they remain in a position to finance their functions. Kellen and SES have no objections to these proposals.

5.10 We invite views on whether the ring fencing conditions described are adequate or whether further conditions are required to ensure that the regulated business remains appropriately ring fenced within the TFI group.

Financing

5.11 An important aspect of our assessment will be to assess whether SES remains able to finance its functions as a water undertaker under TFI's ownership.

5.12 The acquisition vehicle Kellen will be financed using a combination of debt and equity. The aggregate amount of capital (a mixture of debt and equity) provided from within the TFI Group will be approximately £262m. Kellen also has in place up to £458m of debt facilities. These will be used to finance the acquisition of ESH and refinance certain outstanding debt.

5.13 Kellen has indicated that it has no plans to change the financial structure of the water company. It intends that the £100m index linked bonds issued in 2001 by SES with its associated package of financial covenants to be unaffected by the transaction. SES has a covenant that triggers a dividend lock-up (i.e it would be unable to pay further dividends) if gearing

(measured as debt:regulatory capital value) rises above 80%. In practice, it has consistently operated at gearing well below this level.

- 5.14 As is the norm in these circumstances, the rating agencies are currently reviewing their ratings in light of the new ownership and financial structure. Standard and Poors has indicated that it believes TFI's acquisition of ESH may have some impact on the creditworthiness of SES despite the ring-fencing and covenant protections associated with the bonds. It has placed its current A- rating for the water company on 'creditwatch with negative implications'. Moody's has downgraded its underlying rating from A3 to Baa1 as it believes the gearing of SES is more likely to increase given the imminent change in ownership and given the degree of headroom to increase leverage under SES's financial covenants.
- 5.15 One of the aspects of the ring fencing outlined in section 4 is a requirement for SES to maintain an investment grade credit rating. We use this licence condition as an indicator that companies remain in a position to finance their functions. Following the rating review, SES does not expect to be in breach of this new condition. We will consider the outcome of the rating review but do not expect that any further action by Ofwat will be required. Should the review result in an unacceptable downgrading of the credit rating, however, we will consider what further action is required.
- 5.16 Should TFI and Kellen seek to make substantial changes to SES's current financial position in the future, other than that required to finance SES's capital investment programme, we may need to review the proposals, particularly if they lead to a material increase in the level of debt in SES. As the proportion of debt to equity is increased, the financial flexibility of the company and its ability to raise new debt may be more limited. We would therefore need to be content that any future proposals for SES would be sufficiently flexible to withstand any cost shocks and that it would enable SES to access additional finance if necessary to undertake its capital investment requirements.

Management of the regulated water business

- 5.17 We want to be satisfied that SES's acquisition by TFI does not compromise effective management of the regulated business. In response to previous consultation papers issued by Ofwat on mergers, concern was expressed about the loss of managerial effectiveness as a result of mergers.
- 5.18 Whilst TFI intends to retain SES's existing management and structure following the acquisition, leading to minimal impact on SES's day-to-day business, it has indicated that it will consider the strategic position of SES following the Ordinary Scheme Proposals becoming effective. We would be concerned about any prolonged uncertainty with regard to the long term ownership of SES.

- 5.19 There are currently no plans by TFI to separate the ownership of SES's assets from their operation through substantial outsourcing of the company's functions. Should it choose to do so in the future, we might require further licence modifications, including modifications to ensure that the regulated business retained control of its outsourced functions, to enable it to meet its responsibilities as a water undertaker.
- 5.20 Aside from the modifications to SES's licence conditions F and P, proposed above and in Chapter 4 of this consultation paper, we are not proposing any licence modifications in connection with the management of SES but look to TFI and Kellen to clarify its intentions with regard to long term ownership of the company as soon as is practicable.

Comparative information

- 5.21 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).
- 5.22 Following the acquisition, ESH's shares will no longer be listed on the London Stock Exchange. This means that we could no longer rely on the listing of ESH to make comparisons of how the market values ESH relative to other companies. This type of analysis informs our judgements for example on the appropriate cost of capital for water only companies.
- 5.23 However, the relatively low frequency with which ESH's shares are traded means that this is not as great a detriment as the loss, for example, of a larger water and sewerage company. SES already maintains a listing of a bond, which provides some market information, though less than would be gained from an equity listing.
- 5.24 In addition, as detailed above, SES has no objections to a licence modification requiring it to publish financial information as if it were listed and subject to the rules of the London Stock Exchange.
- 5.25 Because TFI has no other water interests in England and Wales, the initial acquisition does not involve the loss of an independently owned comparator for use in making regulatory judgements about efficiency and standards of services.

Prices and service standards

- 5.26 Customers will expect SES to provide proper standards of service at appropriate prices irrespective of its ownership. SES will continue to have the obligations imposed upon it by legislation (especially the Water Industry Act 1991) and the conditions of its licence. We will continue to regulate SES under those provisions.
- 5.27 SES's existing price limits will remain unchanged from those determined by Ofwat, at the 2004 periodic review, which allow it to maintain its service

to customers. SES accepted these price limits. Future price limits will be set as for all other companies. Customers should be able to assume that a change of ownership will have no adverse impact on the price or the quality of service that they receive. We will monitor this and, where appropriate, we will exercise our powers to that end.

Conclusions on the need for licence modifications

- 5.28 As set out in sections above and in Chapter 4 of this consultation paper, we propose to make modifications to SES's licence condition F and insert licence condition P. These modifications will enhance its ring fence and provide further protection for customers following its acquisition. They will bring SES into line with other companies that have been involved in significant corporate activity in recent years.
- 5.29 Other than this, we do not consider that the acquisition raises significant regulatory issues and we are not proposing any further licence modifications at this stage. However, we would like to hear the views of others on whether they believe further licence modifications are necessary.

6 Responses to this consultation paper

6.1 We have discussed with SES, TFI and Kellen the issues noted above. The companies have agreed to our proposals for the modification of SES's licence and have agreed to act as if the modifications were already in place.

6.2 Responses to this consultation should be made in writing by no later than 5.00pm 16 June 2005 to:

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