



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 consultation paper by Ofwat

March 2006

Contents

1 Purpose

2 Details of the acquisition

3 The statutory position on mergers

4 Deutsche Bank AG's ownership and group structure

5 Other regulatory issues arising from the acquisition

- The capacity of Aqueduct Capital (UK) Limited and Deutsche Bank AG to be the owners of a regulated water company
- Ring fencing
- Financing
- Management of the regulated water business
- Comparative information
- Prices and service standards
- Conclusions on the need for licence modifications

6 Responses to this consultation paper

1 Purpose

1.1 This document:

- describes the completed acquisition by Aqueduct Capital (UK) Limited, a company owned by Deutsche Bank AG, of the Sutton and East Surrey Holdings Group (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 Aqueduct Capital (UK) Limited'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 Deutsche Bank AG and Aqueduct Capital (UK) Limited to be the owners of a regulated water business;
- whether the entities that have provided Condition P undertakings to SES (see Section 4 of this paper) are the appropriate entities in the Deutsche Bank AG group structure to do so;
- the need for modifications to 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 Aqueduct Capital (UK) Limited group and the wider Deutsche Bank AG 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 28 April 2006.

2 Details of the acquisition

2.1 On 16 December 2005, Deutsche Bank AG announced that Aqueduct Capital (UK) Limited (Aqueduct), a company owned by the Deutsche Bank AG group, had agreed to buy the East Surrey Holdings Group (ESH) for £189m from Kellen Acquisitions Limited (Kellen). Aqueduct acquired ESH on 27 January 2006. ESH is the owner of Sutton and East Surrey Water plc (SES), an appointed water undertaker regulated by Ofwat.

2.2 Deutsche Bank AG is a worldwide international financial service provider with assets of around £700bn. It is organised in three Group Divisions: Corporate and Investment Bank, Private Clients and Asset Management and Corporate Investments.

Its infrastructure investment group, within the Corporate and Investment Bank division, seeks investments in assets that:

- occupy protected market positions eg essential services and natural monopolies;
- deliver stable relatively secure cash-flows over the long term; and
- are capital intensive with financing representing a major component on the cost structure.

Deutsche Bank AG, through Aqueduct, currently has full legal ownership and economic interest of ESH. It is currently in the process of selling part of its investment to other institutional investors. The underlying capital structure of SES remains unchanged following the acquisition, including the £100m index-linked bond issued by it in 2001.

2.3 The acquisition vehicle, Aqueduct, is wholly financed (via a combination of debt and equity) by the Deutsche Bank AG group. No external financing was required for the acquisition.

2.4 Kellen had previously acquired the entire share capital of East Surrey Holdings, a regulated multi-utility infrastructure business in the UK, on 28 October 2005. In addition to SES, East Surrey Holdings then comprised 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). Aqueduct's acquisition excludes both Phoenix Natural Gas Limited and E.S. Pipelines Limited which remain under Kellen's ownership.

2.5 We consulted on Kellen's proposed acquisition of East Surrey Holdings in our paper on 27 May 2005. We published a position note on the acquisition on 20 July 2005 including our decisions on the need for modifications to SES's licence. We subsequently issued our formal intention to modify SES's licence on 11 November 2005. These licence modifications are described later in this paper.

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.

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 (EA02) 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.
- 3.2 In addition to the sector-specific merger provisions in WIA91, the EA02 sets out circumstances under which the 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 There is no obligation on Deutsche Bank AG to notify the OFT of the acquisition of ESH. At the time of publication we understand that Deutsche Bank AG has not notified the OFT.
- 3.4 These are matters for the company and the OFT but we understand that Deutsche Bank AG does not have any other water interests that it owns directly (or through wholly owned or majority owned subsidiaries). However, as a global investment bank it may have interests in water companies indirectly through holdings that it may own in index or portfolio funds. We understand that such investments would be passive in their nature and as such Deutsche Bank AG would not be able to exert material influence on these entities.
- 3.5 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 Aqueduct's ownership and group structure

4.1 Aqueduct is a private company incorporated in England and Wales on 12 October 2005 and has been formed at the direction of Deutsche Bank AG. It had not conducted business prior to its acquisition of ESH. The current directors of Aqueduct are employees of Deutsche Bank AG.

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 Condition P in their licences that require 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 Following Kellen's acquisition of East Surrey Holdings we indicated our intent to insert Condition P into SES's appointment on 11 November 2005. SES agreed to act as if this modification had been made from the date of acquisition (28 October 2005) rather than from when it formally becomes effective. As a result SES must secure undertakings from:

- its UK holding company; and
- 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.

4.4 Condition P of SES' licence requires it to secure new undertakings following any subsequent change of ownership. SES has provided the relevant undertakings from Deutsche Bank AG London (the Ultimate Controller) and Aqueduct (its UK holding company).

The undertaking from Deutsche Bank AG London is provided on the basis that it is not a separate corporate entity from Deutsche Bank AG but is

simply a branch of it. As such the undertaking given by Deutsche Bank AG London is effectively an undertaking of Deutsche Bank AG itself. We invite views on whether these are the appropriate entities.

- 4.5 As mentioned above in paragraph 2.2, Deutsche Bank AG is currently in the process of selling part of its investment to other institutional investors. We will need to consider the implications of this for SES' ownership structure and any consequential impact on which entities should be providing the Condition P undertakings at the appropriate stage in this process.

5 Other regulatory issues arising from the acquisition

The capacity of Deutsche Bank AG and Aqueduct 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 the operational and financial capacity to assume that role.
- 5.3 Deutsche Bank AG is a global investment bank and has assets of around £700bn and market capitalisation of around £30bn. Deutsche Bank AG has indicated it is very familiar with the UK water sector, for instance as a financier to some of the regulated water companies. Deutsche Bank AG has senior unsecured credit ratings of AA- from both Standard and Poors and FitchRatings and Aa3 from Moody's Investor Services.
- 5.4 Deutsche Bank AG has indicated that ESH fits with its investment strategy of targeting asset intensive businesses with strong and reliable cashflows operating in basic service industries.
- 5.5 Deutsche Bank AG has indicated that it views existing management as a key feature of its investments. As a result it has retained the services of both the executive and non-executive directors of ESH and SES following the acquisition. However, one non-executive director has signalled his intention to resign as a result of other commitments. Deutsche Bank AG London executives have been appointed to the ESH and SES boards.
- 5.6 We invite views on the capacity of Deutsche Bank AG and Aqueduct to be the owners of a regulated water company.

Ring fencing

- 5.7 Any activities of Deutsche Bank AG 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 As a result of Kellen's acquisition of East Surrey Holdings we issued our formal intention to modify SES' licence on 11 November 2005. This included proposals to update Condition F of SES's appointment to bring it

into line with the current standard which most other water companies have. These changes to Condition F are in addition to the licence modifications described in Section 4 concerning Condition P. The modifications have not been formally incorporated into SES' licence but SES has agreed to act as if the modifications are in already in place. In summary the modifications to Condition F:

- 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;
- require SES to have sufficient financial and managerial resources to carry out its activities;
- ensure that 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 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 Deutsche Bank AG group.

Financing

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

5.11 The acquisition vehicle Aqueduct is financed by a combination of debt and equity provided by the Deutsche Bank AG group. No external financing was required for the acquisition.

5.12 SES is considering paying out cash reserves from the 2000-01 bond issue in the form of a special dividend in 2006-07. As a result of this special dividend, SES's level of gearing would increase from its current level to closer to its covenant level. Whilst the gearing would remain below the covenanted level of gearing in SES's bond documentation (80%) in relation to dividend lock-ups, SES's projections show its gearing moving much tighter to the covenanted levels than historically. We will want to consider the implications of this gearing up going forward if and when such

a proposal is finalised and to understand any implications for the company's credit ratings.

- 5.13 One of the aspects of the ring fencing outlined above 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.
- 5.14 Following Kellen's acquisition of East Surrey Holdings the rating agencies reviewed their ratings in light of the new ownership and financial structure. Standard and Poors placed its A- rating for the water company on 'creditwatch with negative implications'. This reflected S & P's belief that the acquisition of East Surrey Holdings plc by Kellen Acquisitions Limited may have had some impact on the creditworthiness of SES despite the ring fencing and covenant protections associated with the bonds. At the same time Moody's downgraded its underlying rating from A3 to Baa1 as it believed the gearing of SES was more likely to increase given the change in ownership and given the degree of headroom to increase leverage under SES's financial covenants. These ratings have not changed in the light of Aqueduct's acquisition of ESH. FitchRatings currently rates SES as A-. But as indicated in paragraph 5.12, we will want to understand the implications, if any, of the proposed special dividend.
- 5.15 Other than the consideration of a reduction of cash reserves, Deutsche Bank AG has indicated that it has no plans to change the overall financial structure of the water company as shaped by the covenants set out in its 2001 bond.

Management of the regulated water business

- 5.16 We want to be satisfied that SES's acquisition by Deutsche Bank AG does not compromise effective management of the regulated business. Previous respondents to our consultation papers on changes of ownership have expressed concerns about the loss of managerial effectiveness as a result of the corporate activity.
- 5.17 Deutsche Bank AG intends to retain SES's existing management and board structure following the acquisition. This should mean that there will be minimal impact on SES's day-to-day business.
- 5.18 There are currently no plans by Deutsche Bank AG 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.
- 5.19 We are not proposing any licence modifications in connection with the management of SES.

Comparative information

- 5.20 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).
- 5.21 Following Kellen's acquisition of East Surrey Holdings its shares were no longer listed on the London Stock Exchange and therefore we could no longer rely on the listing of East Surrey Holdings to make comparisons of how the market values it relative to other companies. This type of analysis informs our judgements for example on the appropriate cost of capital for water only companies.
- 5.22 However, the relatively low frequency with which its shares were traded meant that we did not regard it 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.
- 5.23 In addition, one of the licence modifications we propose requires SES to publish financial information as if it were listed and subject to the rules of the London Stock Exchange. SES has agreed to act as if this modification is already in place.
- 5.24 We explain in paragraph 3.4 that, as far as we understand, Deutsche Bank AG has no other water interests in England and Wales. As a result its acquisition of ESH 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

- 5.25 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.
- 5.26 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

5.27 In the light of the licence modifications we proposed following Kellen's acquisition of East Surrey Holdings, which SES has accepted, we do not consider that the acquisition raises further significant regulatory issues. Therefore we do not propose 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, Deutsche Bank AG and Aqueduct the issues noted above. As we have explained in paragraph 5.8, SES has agreed to act as if the licence modifications proposed when Kellen acquired East Surrey Holdings were already in place. No further licence modifications are proposed.

6.2 Responses to this consultation should be made in writing by no later than 5.00pm 28 April 2006 to:

Keith Mason
Director of Regulatory Finance and Competition
Office of Water Services
Centre City Tower
Hill Street
Birmingham
B5 4UA

Fax: 0121 625 3609
E-mail: keith.mason@ofwat.gsi.gov.uk

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.