



**The syndication of Deutsche Bank's
ownership of Aqueduct Capital (UK)
Limited and its impact on Sutton and East
Surrey Water plc**

A position note by Ofwat

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1 Background

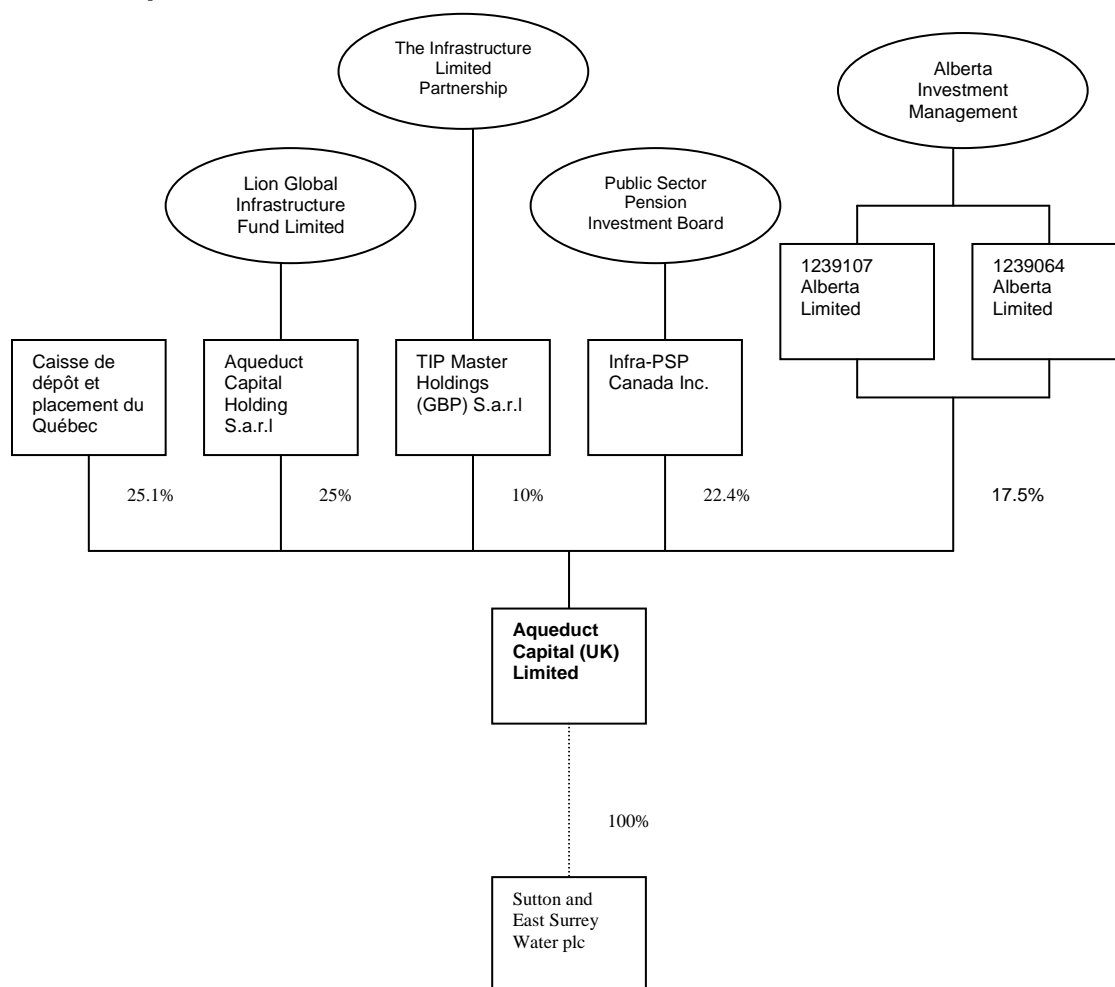
- 1.1 Deutsche Bank AG (Deutsche) completed the syndication of its stake in Aqueduct Capital (UK) Limited (ACUK) on 5 January 2007. ACUK is the parent company of East Surrey Holdings Limited and the UK holding company of Sutton and East Surrey Water plc (SES), the regulated water company.
- 1.2 We issued a consultation paper in May 2007¹ in which we invited views on:
- the capacity of ACUK under its revised ownership structure to be the owner of a regulated business;
 - which entities should provide ultimate controller undertakings as required by Condition P of SES's Instrument of Appointment (Appointment); and,
 - the addition of the cash-lock up conditions to SES's Appointment.
- 1.3 This note sets out our position on these issues. We have taken into account the views of the two respondents to our consultation paper, the Consumer Council for Water (CCWater) and Martin Blaiklock.

2. The capacity of Aqueduct Capital (UK) Limited and its investors to be the owner of a regulated water company

- 2.1 ACUK is a private company incorporated in England and Wales on 12 October 2005 and was formed at the direction of Deutsche. It had not conducted business prior to its acquisition of East Surrey Holdings Limited.
- 2.2 The ownership structure was described in our consultation paper and the chart below shows the entities involved in the ownership of SES.
- 2.3 We understand that, collectively, the investors have experience in owning infrastructure assets internationally including, but not limited to, electricity transmission grids, gas transmission networks, airports and roads. We also understand that the investors are familiar with owning assets in a regulated environment. ACUK have told us the investors understand their responsibilities to all stakeholders, including customers, arising from ownership of infrastructure assets.

¹ The syndication of Deutsche Bank's ownership of Aqueduct Capital (UK) Limited and its impact on Sutton and East Surrey Water Plc, A consultation paper by Ofwat, May 2007.

Ownership structure



- 2.4 CCWater stated it felt reasonably comfortable that the three Canadian investment funds are likely to be looking for a long term relationship with SES but CCWater were less sure about the intentions of the Lion Global Infrastructure Fund Limited and the Infrastructure Limited Partnership as Deutsche retains a minority interest in both and had, to date, demonstrated a short-term focus on investing in water infrastructure.
- 2.5 Martin Blaiklock raised a concern that the financial structure of the entities involved in the ownership of SES enabled Deutsche to limit their liability and maximise their financial returns. He also raised concerns that the creation of such financial structures introduced inherent ownership instability, a lack of transparency in corporate governance and financial risks through possible asset stripping. Martin Blaiklock considered these issues were not foreseen by the Water Industry Act 1991.

- 2.6 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. We make it clear to prospective owners of water companies that there will be no 'regulatory bail out' in the event of distress. The ring fencing provisions including the new cash lock up Appointment conditions (see section 4) require that SES has sufficient financial and managerial resources in place to carry out its functions. We have introduced additional ring fencing provisions to the water company Appointments since 1991 to ensure customer interests are protected under different ownership structures.
- 2.7 In addition, the annual monitoring we conduct ensures that we become aware of financial risks such as those cited by Martin Blaiklock. For example companies are required to maintain their non-infrastructure assets and networks of water mains and sewers so that they can provide services to customers now and in the future, whilst protecting the environment. We monitor annually the serviceability of companies' assets in achieving this objective and take regulatory action if this is seen to be deteriorating. Condition K of the Appointment also requires SES to ensure that if a special administrator is appointed it would have sufficient rights and assets to enable the special administrator to manage the business.
- 2.8 Our focus is on the proper governance of the regulated entity and these arrangements have not changed following this transaction. SES is required by its Appointment to have three independent non-executive directors on its board who are persons of standing with relevant experience and who, collectively, have connections with and knowledge of the areas within which the Appointee provides water services. The Appointment condition also requires the independent non-executive directors to have an understanding of the interests of the customers of the Appointee and how these can be respected and protected. SES continues to fulfil this requirement.
- 2.9 CCWater considered that new owners often take a fresh look at the business and seek to make efficiency savings. CCWater stated it would be concerned if the drive for efficiency savings was accompanied by deterioration in customer service as a result of a diversion of management focus to meeting more stringent financial targets. CCWater sought reassurance that there are sufficient safeguards in place to prevent such deterioration in customer service.

- 2.10 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 from their regulated water company. SES will continue to have the obligations imposed upon it by legislation (especially the Water Industry Act 1991 and the Guaranteed Standards Scheme) and the conditions of its Appointment. We will continue to regulate SES under these provisions. SES must deliver the outputs underpinning the price limits it accepted at the 2004 periodic review.
- 2.11 In light of our views stated above we consider there are no current regulatory concerns with the capacity of ACUK and its investors to be the owner of a regulated water company.

3. Role of the owners of Sutton and East Surrey Water plc

- 3.1 The Company needs the active co-operation of its owner in carrying out its functions as a water undertaker and complying with its Appointment.
- 3.2 SES currently has Condition P in its Appointment which requires it to obtain legally enforceable undertakings from its UK holding company and ultimate controller. The companies giving the undertakings are required to:
- give the regulated business any information it needs to comply with the conditions of its Appointment;
 - refrain from any action that could cause the regulated business to breach the conditions of its Appointment; and
 - maintain a minimum of three independent non-executive directors on the board of the regulated business.
- 3.3 The syndication of Deutsche's ownership did not lead to any change to the UK holding company, therefore the undertaking from ACUK as the UK holding company will remain in place.
- 3.4 The investors in ACUK have suggested that ACUK should provide the ultimate controller undertaking to SES.
- 3.5 Martin Blaiklock raised a general issue concerning the legal and financial enforceability of the ultimate controller undertaking where the undertaking is from a non-UK private company, whose accounts are not open to public scrutiny.

- 3.6 In this instance the investors proposed that the ultimate controller undertaking be provided by ACUK, a company registered in the UK whose accounts will be available from Companies House. Ultimately however it is the responsibility of the Appointee to ensure that it complies with the conditions of its Appointment by procuring legally enforceable Condition P undertakings from the appropriate entities, irrespective of where or how they are registered.
- 3.7 In light of the information presented to us, and explained in the consultation paper, and in the absence of any dissenting view from respondents to our consultation paper, we see no reason to dispute the investors' view of which entities should provide the Condition P undertakings.

4. Ring fencing Appointment conditions

- 4.1 SES already has the standard suite of ring fencing conditions in its Appointment. Our consultation paper proposed that we introduce cash lock-up conditions into SES's Appointment.
- 4.2 CCWater stated it was content with the ring fencing conditions already in place in SES's Appointment and welcomed the introduction of the cash lock-up conditions. CCWater questioned however the enforceability of the ring fencing Appointment condition governing dividend policy given the £12 million special dividend paid by SES in 2006-07. This condition requires SES to ensure 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.
- 4.3 We have been clear that capital structures are essentially a matter for companies and the markets and that it is for each company to determine a capital structure that is appropriate for its circumstances. The special dividend paid by SES in 2006-07 was the result of such a financial restructuring. We commented on our review of this financial restructuring in the position note we published in September 2006², in which we stated our conclusion that nothing had come to light from our review to warrant further action. We noted that SES's credit ratings provide headroom against the floor for investment grade credit quality and we consider this is an important safeguard for future uncertainties. The payment of the special dividend in this instance raises no suggestion that the Appointment Condition governing dividend policy is not enforceable.

² 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

- 4.4 Martin Blaiklock suggested that SES should maintain an on demand bond to the value of SES's regulatory capital value which could be called upon if the company were to breach its statutory duties. Martin Blaiklock considered such a bond could be posted by investment institutions that underpin financial structures such as the case of SES and that the costs of maintaining such bonds would be met by shareholders.
- 4.5 We have explained our position on maintenance of such a bond in a previous position statement³. There would be a cost to SES of reserving such a bond, which would ultimately be passed to customers, however it is funded. In the event that shareholders were required to maintain such a bond, in the manner suggested by Martin Blaiklock, then this would flow through to the cost of equity component of the cost of capital and ultimately to customer bills. We consider that the powers available to us, which include enforcement action and imposition of a financial penalty where a company contravenes the conditions of its Appointment, provide sufficient protection to consumers.
- 4.6 Martin Blaiklock also considered that the owners of SES should be required, through SES's Appointment, to publish an annual report and to face customers at a stakeholders meeting. He considered this is necessary as customers have no platform to call the water company to account or seek redress other than through CCWater. Martin Blaiklock considered his proposals would be an effective mechanism to encourage corporate governance.
- 4.7 Water companies that are not listed on the London Stock Exchange are required by their Appointments to publish information about their financial results as if they were listed. The Appointment also requires companies to publish their regulatory accounts and, from the 2006-07 reporting year, this includes a requirement to publish an operating and financial review which is consistent with best practice published by the Accounting Standards Board.
- 4.8 Martin Blaiklock's suggestion is analogous with an annual general meeting, the purpose of which is for shareholders to take part and to decide on matters associated with their membership. Such general meetings are not customer forums. As we have stated previously, it is for each company to manage its relationship with its stakeholders. We monitor and report on the services provided by each company to its customers. We will take firm and appropriate action where a company provides services to customers that are below the level required by its Appointment and funded in its price limits.
- 4.9 We have considered the proposals raised in response to our consultation and we see no need for additional Appointment modifications other than the introduction of the cash lock-up conditions.

³ The completed acquisition of Thames Water Holdings Plc by Kemble Water Limited, A position paper by Ofwat, May 2007

5. Conclusions and the need for modifications to Sutton and East Surrey Water plc's Appointment

- 5.1 We do not consider that the acquisition raises significant regulatory issues. SES's ring-fencing Appointment conditions are already consistent with those of other water undertakers with similar ownership structures. However, as stated above, we will amend SES's Appointment to introduce the cash lock-up provisions.
- 5.2 We have drafted a cash lock-up provision designed to accommodate the diversity of capital structures in the water industry. SES has, in principle, accepted this for inclusion in its Appointment.
- 5.3 These changes will be made following a notice under section 13 of the Water Industry Act 1991.