

WATER INDUSTRY ACT 1991, SECTION 13 PROPOSALS BY THE WATER SERVICES REGULATION AUTHORITY (OFWAT) TO MODIFY THE CONDITIONS OF APPOINTMENT OF SOUTH STAFFORDSHIRE WATER PLC AS A WATER UNDERTAKER

THE PROCESS

This Notice seeks responses to the proposed modification 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 Friday 16 May 2008.

DESCRIPTION OF AND REASONS FOR THE PROPOSED MODIFICATION

On 29 October 2007 it was announced that Arcapita and its affiliates sold South Staffordshire plc to the Alinda Infrastructure Fund, an institutional fund managed and controlled by Alinda Capital Partners LLC, an independent private investment firm, for an undisclosed amount. Alinda Infrastructure Fund financed its acquisition with 100 percent equity. South Staffordshire plc is the owner of South Staffordshire Water plc (SSW) which holds an appointment under the Water Industry Act 1991.

We issued a consultation document in March 2008 in which we invited views on:

- the capacity of Alinda Capital Partners LLC to be the owner of a regulated water business;
- which entities should provide undertakings under Condition P of South Staffordshire Water plc's Appointment;
- the implications of the proposed long-term financial structure
- the impact of these proposals on comparative competition; and
- the need for modifications to South Staffordshire Water's Appointment 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 group.

The proposed Appointment modifications which have been accepted by SSW are as follows;

Condition F

1. Cash Lock Up

We will introduce the cash lock-up provision which would prohibit, subject to certain limited exceptions, and without Ofwat's prior consent, the transfer of cash or other assets to an associated company in certain circumstances where the company's investment grade credit rating is threatened.

2. Maintain a listing of a financial instrument

Although not a substitute for an equity listing, this would ensure the existence of a financial comparator.

3. Requirement to certify adequate systems of internal controls

We will require SSW 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 its Directors, SSW 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.

Condition P

SSW's existing Condition P requires it to obtain from its ultimate holding company legally-enforceable undertakings in favour of SSW. These are designed to ensure that SSW has the active co-operation of its ultimate holding company in complying with the conditions of SSW's appointment, including the ring-fencing provisions, and with the proper discharge of its functions as a water undertaker.

Under the proposed modification, the existing Condition P will be amended to require SSW 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 amended condition will also include a successor clause that requires the SSW to obtain new undertakings in the event of a change of control.

ISSUES ARISING FROM THE CONSULTATION

The Consumer Council for Water Central & Eastern (CCW) have raised concerns regarding the debt raised against SSW's dividend stream. In addition to this, CCW are concerned over the financing arrangements which, in its views, may impair SSW's ability to continue to deliver good service to customers, if higher dividends were required by Alinda Capital Partners LLC than is currently the case.

Under its current Appointment, SSW must not, whether through its involvement in 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. This particular ring-fencing Appointment condition is already consistent with those of other water undertakers of a similar size and structure.

Martin Blaiklock, a consultant in infrastructure & energy project finance, raised concerns about overseas investors and highly geared capital structures.

The domicile of the entities providing condition P undertakings (see above) does not alter the obligations under the undertakings in any way. Ultimately it is the responsibility of SSW to ensure it procures legally enforceable Condition P undertakings from the appropriate entities.

We regulate SSW, the appointed business. If SSW were to breach any of the conditions of its Instrument of Appointment, we would use our powers to take appropriate action against the Appointee, not its owners.

In relation to concerns with highly geared capital structures, each company is free to choose a more highly-g geared structure than we assume when setting price limits. This is wholly at its investors' risk. The need for modifications to South Staffordshire Water's Appointment is to ensure that, whoever its owners or whatever its structure, 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 group.

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