



**The completed acquisition of Kelda Group Plc by
Saltaire Water Limited**

A consultation paper by Ofwat

June 2008

Contents

- 1 Purpose**
- 2 Details of the acquisition and consortium members**
- 3 The statutory position on mergers**
- 4 Regulatory issues arising from the acquisition and the need for Appointment modifications**

The capacity of Saltaire Water and its investors to be the owner of a regulated water company

Management of the regulated water business

Role of the new owners

Ring-fencing arrangements and Appointment modifications

Financing

Comparative information

Prices and service standards

Conclusions on the need for Appointment modifications

- 5 Responses to this consultation paper**

1 Purpose

1.1 The purpose of this consultation paper is to consult on any regulatory issues arising from the completed acquisition of Kelda Group plc ('Kelda') by Saltaire Water Limited ('Saltaire Water'). Kelda Group plc is the parent company of Yorkshire Water Services Limited ('Yorkshire Water'), an appointed water and sewerage undertaker regulated by Ofwat. It relates to the appointed water and sewerage undertaker and whether any modifications should be made to its instrument of appointment ('Appointment').

1.2 Ofwat as the economic water regulator itself has no ability to block acquisitions or mergers of water companies. But in the interests of water consumers it looks to ensure that any owner of a water company is 'fit and proper' to provide such an essential public service. Ofwat regulates through the provisions of the Appointment of each company and can impose suitable amendments if necessary, subject to appeal by the company to the Competition Commission in the event of disagreement.

1.3 This document:

- describes the completed acquisition of Kelda by Saltaire Water;
- explains the statutory position on mergers;
- describes the group ownership and structure;
- sets out the regulatory issues, including Appointment modifications we propose; and
- sets out our initial assessment of these issues.

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

- the capacity of Saltaire Water and its investors to be the owner of a UK regulated water business;
- which entities should provide parent undertakings to Yorkshire Water under Condition P of its Appointment;
- the need for modifications to Yorkshire Water's Appointment to ensure that, whoever its owners, it has sufficient financial and managerial resources to carry out its functions as a water and sewerage company and is appropriately ring-fenced from the rest of the group.

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

- 1.5 Responses to this paper are required by no later than 17 July 2008. Details of how to respond are set out in section 5.

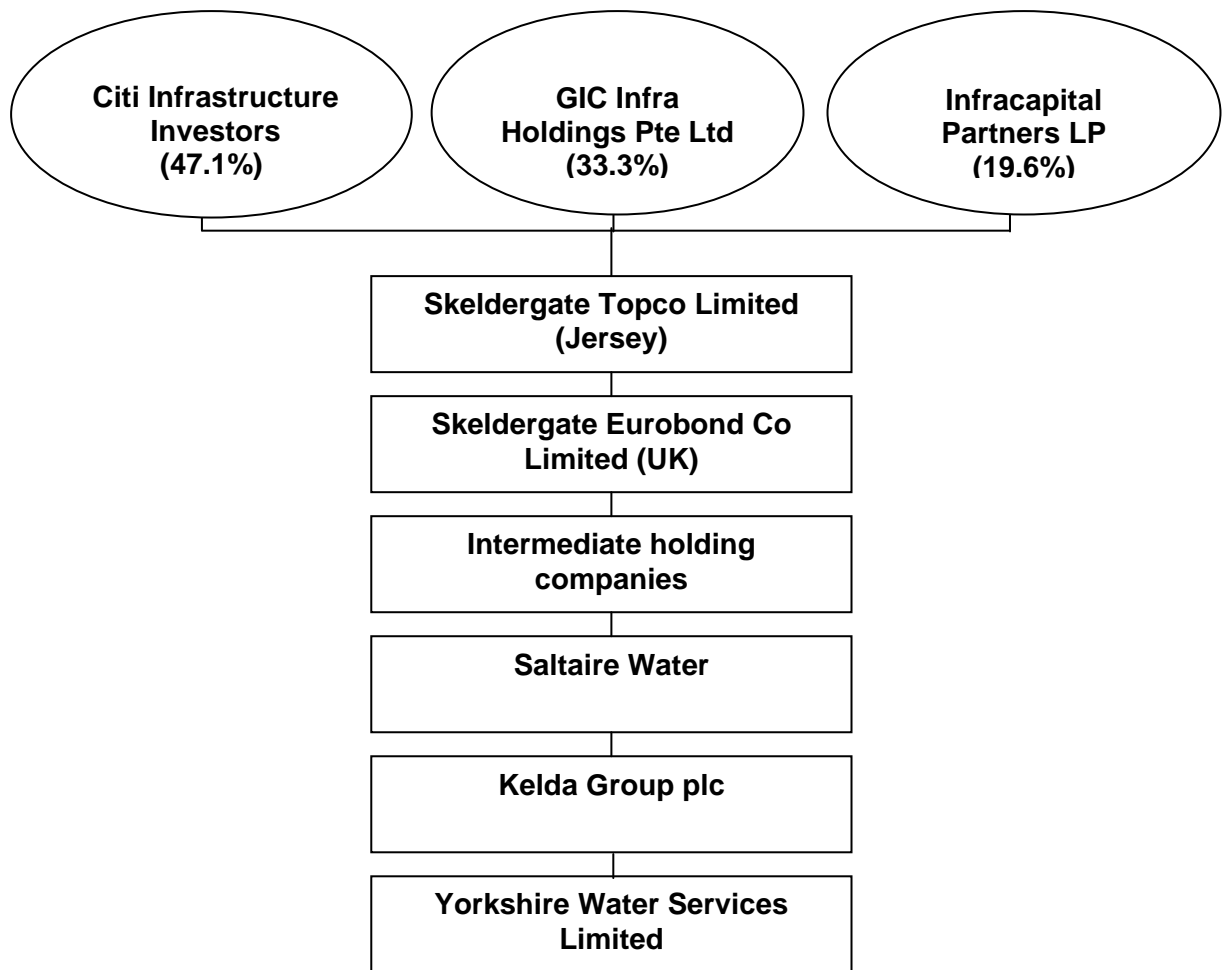
2 Details of the acquisition and consortium members

- 2.1 The boards of directors of Saltaire Water and Kelda announced on the 26 November 2007 that they had reached agreement on the terms of a recommended cash offer for the entire issued and to be issued share capital of Kelda, to be implemented by way of two schemes of arrangement¹ (the 'Acquisition'). The schemes of arrangement implementing the Acquisition became effective in accordance with their terms on 8 February 2008. The offer valued each Ordinary Share at 1,100.65 pence (including the right to retain the interim dividend of 10.65 pence) and Kelda's existing issued ordinary share capital at approximately £3,036 million.
- 2.2 Following the acquisition, Kelda's shares were de-listed from the London Stock Exchange on 12 February 2008.
- 2.3 Saltaire Water is a newly incorporated company formed at the direction of a consortium ('the Consortium') which at the time of the acquisition comprised:
- Citi Infrastructure Investors ('CII')
 - GIC Special Investments ('GICSI')
 - Infracapital Partners LP ('Infracapital')
 - HSBC Bank plc ('HSBC')
- 2.4 Saltaire Water is 100 per cent indirectly owned by Skeldergate Topco Limited ('Skeldergate'). Skeldergate is a company formed for the purposes of establishing the Consortium and undertaking the Acquisition.
- 2.5 Since completion of the acquisition of Kelda, HSBC sold its stake of 10 per cent in Skeldergate to entities formed at the direction of CII, GICSI and Infracapital. This was completed on 22 May 2008.
- 2.6 Following the sale of the HSBC stake, the stakes that each member of the consortium (and funds controlled by them) has in Skeldergate, and which is ultimately reflected in their holding of Yorkshire Water through Kelda, are as follows:

	%
CII	47.1
GIC Infra Holdings Pte Ltd	33.3
Infracapital	19.6
	<hr/> 100 <hr/>

¹ Kelda's share capital comprised two separate classes of shares – ordinary shares and non-voting "B" shares. Saltaire Water acquired both classes of shares by way of two separate schemes of arrangement under section 425 of the Companies Act 1985.

Simplified Ownership Structure



- 2.7 CII has an investment team with offices located in London and New York. CII has informed us that individual members of its investment team have diverse backgrounds in key areas within infrastructure, including equity investment, asset management, project operation and execution, debt finance, capital markets, mergers and acquisitions, private placements, industry coverage and public policy. CII is a business unit of Citi Alternative Investments ('CAI') that focuses on making long term investments in core infrastructure assets, including water, waste, roads, airports, ports, rail and electricity, and oil and gas networks, largely in OECD countries. CAI manages over US\$60 billion of client and proprietary capital in private equity, real estate, hedge funds and fixed income products.

- 2.8 GIC Infra Holdings Pte Ltd ('GIC Infra Holdings') is the company that holds GICSI's investments in infrastructure. The Consortium has informed us that GIC Infra Holdings is the parent company of significant investments in BAA, the world's largest airport operator, and also Associated British Ports, the UK's leading ports business. We understand that GIC Infra Holdings' assets are predominantly operational assets in regulated environments or in businesses with high barriers to entry and it is the intention that they are held for the long term. GICSI is the private equity and infrastructure investment arm of the Government of Singapore Investment Corporation Pte Ltd ('GIC').
- 2.9 Infracapital is an infrastructure fund focussed on the UK and Western Europe. The fund's strategy is to make investments in income-generative infrastructure assets and businesses, including electricity and gas networks, water and sewerage companies, transport infrastructure and renewable energy. We understand that to date, in addition to its investment in Kelda, Infracapital has made investments in Associated British Ports, the UK's leading ports business; Zephyr Investments, the owner of the UK's largest wind portfolio; Meterfit, an exclusive provider and asset owner of gas and electricity meters and Red Funnel Ferries.
- 2.10 Yorkshire Water is an appointed water and sewerage undertaker, regulated by Ofwat. With a regulatory capital value of £4,245 million at 31 March 2008, it is the fifth largest of the ten water and sewerage companies in England and Wales. It supplies around 1,280 mega litres of drinking water each day to more than 4.7 million people and around 130,000 businesses.

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 (subsequently 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 set 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 Saltaire Water or the consortium members to notify the OFT of the acquisition of Kelda. At the time of publication we understand that no party to this acquisition has notified the OFT.
- 3.4 These are matters for the company and the OFT but we have been assured that neither Saltaire Water nor any of the Consortium members (or their group companies) has a material interest in any water or water and sewerage company in England and Wales.
- 3.5 The purpose of this consultation paper is to consult solely on any regulatory issues arising from the acquisition in relation to Yorkshire Water as the appointed water and sewerage undertaker and whether any modifications should be made to Yorkshire Water's Appointment.

4 Regulatory issues arising from the acquisition and the need for Appointment modifications

The capacity of Saltaire Water and its investors to be the owner of a regulated water company

- 4.1 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.
- 4.2 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.
- 4.3 Saltaire Water is a private company incorporated in United Kingdom on 21 November 2007 and has been formed at the direction of the Consortium (see paragraph 2.3) for the purpose of acquiring Kelda.
- 4.4 We have described the Consortium members in section 2. We understand that all the investors in the Consortium are established international investment groups. The Consortium has informed us that it sees Kelda as the most compelling long-term investment opportunity within the sector and that it is committed to the long-term ownership and continued stability of Yorkshire Water's business.
- 4.5 We understand that, collectively, the investors have long term experience in owning infrastructure assets internationally such as oil and gas networks, airports, ports and roads.

We invite views on the capacity of Saltaire Water and its investors to be the owner of a UK regulated water company.

Management of the regulated water business

- 4.6 We also want to be satisfied that Yorkshire Water's acquisition by Saltaire Water 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 corporate activity.

- 4.7 The Consortium has informed us that it attaches great importance to the skills and experience of the existing management and employees of Yorkshire Water, and considers the continuation of those skills and experience to be an important factor in the future success of the business. Accordingly, the Consortium has retained Yorkshire Water's current senior management team to support it in further developing the business, and intends to appoint Kelda's Chairman and Chief Executive to roles on the board in Skeldergate. The Consortium has informed us there are no changes to management or employees proposed beyond those occurring in the normal course of business.
- 4.8 We understand that the Consortium has no current intention to change the strategic focus or day-to-day operations of the appointed business.

Role of the new owners

- 4.9 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 Appointments 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 Appointment;
 - refrain from any action that could cause the regulated business to breach its Appointment; and,
 - maintain a minimum of three independent non-executive directors on the board of the regulated business.
- 4.10 These undertakings help to protect customers by strengthening the ability of the regulated business to comply with the conditions of its Appointment and to maintain its independence from the rest of the group to which it belongs.
- 4.11 Yorkshire Water already has a version of Condition P in its Appointment. This requires Yorkshire Water to obtain from Yorkshire Water plc² legally enforceable undertakings in favour of Yorkshire Water.

² These undertakings became enforceable against Kelda Group plc following Yorkshire Water plc changing its name to Kelda Group plc following a special resolution which was passed on 3 August 1999.

- 4.12 We intend to modify Condition P of Yorkshire Water's Appointment. The amended Condition P will require Yorkshire Water to maintain a minimum of three independent non executive directors on its board and to secure undertakings from its Ultimate Controller and, when the Ultimate Controller is not the UK holding company, from its UK holding company. The purpose of this modification is to standardise this ring-fencing condition for all regulated water and sewerage companies and to ensure that it allows the Appointee to procure undertakings from the appropriate entities under a variety of ownership structures.
- 4.13 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.
- 4.14 The Consortium has informed us that no individual consortium member has the ability to veto shareholder reserved decisions and none of the investor appointed directors is individually able to veto board decisions.
- 4.15 All owners might be considered through their shareholding or board representation to have any ability to exercise material influence over the policies or affairs of Yorkshire Water. The Consortium suggested that the entities described below should provide Condition P undertakings to Yorkshire Water. The Consortium has confirmed these entities will provide active co-operation in ensuring that Yorkshire Water carries out its functions:
- Skeldergate Eurobond Co Limited as the ultimate UK holding company of Yorkshire Water.
 - The parent companies of Skeldergate Eurobond Co Limited as joint controllers of Skeldergate, namely:
 - CII - as joint ultimate controller of Yorkshire Water on the basis (a) that it has funds controlling 47.1 per cent of the equity in Skeldergate and (b) that it is the most appropriate entity to provide the undertakings within CAI to ensure compliance with the undertakings because it is the entity that can take positive steps to ensure compliance.
 - GICSI Infra Holdings - as joint ultimate controller of Yorkshire Water on the basis (a) that it has funds controlling a 33.3 per cent interest in Skeldergate and (b) that it is the most appropriate entity within the GICSI structure to provide the undertakings and ensure compliance with the undertakings.

- Infracapital – as joint ultimate controller of Yorkshire Water on the basis (a) that it has funds controlling a 19.6 per cent interest in Skeldergate and (b) that it is the most appropriate entity to provide the undertakings within the Infracapital infrastructure fund and ensure compliance with the undertakings.

4.16 In light of the information presented to us above, we see no reason to challenge Saltaire’s view of which entities should provide the Condition P undertakings.

4.17 However, ultimately it is the responsibility of Yorkshire Water to ensure that it complies with its Appointment by procuring Condition P undertakings from the appropriate entities.

We invite views on which entities should provide Condition P undertakings

Ring-fencing arrangements and Appointment modifications

4.18 Any activities of Saltaire Water that could prejudice the financial and managerial viability of the regulated business would be of concern to us. Such concerns have in the past been addressed by Appointment modifications to ensure that the water company is ring-fenced from the other activities of the group.

4.19 Yorkshire Water at present has a limited number of ‘standard’ financial ring-fencing Appointment conditions. Amongst other things these conditions:

- require Yorkshire Water to have sufficient financial and managerial resources to carry out its activities;
- require Yorkshire Water to operate as if it were a separate company, for its board to be able to act independently of the parent company; and,
- require Yorkshire Water 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.

4.20 We propose to make the following modifications to Condition F:

- additional transfer pricing conditions, including requirements for the provision of information to Ofwat from associated companies;
- restrictions on the transfer of assets to associated companies;

- prohibition (without Ofwat's consent) on any guarantee or loan between the regulated business and any associated company;
- prohibition (without Ofwat's consent) on Yorkshire Water entering into cross default arrangements, whereby Yorkshire Water's financial liabilities are increased or accelerated because of a default of any other companies in the group;
- require Yorkshire Water to have regard to the Principles of Good Governance and Code of Best Practice as apply for the purposes of the Financial Services Authority;
- require Yorkshire Water, at such times and in such ways as may be required by the Listing Rules of the Financial Services Authority, to publish such information about its results as is by those rules required to be announced as if it were listed on the London Stock Exchange;
- require Yorkshire Water to use all reasonable endeavours to maintain an investment grade credit rating for its corporate debt;
- require Yorkshire Water 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. This modification will also require Yorkshire Water to submit an annual certificate that in the opinion of the Directors, Yorkshire Water will, for at least the following 12 months, have available to it systems of internal control which are sufficient to enable it to carry out its functions;
- require Yorkshire Water to maintain a listing of a financial instrument whose market price should react to the financial position of Yorkshire Water. Although not a substitute for an equity listing, this would ensure the existence of a helpful financial comparator; and,
- introduction of the cash lock-up provisions which would prohibit, subject to certain limited exceptions, and without the regulator'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.

4.21 There are a significant number of modifications proposed as there has been a prolonged period of time since modifications have been made to the Appointment. This change of ownership has provided an opportunity to bring the Appointment of Yorkshire Water up to date with all standardised ring-fence conditions.

- 4.22 Yorkshire Water has indicated that in principle it is willing to accept these Appointment modifications.

We invite views on the Appointment modifications proposed and 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 wider group.

Financing

- 4.23 An important aspect of our assessment will be to assess whether Yorkshire Water remains able to finance its functions as an Appointee under Saltaire Water's ownership. We understand that Saltaire Water intend to restructure the group in the near future.
- 4.24 Yorkshire Water's gearing (net debt/RCV) was 60.6% at 31 March 2007. At the level of the Appointee, gearing remained at 60% following the acquisition. Yorkshire Water has informed us that it intends to increase gearing at the Appointee to around 65% in the short term.
- 4.25 Following the announcement of the acquisition, Yorkshire Water was assigned a credit rating of A- watch negative by Standard and Poor's and a credit rating of A- watch negative by Fitch Ratings. Yorkshire Water has a rating of A3 from Moody's and remains on review for further possible downgrade. Each of the rating agencies has Yorkshire Water on watch negative or on review for possible downgrade in lieu of the finalised financial structure.
- 4.26 The acquisition was financed in part by raising debt at holding companies of Saltaire Water which is equivalent to around 25% of Yorkshire Water's RCV. We would be concerned if this acquisition finance jeopardised the credit quality of Yorkshire Water. We have been assured that there is no guarantee or security given by Kelda or Yorkshire Water which is enforceable in the event that the holding companies of Saltaire Water were to default on their obligations but Yorkshire Water were not to default on its obligations.
- 4.27 For the timing of this consultation, the process of finalising the financial structure is not complete. We will therefore publish a separate consultation when such arrangements have taken place.

Comparative Information

- 4.28 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).

- 4.29 As a result of Saltaire Water's acquisition, Kelda's shares were de-listed from the London Stock Exchange and therefore we will no longer be able to rely on the listing of Kelda to make comparisons of how the market values it relative to other listed companies. This type of analysis informs our judgements for example on the appropriate cost of capital for water companies.
- 4.30 Yorkshire Water's Appointment does not contain the current standard provision that requires an Appointee to maintain the listing of a financial instrument. In light of the de-listing of Kelda's shares and the loss of the market information it provided, we are proposing to introduce this condition into Yorkshire Water's Appointment (please see 4.20).

We invite views on the impact of these proposals on comparative information

Prices and service standards

- 4.31 Customers will expect Yorkshire Water to provide proper standards of service at appropriate prices irrespective of its ownership. Yorkshire Water will continue to have the obligations imposed upon it by legislation and the conditions of its Appointment. We will continue to regulate Yorkshire Water under those provisions.
- 4.32 Yorkshire Water'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. Yorkshire Water 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 Appointment modifications

- 4.33 We propose to modify Yorkshire Water's Appointment stated in paragraphs 4.12 and 4.20. These modifications will bring Yorkshire Water's Appointment up to date with the current ring-fence standard. We are not proposing any additional modifications at this stage.

5 Responses to this consultation paper

5.1 Responses to this consultation should be made in writing by no later than 17 July 2008.

5.2 Responses should be addressed to:

Emma Cochrane
Head of Corporate Finance
Water Services Regulation Authority
Centre City Tower
Hill Street
Birmingham
B5 4UA

Fax: 0121 625 3609

E-mail: emma.cochrane@ofwat.gsi.gov.uk

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

5.4 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

5.5 If you would like the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory 'Code of Practice' which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

5.6 An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.