

WATER INDUSTRY ACT 1991, SECTION 13 PROPOSALS BY THE WATER SERVICES REGULATION AUTHORITY (OFWAT) TO MODIFY THE CONDITIONS OF APPOINTMENT OF SOUTHERN WATER SERVICES LTD AS A WATER AND SEWERAGE 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 25 July 2008.

DESCRIPTION OF AND REASONS FOR THE PROPOSED MODIFICATIONS

On 15 October 2007, Greensands Investments Limited completed the acquisition of 100% of the issued share capital in Southern Water Capital Limited. Southern Water Capital Limited was then the parent company of Southern Water Services Limited (Southern Water), an appointed water and sewerage undertaker regulated by Ofwat, and it continues to control 100% of the issued share capital in Southern Water.

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

- the capacity of Greensands and its investors to own a regulated water company;
- which entities should provide undertakings as required by Condition P of Southern Water's Instrument of Appointment (Appointment);
- the implications for Southern Water of the proposed long-term financial structure for Southern Water and the Southern Water group; and,
- the need for modifications to Southern 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.

Proposed Appointment modifications which have been agreed by Southern Water are described below.

Condition F

We will introduce the cash lock-up provisions 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.

We also propose to modify Condition F of Southern Water's Appointment to require it 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 require Southern Water to submit an annual certificate that in the opinion of the Directors, Southern Water will, for at least the next 12 months, have available to it systems of internal control which are sufficient to enable it to carry out its functions.

Condition M

Southern Water's existing Condition M includes a requirement for it to provide a separate data set in its June returns for the Hampshire water supply area. The condition was inserted following the Competition Commission's inquiry in 2002. It was part of the remedy to offset the harm caused by the loss of an independent comparator from our comparative analysis as a result of Veolia being able to control or influence the policy of Southern Water in addition to water companies it already owned. Following the subsequent change of ownership, Southern Water requested this requirement to be removed from Condition M. We consider the requirement is no longer necessary and we propose to remove this obligation from Condition M which reduces the regulatory reporting burden of the company.

Condition P

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

Under the proposed modification, the existing Condition P will be amended to require Southern Water 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 Southern Water to obtain new undertakings in the event of a change of control.

We also propose to amend Southern Water's Condition P to require it to maintain not less than three independent non executive directors on the board.

ISSUES ARISING IN RESPONSE TO THE CONSULTATION

We received responses to the consultation from CCWater and Martin Blaiklock (a consultant in infrastructure and energy project finance). CCWater broadly agreed our proposed Appointment modifications. Martin Blaiklock 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 Southern Water to ensure it procures legally enforceable Condition P undertakings from the appropriate entities. We regulate Southern Water, the appointed business. If Southern Water were to breach any of the conditions of its 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 financial ring-fencing conditions already in place in Southern Water's Appointment ensure that, whoever its owners or whatever its structure, 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. The introduction of the cash lock up Appointment condition will reinforce this financial ring-fence.

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