

WATER INDUSTRY ACT 1991, SECTIONS 8 AND 13

Notice of proposals by the Water Services Regulation Authority (Ofwat) that South East Water Limited replace Mid Kent Water Limited as the Water Undertaker for the latter's Water Supply Area and to modify the conditions of appointment of South East Water Limited as a Water Undertaker

THE PROCESS

The notice seeks views on the proposed variation and modifications described below. Any representations or objections can be sent in writing to Keith Mason, Director of Regulatory Finance and Competition, Ofwat, Centre City Tower, 7 Hill Street, Birmingham, B5 4UA (fax 0121 625 1400 or e-mail Keith.Mason@ofwat.gsi.gov.uk) and should be received no later than 30 November 2007

THE PROPOSAL

In October 2006 Hastings Diversified Utilities Fund and Utilities Trust of Australia (together "Hastings") purchased South East Water Limited ("South East Water"), an Appointed Water Undertaker regulated by Ofwat. Hastings already owned Mid Kent Water Limited ("Mid Kent Water"), also an Appointed Water Undertaker regulated by Ofwat. Accordingly a merger situation existed for the purposes of Section 32 of the Water Industry Act 1991 ("WIA91").

On 16 November 2006, the Office of Fair Trading ("OFT") referred this merger to the Competition Commission ("CC"). On 1 May 2007, the CC published its final report. The CC identified limited detriment to Ofwat's ability to perform its regulatory functions, but concluded that the benefits of the merger outweighed the detriment and that the detriment could be remedied. The CC identified a number of remedies to address the detriment. On this basis, the CC allowed the merger to proceed.

In order to give effect to the CC's decision it is proposed (with the consent of Mid Kent Water) that South East Water replaces Mid Kent Water as the Water Undertaker for the latter's Water Supply Area. Mid Kent Water's Appointed Business will be transferred to South East Water. South East Water will operate an enlarged service area including what was Mid Kent Water's area of operation. Mid Kent Water's Appointment will be terminated.

MODIFICATIONS OF CONDITIONS OF APPOINTMENT

It is also proposed that, in order to achieve the merger and ensure that the consumer interest continues to be protected, South East Water's Conditions of Appointment will be amended to reflect:

- (a) the merger of the two businesses (Condition B will be amended to set a new adjustment factor for the enlarged South East Water, which will be calculated through a combination of the adjustment factors for the two pre-merger businesses. The new adjustment factor will apply for the remainder of the current price review period, which ends on 31 March 2010);

- (b) current regulatory best practice including:
 - (i) cash lock-up provisions pursuant to MD218¹ (This will make explicit the steps the regulator requires of the regulated company in order that the financial viability of the regulated company is preserved if its investment grade credit quality is threatened.), and
 - (ii) replacing its existing Condition P with a generic form of Condition P (South East Water should have the active cooperation of its owners in carrying out its functions as a Water Undertaker and in complying with the conditions of its appointment. This will require South East 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.); and
- (c) changes in the statutory framework.

¹ Notification of intent to introduce a cash lock-up provision to Condition F of companies' instruments of appointment – 7 September 2006
<http://www.ofwat.gov.uk.aptrix/Ofwat/publish.nsf/Content/md218>