

**REFERENCE RELATING TO THE COMPLETED ACQUISITION BY HASTINGS
DIVERSIFIED UTILITIES FUND AND UTILITIES TRUST OF AUSTRALIA OF
SOUTH EAST WATER**

**Notice of possible remedies under Rule 11 of the
Competition Commission Rules of Procedure**

Introduction

1. On 16 November 2006 the Office of Fair Trading (OFT) in the exercise of its duty under section 32(b) of the Water Industry Act 1991 (the WIA) referred to the Competition Commission (CC) the completed acquisition by Hastings Diversified Utilities Fund (HDUF) and Utilities Trust Of Australia (UTA) of South East Water (SEW).
2. In its provisional findings on the reference notified to HDUF and UTA (the main parties) on 8 March 2007, the CC inquiry group (the Group) concluded provisionally that a water merger has taken place and that the merger may be expected to prejudice the ability of the Water Services Regulation Authority (Ofwat), in carrying out its functions by virtue of the WIA, to make comparisons between different water enterprises (the prejudicial outcome).
3. This notice sets out the actions which the Group considers might be taken by the CC, including any recommendations it might make for action on the part of others, for the purpose of remedying the prejudicial outcome identified in the provisional findings and any resulting adverse effects, and invites comments on the issues set out below (see note (i)).

Criteria

4. In considering appropriate remedial action, the Group will have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to remedy the prejudicial outcome and any adverse effects expected to result from the merger. When deciding on an appropriate remedy, the Group will consider the effectiveness of different possible remedies and their associated costs and will have regard to the principle of proportionality. Between two remedies that the Group considers equally effective, it will choose that which imposes the least cost or restriction.

Possible remedies on which views are sought

5. The Group has identified three possible types of remedy which may be appropriate in the present case: a divestiture remedy, maintaining separate sources of information, and an additional price reduction. The Group will also consider whether an appropriate remedy might combine more than one of these three elements.

Option 1: Divestiture

6. A divestiture remedy might require the main parties to divest either the acquired company (SEW) or Mid Kent Water (MKW) which was owned by the main parties before the merger. A divestiture remedy might involve full or partial divestiture by the main parties of either SEW or MKW.

7. The Group will consider whether partial divestiture might be an effective and proportionate remedy. SEW consists of two separate geographical areas—the northern region in Surrey and Hampshire and the southern region in Kent and Sussex, which is contiguous with MKW. A partial divestiture remedy might require the divestiture of either the northern region or the southern region of SEW. The Group will consider the practicability of such remedy options, the associated cost and the degree of risk involved.
8. If the Group were to conclude that the divestiture of the whole of SEW or MKW is necessary to remedy the prejudicial outcome, the Group's initial view is that the divestiture of either company would provide an equally effective remedy.
9. The CC's Guidelines on Water Merger References state that subject to the proportionality test, one-off structural remedies are likely to be preferable to behavioural remedies. However, in the present case, the Group will give consideration to whether Options 2 and/or 3 would be more proportionate to the prejudice the Group has identified in its provisional findings.
10. The Group invites views on the proportionality and effectiveness of a divestiture remedy, and on the appropriate scope of any such remedy.

Option 2: Maintaining separate sources of information

11. The Group has been told that, if permitted, the main parties would merge the operations of SEW and MKW under a single water licence. On that basis, the information collected by the merged company and provided to Ofwat would relate to one water enterprise rather than two separate water enterprises.
12. Accordingly, the Group will consider whether a proportionate and effective remedy would permit the main parties to retain ownership of both MKW and SEW, but to ensure that the main parties continue to operate two separate water enterprises under separate licences. The two water enterprises might be:
 - the two existing enterprises; or
 - two new enterprises created from the two existing companies. In this regard, the Southern region of SEW and MKW (which are contiguous) might be merged to create a new enterprise, and the Northern region of SEW might form a second separate enterprise.
13. The Group will consider how far these remedy options would require the two enterprises to be operated separately and whether they would require additional measures to be put in place to monitor and enforce the separate operation of the two enterprises.
14. The Group will also consider whether the prejudicial outcome might be remedied if the main parties were permitted to merge the operations of the two companies under a single water licence, subject to an obligation to provide two or more sets of data to Ofwat for some or all purposes. Thus the merged company might be required to provide Ofwat with separate management accounts and June return data for two separate areas as set out in paragraph 12. Similar arrangements might be made in relation to any other data provided to Ofwat.
15. The Group invites views as to whether an obligation on the main parties to provide separate data sets to Ofwat would represent a practicable and effective remedy; if so, what data should be the subject of the obligation; and the extent to which

independent ownership and/or separate licences are necessary to maintain the value of separate data sets.

Option 3: Price reduction

16. The Group will consider whether the prejudicial outcome might be remedied if an additional price reduction in favour of customers were imposed on the merged company (over and above that which Ofwat would ordinarily require through the price review process). Such a price reduction would be imposed through a modification of the merged company's licence conditions. The Group invites views as to whether such a remedy would be effective and proportionate, how any price reduction should be calculated, from when any price reduction should take effect and which customers would benefit.

Relevant customer benefits

17. The Group will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 30 of the Enterprise Act 2002¹ provided that:
- (a) consideration of those benefits would not prevent a solution to the prejudice the Group has provisionally identified; or
 - (b) the benefits which have accrued or may be expected to accrue, are substantially more important than the prejudice concerned.
18. A benefit is only a relevant customer benefit if the CC believes that: (a) the benefit has accrued or may be expected to accrue within a reasonable period as a result of the merger concerned; and (b) the benefit was, or is, unlikely to accrue without the merger concerned or a similar prejudice to Ofwat. Relevant customer benefits will comprise lower prices, higher quality or greater choice of goods or services in any market in the UK, or greater innovation in relation to such goods or services.
19. The main parties have said that the merger would give rise to:
- cost savings due to economies of scale. These would be passed through to customers (in whole or in part) in subsequent price reviews and might voluntarily be passed through before that;
 - improved security of supply, particularly in SEW's Southern region; and
 - improved planning of water resources.
20. The Group invites views as to:
- whether the benefits claimed by the main parties are relevant customer benefits as defined by the Enterprise Act 2002;
 - the timing and relative certainty of the proposed benefits;
 - whether consideration of any benefits would prevent a solution to the prejudice the Group has provisionally identified; and

¹As amended by regulation 6 of the Water Mergers (Modification of Enactments) Regulations 2004.

- whether the benefits which have accrued or may be expected to accrue are substantially more important than the prejudice concerned.

Next steps

21. The main parties are requested to provide any views in writing, including any practical alternative remedies they wish the Group to consider, by 29 March 2007 (see note (i)).
22. A copy of this notice will be posted on the CC website. Other interested parties are requested to provide any views in writing, including any other practical remedies they wish the Group to consider, by 29 March 2007.

Peter Davis, Group Chairman

8 March 2007

Note

- (i) This notice of possible actions to remedy the prejudicial outcome and any resulting adverse effects is given having regard to the provisional findings notified to the main parties on 8 March 2007. The main parties have until 29 March 2007 to respond to the provisional findings published on 8 March 2007. In the light of any responses by the main parties, or by other interested or affected third parties, the Group's findings may alter, in which case the Group may consider other possible remedies, if appropriate.