

COMPLETED WATER MERGER BETWEEN SOUTH EAST WATER LIMITED AND MID KENT WATER LIMITED

FINAL UNDERTAKINGS GIVEN PURSUANT TO SECTION 82 OF THE ENTERPRISE ACT 2002 AS MODIFIED BY REGULATION 23 OF THE WATER MERGERS (MODIFICATION OF ENACTMENTS) REGULATIONS 2004 BY:

1. SOUTH EAST WATER LIMITED
2. MID KENT WATER LIMITED

Whereas, on 16 November 2006, the OFT made the reference (“the reference”) to the CC under section 32(b) of the Water Industry Act 1991 (“WIA”) concerning the completed acquisition of Macquarie Luxembourg Water Sarl (now Hastings Luxembourg Water Sarl) by HDF (UK) Holdings Limited, which is jointly owned by Utilities of Australia PTY Limited (in its capacity as trustee of Utilities Trust of Australia (“UTA”)) and Hastings Funds Management Limited (in its capacity as responsible entity of Hastings Diversified Utilities Fund (“HDUF”));

Whereas on 1 May 2007, the CC published its final report on the reference (“the Report”) in which the CC concluded that the merger may be expected to prejudice the ability of Ofwat, in carrying out its functions by virtue of the WIA, to make comparisons between different water enterprises (“the prejudicial outcome”);

Whereas the report concluded that the prejudicial outcome should be remedied by a requirement upon Mid Kent Water Limited and South East Water Limited to reduce prices to customers of their companies by a total amount of £4 million on a “one off” basis, to be given effect through bills issued to customers for the year 2008/2009,

Whereas the report concluded that the price reduction remedy described above should be accompanied by requirement on Mid Kent Water Limited and South East Water Limited to accept a price determination at the next quinquennial price review that reflects £3.1 million annual merger savings in operating expenditure (as compared with current operating expenditure costs and projections) (“the opex adjustment”),

Whereas Ofwat, South East Water Limited, Mid Kent Water Limited, UTA and HDUF have agreed an approach to the opex adjustment, as set out in the document attached at Annex B;

SEW and MKW hereby give to the CC these Undertakings pursuant to section 82 of the Act.

The Undertakings shall take effect on the Commencement Date.

Section A. Interpretation and Definitions

1. For the purposes of these Undertakings:

“**the Act**” means the Enterprise Act 2002, including the modifications given effect by the Water Mergers (Modification Of Enactments) Regulations 2004;

“**business**” has the meaning given by section 129(1) and (3) of the Act;

“**the CC**” means the Competition Commission;

“**Commencement Date**” means the date of these Undertakings;

“the Company Reporter” means the individual or individuals appointed by the water undertakers and approved by Ofwat for the purpose of examining, testing and providing an independent opinion on the regulatory information the water undertakers provide to Ofwat;

“the former SEW” means the geographical area which was, prior to the creation of the Merged Business, served by SEW;

“the former MKW” means the geographical area which was, prior to the creation of the Merged Business, served by MKW;

“FY08/09” means the financial year 1 April 2008 - 31 March 2009;

“FY09/10” means the financial year 1 April 2009 - 31 March 2010;

“June Return” means the document provided by appointed water undertakers to Ofwat annually (in accordance with condition F of the instrument of appointment) to enable Ofwat to monitor each undertaker's progress in meeting its obligations and to compare performance between water undertakers;

“k value” means, save in relation to “adjusted k value”, a number (which may be positive, zero or negative), which is fixed by Ofwat as part of the price review process, and which limits permitted annual changes in prices for water services;

“Large Users” means users who use more than 50 mega-litres per annum;

“the merger” means the acquisition of Macquarie Luxembourg Water Sarl (now Hastings Luxembourg Water Sarl) by HDF (UK) Holdings Limited jointly owned by UTA and HDUF;

“the Merged Business” means a single business which consists of or includes the businesses of SEW and MKW as carried on separately prior to the merger;

“MKW” means Mid Kent Water Limited;

“the MKW business” means the business of MKW as carried on prior to the creation of the Merged Business;

“the OFT” means the Office of Fair Trading;

“Ofwat” means the Water Services Regulation Authority;

“operating expenditure” and **“opex”** mean a water undertaker's day-to-day costs, for example power, rates, payroll costs and materials and consumables, but excluding capital-related costs such as depreciation, as reported in line 22 of table 21 of the June Return.

“PR04” means the price determination made by Ofwat in 2004 for all water undertakers for the period 1 April 2005 - 31 March 2010;

“PR09” means the price determination to be made by Ofwat in 2009 for all water undertakers for the period 1 April 2010 - 31 March 2015;

“the Price Reduction” means the price reduction remedy set out in part B of these Undertakings.

“Principal Statement” means the annual return that every appointed water undertaker sends to Ofwat by 31 January every year. The Principal Statement provides information to enable Ofwat to check that the relevant water undertaker's weighted average charges increase is not in breach of licence condition B by exceeding its adjusted charges limit, or in breach of licence condition E by showing undue preference or undue discrimination in charging.

“SEW” means South East Water Limited.

“the SEW business” means the business of SEW as carried on prior to the creation of the Merged Business

“Undertakings” means these undertakings.

“water undertakers” means companies appointed to be water undertakers pursuant to section 6 of the WIA.

and unless the context requires otherwise, the singular includes the plural and vice versa.

2. The Interpretation Act 1978 shall apply to these Undertakings as it does to Acts of Parliament.

Section B. The Price Reduction

3. SEW and MKW undertake that the Merged Business will calculate and apply the Price Reduction in favour of its customers in accordance with this Section B.
4. The objectives of the Price Reduction are that:
 - a. in FY08/09, the total of the amounts paid by customers of the Merged Business for water services shall be £4 million less than those customers would have paid if the Merged Business had not been created from the SEW business and the MKW business; and
 - b. the price reduction described in paragraph a. above shall be given effect by a fair and equitable reduction of the prices paid by all water service customers of the Merged Business.

In the event of any question arising as to the proper interpretation of the Undertakings set out in paragraphs 5 to 13 below, they shall be interpreted so as to give effect to the objectives set out in this paragraph.

5. The total amount of the Price Reduction, £4 million, shall be split between and allocated to, on the one hand, customers in the former SEW, and on the other hand, customers in the former MKW, in proportion to the water service revenues received by SEW and MKW in 2006/2007 as set out in their respective 2007 June Returns. The proportion of the £4 million allocated to all customers in the former SEW is referred to below as the “SEW Proportion”. The proportion of the £4 million allocated to all customers in the former MKW is referred to below as the “MKW Proportion”.
6. The Merged Business shall estimate the revenues which it will receive in FY08/09 for the provision of water services. The preparation of that estimate shall include the following steps:
 - a. Revenues will be estimated separately for customers in the former SEW and the former MKW respectively. The two estimates of revenue calculated under this

paragraph are referred to below as the “SEW Estimate” and the “MKW Estimate” respectively;

- b. Revenues shall be estimated for each of the former SEW and the former MKW using a set of tariffs for 2008/09 (one for each of the former SEW and the former MKW) derived from the Principal Statements for each of SEW and MKW. The tariffs calculated for 2008/2009 shall be based on the k values determined for FY08/09 in PR04 for SEW and MKW respectively, and on property numbers, rateable values and volumes derived from:
 - i. internal company budgets for each of MKW and SEW for the financial year 2007/2008 which have been approved by company boards of SEW and MKW respectively; and
 - ii. the estimated growth in numbers of properties, the estimated numbers of meter conversions and the estimated growth in water consumption in the former SEW and the former MKW during FY08/09.
7. The SEW Proportion shall be subtracted from the SEW Estimate to provide a revised estimate of revenues for water services from customers in the former SEW for FY08/09 following the application of the Price Reduction (“the Revised SEW Estimate”).
8. The MKW Proportion shall be subtracted from the MKW Estimate to provide a revised estimate of revenues for water services from customers in the former MKW for FY08/09 following the application of the Price Reduction (“the Revised MKW Estimate”).
9. The Merged Business shall calculate revised tariffs for FY08/09 in accordance with the principles set out further below in this paragraph (“the Revised Tariffs”). The Revised Tariffs shall include separate tariffs for customers in each of the former SEW and the former MKW, and shall be calculated through the preparation of a further Principal Statement for each of the former SEW and the former MKW in which the k values determined for FY08/09 in PR04 for SEW and MKW respectively shall be abated to arrive at adjusted k values for each of the former SEW and the former MKW. The Revised Tariffs shall ensure, subject to paragraph 13 below, that:
 - a. total revenues for water services received from customers in the former SEW in FY08/09 amount to the Revised SEW Estimate;
 - b. total revenues for water services received from customers in the former MKW in FY08/09 amount to the Revised MKW Estimate;
 - c. prices are reduced by a fair and equitable amount for all customers of the Merged Business. In assessing what represents a fair and equitable amount for the purposes of this paragraph the Merged Business shall:
 - i. ensure, subject to paragraph ii. below, that prices are reduced by substantially the same proportion for all customers; but
 - ii. shall also be entitled to have regard to the past practices of SEW and MKW in establishing tariffs and the need for clarity and practicality in fixing tariffs for water customers.
 - d. the Price Reduction shall be applied in favour of customers on an unmeasured tariff by a reduction in the rateable value charge, save in respect of customers on assessed tariffs, for whom the Price Reduction shall be applied by a reduction in the assessed volumetric charge; and

- e. the Price Reduction shall be applied in favour of customers on a measured water tariff by a reduction in the volumetric charges;
10. The Merged Business shall also ensure that prices to:
- a. Large Users; and
 - b. Vulnerable Group Tariff customers who pay the maximum capped amount for such customers;
- are reduced by a fair and equitable amount, having regard to the principles set out in paragraph 9.c above. For the avoidance of doubt, such amount forms part of the Price Reduction.
11. SEW and MKW undertake that the Merged Business will, following the audit of its Principal Statement for FY08/09, obtain a letter from the Company Reporter confirming whether the Price Reduction has been applied in accordance with paragraphs 5 to 10 above, and provide a copy of that letter to Ofwat and to the OFT. For the avoidance of any doubt, the letter obtained by the Merged Business pursuant to this paragraph shall explicitly address whether the estimates used on property numbers, rateable values and volumes derived by the Merged Business for the purposes of paragraph 6.b above are reasonable.
12. Further, the Merged Business will obtain from Ofwat, following the process of approval by Ofwat of its tariffs for FY08/09, a letter from Ofwat confirming whether the Price Reduction has been applied in accordance with paragraphs 5 to 10 above and provide a copy of that letter to the OFT.
13. Within 28 days of the date on which the Merged Business submits its June Return for FY08/09 to Ofwat, the Merged Business will carry out the calculation set out in Annex A. The Merged Business will write to the OFT, copying that letter to Ofwat, setting out the result of the calculation (“the Result”). Further as to “the Result”:
- a. If the Result is between - £50,000 and + £50,000, this Price Reduction remedy shall have no further effect on the prices which the Merged Business shall charge or is entitled to charge in any year after FY08/09;
 - b. If the Result is less than - £50,000, the Merged Business undertakes to accept that the total amount which the Merged Business would otherwise be entitled to charge to its customers for water services in the financial year 2010/2011 shall be reduced by an amount equivalent to the Result when prices to customers for water services are determined by Ofwat for that year; and
 - c. If the Result is greater than + £50,000, the total amount which the Merged Business would otherwise be entitled to charge to its customers for water services in the year 2010/2011 shall be increased by an amount equivalent to the Result when prices to customers for water services are determined by Ofwat for that year.
14. Paragraphs 3 to 13 above assume that the Merged Business will be created prior to the commencement of FY08/09. If the Merged Business has not been created by that date, these Undertakings shall be interpreted and applied so as to require each of SEW and MKW to implement a reduction in prices in favour of their respective customers, and in particular:

- a. the price reductions given effect by SEW and MKW respectively shall be calculated and applied in so far as possible by applying the principles and the methodology set out in paragraphs 5 to 13 above;
 - b. thus, in FY08/09, the total amount paid by customers of SEW for water services shall be less than the amount which those customers would have paid for water services in the absence of the Merger by the amount of the SEW Proportion;
 - c. similarly, in FY08/09, the total amount paid by customers of MKW for water services shall be less than the amount which those customers would have paid in the absence of the Merger by the amount of the MKW Proportion; and
 - d. the price reduction described in paragraphs a. to c. above shall be given effect by a fair and equitable reduction of prices paid by all customers of SEW and MKW.
15. For the avoidance of doubt, the abatement made to the k values for SEW and MKW pursuant to paragraph 9 above shall be added back to the k values calculated for SEW and MKW in preparing Principal Statements for FY09/10.

Section C. Opex Merger Savings

16. SEW and MKW undertake that the Merged Business will use all reasonable endeavours to achieve at least £3.1 million per annum of savings in operating expenditure as soon as is practicable following the creation of the Merged Business.
17. To the extent that PR09 incorporates an adjustment to opex which is consistent with and reflects the approach set out in Annex B (and only to that extent), SEW and MKW undertake that they and the Merged Business will accept, and will not challenge, the outcome of PR09.

Section D. General Provisions

Limits on Scope of Undertakings

18. For the avoidance of any doubt:
- a. nothing in sections B or C of these Undertakings shall affect the right or ability of SEW to challenge any aspect of PR09 except those aspects in respect of which explicit provision is made in these Undertakings;
 - b. nothing in these Undertakings requires SEW or MKW to take action or to refrain from taking action which would cause either SEW or MKW to be in breach of its instrument of appointment as a water undertaker; and
 - c. prior to the creation of the Merged Business, nothing in these Undertakings requires SEW to procure compliance with these Undertakings in relation to the Mid Kent Water business, and vice versa.

Provision of Information

19. SEW and MKW shall promptly provide to the CC such information as the CC may require for the purposes of performing any of its functions under these Undertakings or under sections 82, 83 or 94(7) of the Act.
20. SEW and MKW shall promptly provide to the OFT such information as the OFT may require for the purposes of performing any of its functions under these Undertakings or under sections 92, 93(6) or 94(6) of the Act.

21. SEW undertakes that should it become aware that it is in breach of these Undertakings, it will write to the OFT and the CC within 5 working days of so becoming aware setting out details of the breach and all of the relevant circumstances.
22. MKW undertakes that should it become aware that it is in breach of these Undertakings, it will write to the OFT and the CC within 5 working days of so becoming aware setting out details of the breach and all of the relevant circumstances.

Directions

23. SEW and MKW shall comply insofar as they are able with such written directions as the CC or the OFT may from time to time give and take such steps as may be specified or described in the directions for the purpose of carrying out or securing compliance with these Undertakings.

Termination

24. If following the creation of the Merged Business, MKW ceases to provide water services to customers in the former MKW, these Undertakings shall cease to apply to MKW.
25. Subject to paragraph 24 above, SEW and MKW accept that these Undertakings shall be in force until such time as they are varied, released or superseded under the Act.
26. SEW and MKW accept that the variation, release or supercession of these Undertakings shall not affect the validity or enforceability of any rights or obligations that arose prior to such variation, release or supercession.

Signed etc

Annex B

Adjustment of £3.1m for base opex and efficiency modelling

SEW, MKW, UTA, HDUF and Ofwat have agreed upon an approach to give effect to the £3.1m opex adjustment to base operating costs provided for in the CC's Report. That approach is set out in the following note, which was prepared on behalf of SEW, MKW, UTA and HDUF and agreed with Ofwat. References to "the Company" in the note are references to the Merged Business as defined in these Undertakings".