

South East Water (Holdings)

a review

January 2003 - March 2004

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South East Water became part of the Macquarie Water UK Group in October 2003. Following the change of ownership, the financial year end has moved to 31 March.

Business Overview

South East Water is the largest regulated business within Macquarie Water UK Group, and performs a number of different activities:

Water services

The company manages the water supply and invoicing to customers within its licensed area, supplying approximately 400 million litres of drinking water daily to a population of 1.5 million people.

South East Water serves over half a million domestic properties and some 45,000 commercial properties. Its main commercial customers include the MoD, hospitals, food processing plants and small businesses.

The supply area covers approximately 3,607 km² across Sussex, Kent, Surrey, Hampshire and Berkshire.

Laboratory services

As part of its integral regulated business, South East Water operates a UKAS accredited laboratory specialising in microbiology, inorganic chemistry, organic chemistry, Cryptosporidium and Giardia. In addition it provides analytical services to other organisations and companies.

Other non-regulated business

South East Water receives billing commissions from Thames Water, meter reading income from Southern Water, mast rentals, and rent from domestic properties still owned by the company.





Financial Performance

Turnover

The 2003/4 15 month Statutory year's total turnover of £119.1m is £27.6m above the results for the previous 12 months. On a regulatory year-end basis the level of total income during 2003/04, compared with 2002/03, shows an increase of £4.3m to £96.3m. Of this increase some £3.6m is due to an average price increase of 2.65% and to increased water consumption for the metered supplies. The rest of the increase of £0.7m is from new connections and rechargeable works.

Key financials

Year ending	31 Dec 2000	31 Dec 2001	31 Dec 2002	31 Mar 2004
Income	92.3	91.5	91.5	119.1
Cost of sales	52.4	52.4	54.5	78.4
Operating Profit	39.9	39.1	37.0	40.7
Less: Depreciation (incl. renewals expenditure)	-12.2	-11.6	-13.4	-17.1
EBITDA	52.1	50.7	50.4	57.8

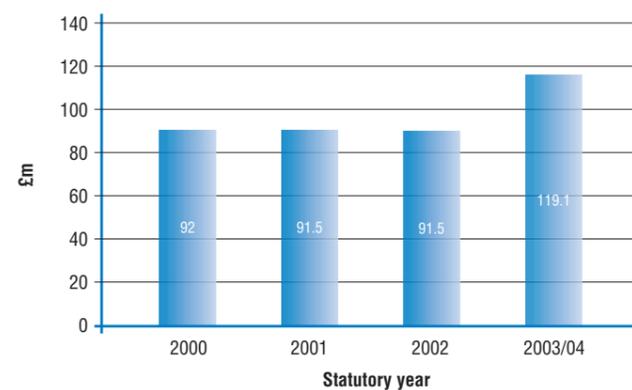
Statutory Accounts for 2003/04 have been prepared for 15 months to 31.03.04. The previous years are based on a 12 month calendar year.

South East Water has the following main revenue streams:

- **Unmetered water supply services** are provided where a charge is made according to the rateable value of the property supplied, as well as a standing charge.
- **Metered water supply services** are provided to properties fitted with a water meter, with the charge based on consumption.
- **Other income** includes rechargeable work for third parties, new connections to a public water mains for domestic properties and other non-regulated work.

Ofwat set price limits in November 1999 for the five years March 2000 to March 2005. The price limit is termed the K-factor and prices of the average water bill are permitted to rise by the retail prices index ("RPI") prevailing at the previous November plus or minus the assigned K factor. For each of the three Regulated years since 2001/02, the K-factor has been: • 2001/02 : 1% • 2002/03 : 1.5% • 2003/04 : 0%.

South East Water total income by statutory year including 15 month period 2003/04



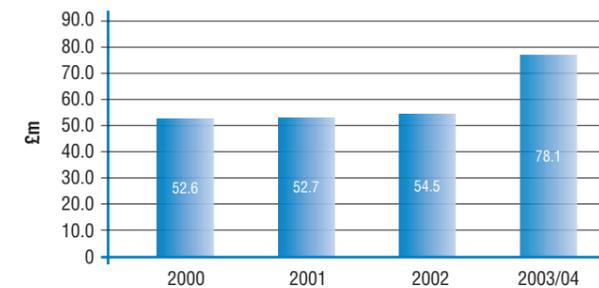
Operating Profit

The 2003/4 15 month Statutory year's operating profit of £40.7m is £3.7m above the results for the 12 months results.

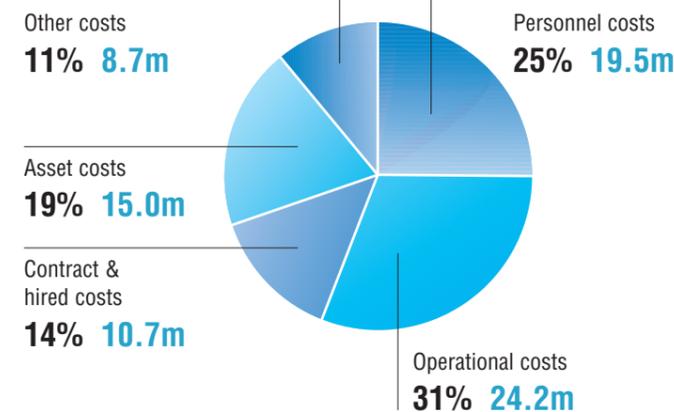
Operating Expenditure

The following tables show total operating expenditure for the Statutory year including the 15 month period 2003-2004, together with a category breakdown. A 12 month period comparison is also shown.

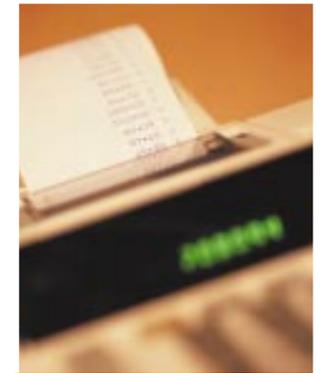
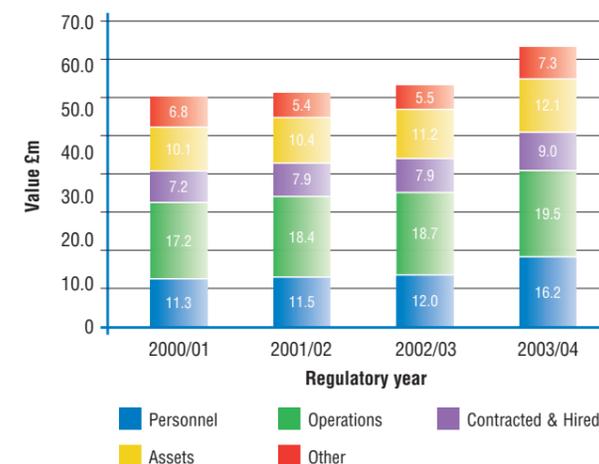
Total expenses by statutory year including 15 month period 2003/04



Operating expenses for 15 month period 2003/04 £78.1m



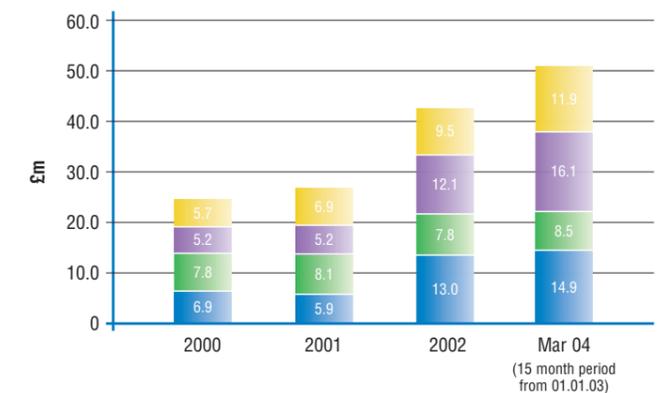
Operating Expenses by regulatory year



Capital Expenditure

This reporting period has seen the biggest ever investment programme by South East Water, with a spend of some £51.4m during the 15 months ended 31 March 2004. This takes the total spend since 2000 to £145m, which is in line with the company's five year business plan.

Capital Expenditure by statutory year





Company Highlights

2003-2004 has been a busy year throughout the company. Significant events such as a change of ownership, and the drought of last autumn brought their own particular challenges. These were fully met, whilst at the same time, we delivered our leakage and mains rehabilitation targets, improved a key customer service rating, and prepared and submitted our Draft Business Plan for the Periodic Review (the final business Plan has now been submitted), to name but a few achievements. We expand on these in the following pages.

Water Supply and Distribution

Water quality

Ensuring the water we supply is clean, safe and wholesome is our top priority. Once again, the quality of our water was confirmed as being extremely high, with our compliance rate against UK and European standards being 99.78%.

Rehabilitation of water mains to improve water quality continued to take the biggest share of our capital investment programme, at 24%, with 230km scraped and relined at a cost of more than £12m.

In relation to specific water quality issues, £2.6m was invested in Cryptosporidium removal, most notably at our Hartlake and Itchell sites, with a further £5.9m on solvent removal at Maidenhead.

Resources

South East Water operates in an area acknowledged as being water resource deficient. There is less usable water available per person than in some parts of Africa.

Planning and investment to improve security of supply is a key priority. Climate change and increased development is increasingly bringing lack of adequate resources into the spotlight. The issue was sharply highlighted last year, when we experienced record-breaking high temperatures in the summer, and nine months of below average rainfall.

Coping with the drought

Demand soared during the summer, with increases of 40% above the norm at peak periods being not uncommon. We were able to cope with these demands, thanks to recent investment in network flexibility and capability, together with the hard work and dedication of our staff.

However, following the hot months, autumn rainfall to recharge our surface reservoirs simply did not arrive. Demand continued to be high and reservoir levels fell to unprecedented lows of under 20%. We undertook a series of engineering measures to reduce pressure on these supplies, however with ground water levels also below normal, we quickly took the decision that we must apply for Drought Permits from the Environment Agency as a precautionary measure.

The Permits allowed us to temporarily exceed our licence conditions when necessary, so that we could maximise the amount of water we could take from the rivers when it did rain, and to on occasion, reduce river levels.

Throughout this time we worked closely with the Environment Agency to ensure any environmental impact was considered and kept to a minimum.

Customer awareness campaigns were run throughout this period in an effort to explain the situation, and appeal to our customers to use water wisely and help us avoid restrictions for the spring of 2004.

In the event, winter rainfall recharged the reservoirs, and groundwater levels also recovered.

Investment

Optimising the resources available to us is essential, and the subject of on-going investment. Last year saw new boreholes sunk at Saints Hill, Headley Park and Pembury. The Pembury site was the subject of £3/4m of investment which included refurbishment of areas of the reservoir and the diffused air flotation units. Our site at Greywell was completely reconstructed throughout the course of 2003 at a cost of £3.4m, with a further significant project, an extension to our source and pumping station at Groombridge completed earlier this year.

A key component of our long-term water resource strategy is the Bewl-Darwell project, and this moved forward significantly during the reporting period. This is a joint project with Southern Water and involves the installation of a new pipeline between Southern Water's Bewl Reservoir in Kent, via Darwell to our Hazards Green treatment works near Bexhill. This project will help safeguard water supplies and meet demand in the East Sussex area.

Extensive public consultation was undertaken before the planning application was submitted in 2003. Changes were made to reduce the impact on the environment and condense the construction programme. The scheme is now expected to be operational by the autumn of 2004, several months ahead of the original plans.

Leakage control

Despite being faced with a significant increase in burst mains, largely due to the hot weather conditions which created ground movement, our leakage teams reached the target set by the company and agreed with Ofwat.



Customers

Customers are at the heart of our business, and we are pleased that Ofwat's annual Levels of Service report reflected our sustained efforts to provide excellent service. Once again we achieved the top rating in all measured categories of customer service.

We were particularly pleased that our overall performance assessment (OPA) score improved by 12% in just one year, taking us to a score of 271 out of a possible 288. The OPA covers such areas as water pressure, drinking water quality, telephone answering, services to customers with special needs, complaint handling and leakage. Audits by WaterVoice, the body which represents the interests of water customers, also contribute to the OPA score.

Regarding a review of letters sent to customers the WaterVoice panel said "We were extremely impressed by the tailored and personal nature of the letters and the high standard of English and grammar used."

During the year, we moved our outsourced customer contact centre to a new provider in Bristol. Anticipated initial teething problems were addressed and we are confident that the experience we provide to our customers will continue at a high standard.

Technology plays a key part in customer management, and throughout the year we continued working on a new customer information system, Sapphire. User requirements and user acceptance testing were carried out. This is due to go live in the autumn of 2004.

It is vital to know what our customers think about the service we provide, and our on-going customer research programme, which has again taken place this year gives us vital feedback. This has been particularly relevant in the preparation of our Five Year Business Plan.

Commercial Services

South East Water is committed to delivering exceptional customer service, and this year its industrial and commercial services was enhanced with the appointment of a third key account manager. This new role has responsibility for medium-sized companies, predominantly in the retail, banking and agricultural sectors.

Our demand management services continued to benefit more businesses, enabling greater control over water consumption and identification of misuse and wastage on business premises. These services include water efficiency audits, leakage and burst detection, and repairs to private infrastructure.

New services for home moves were also launched at the end of 2003, enabling chargeable access to water infrastructure plans to inform a buying decision on a new property. In the region of 20,000 such requests are anticipated in 2004.



Taking the business forward

The Five Year Periodic Review

Our Draft Business Plan setting out our investment plans and operating costs for the period 2005-2010 was prepared and submitted to Ofwat in the summer of 2003. The process then continued with progress to the submission of the Final Business Plan, as further Government and Regulatory guidance was received, and meetings took place between the company and Ofwat.

These plans take account of all the issues the company faces in the forthcoming five years and beyond, and must provide Ofwat with information about all the factors it needs to consider when setting the price limits.

During the preparation of both the Draft and Final Business Plans, we have consulted and communicated widely with our stakeholders, from Government and Regulators to businesses, customers and pressure groups. This has involved one to one meetings, roundtable discussions, breakfast briefings, mailings and surveys.

Our Plans have received positive feedback from Ofwat for the way in which they have been prepared, and currently show price rises below the average for the industry. We look forward to the next steps in the process with the publication of Draft, then Final price limits this year.

Improvements in efficiency

Of relevance to the Business Plan is the way the company is currently operated. We are pleased that published Regulatory performance figures showed that we are now at Band B for both Opex and Capex efficiency.

The environment

South East Water has an enviable reputation in the field of environmental management, and this year has again demonstrated its innovative approach to this area.

Ground-breaking algae control

A common problem in the water industry is blue/green algae. At our Barcombe reservoir, to address this issue, and as part of our ISO14001 project at the site, we trialled a new environmentally friendly method of control. This has not only been successful in treating algae, but has reduced our operational costs at the site by more than £60,000 pa.

Birth of the Barn Owl

Baby Barn Owls were hatched in the nesting boxes we have erected at our Arlington Reservoir site. The award winning site has been completely created by our own intervention, and the hatching of the chicks shows that we have created the perfect habitat, with these creatures being at the top of the food chain.

Staff volunteers

2003 saw a new initiative where all members of our staff are entitled to take one day per year away from their normal role, and instead carry out conservation work on company owned land. By encouraging staff to become involved in this work, they gain a good understanding of the environmental issues facing the company, and it is also an excellent opportunity for team building.

Taking this a step further, our annual staff seminar took the form of a full day for 100 staff working at our Pembury site on a variety of projects, from hedgelaying to coppicing, otter-holt building to wood-turning. We used all local contractors to help us, from the caterers to the marquee provider, illustrating social and environmental sustainability in action. The feedback we received left us in no doubt that this was one of the most enjoyable seminars ever held.

Staff

We are very aware that staff are our most important asset, and our aim is to foster an environment in which they can maximise their potential and are rewarded for their efforts. We are pleased that our Investor in People accreditation has been retained now until 2005.

Training continues to be a priority, and during 2003/04 1101 training days took place. The majority of this was to meet legislative and health and safety requirements. Other training included such diverse subjects as boat handling to assertiveness skills.

Our health and safety record continues to be excellent, and we were awarded OHSAS 18001 certification of our safety management systems. We will be receiving a Gold ROSPA Award in 2004.

Good channels of communication are essential to keep staff informed and motivated. A new improved intranet system was implemented during the early part of 2004. This will form the foundation not only for improved communication, but also significant business benefits. These include the improved control of projects that require teams of people to use a large number of documents in a collaborative way.

A work-life balance is important, and as part of this ethos, we offer a learning and development scheme which staff can apply to for funding to follow a course unrelated to their work. This could be anything from aerobics to learning a language.

Community Programmes

Investing in the local community is a stated aim of the company, be it time, access to sites or financial assistance, and the last 15 months have been no exception.

We supported National Drink Water Day again this year, with an ex-employee, now the premier David Beckham look-alike teaming up with our company mascot to advertise the event.

As always, education played a large part in our community work: water bottles were donated to several schools; speakers gave talks to local children on water supply; we ran a competition to design a water-wise game for our website; our education days proved as popular as ever, and two members of staff acted as business advisors to teams in the Young Enterprise scheme.

Staff themselves participated in events such as the London Marathon, and supported Children in Need with company wide activities, most of which seemed to feature food in one form or another!

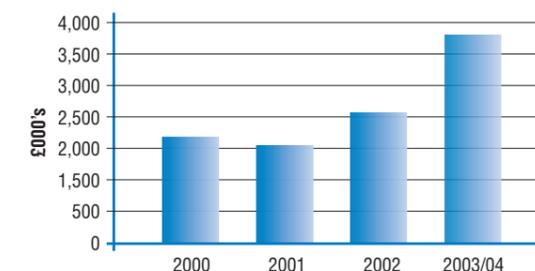
Looking ahead

As we reach the final stages of the Periodic Review, we are ready to face the challenges that this may bring us, both in the next twelve months and in the longer term future. We look forward to continuing to work effectively and efficiently for the benefit of company, customers and shareholders.

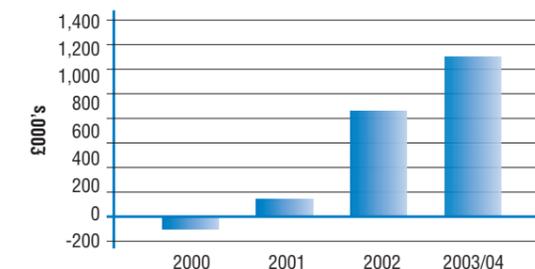
Dynamco

Dynamco Engineering has continued to grow during 2003, showing increases in both turnover and operating profit for a fourth consecutive period.

Dynamco income



Dynamco operating profit



For South East Water, Dynamco has progressed projects with a total value of over £29million including £12m mains rehabilitation, £4m mains replacement, 3 membrane plants for the removal of *Cryptosporidium*, a plant for solvent removal, and significant modifications to a reservoir embankment.

Externally, Dynamco has been successful in generating interest in both its process and hydrogeological expertise, from owners of private water supplies, as well as from industrial customers. Internationally, Dynamco assisted Saur with a comprehensive technical assessment of the water supply systems in Armenia, which was well received by the World Bank in their evaluation of the Saur bid. Dynamco also provided input into Saur bids for other operating contracts around the world.

Operational research has resulted in improved Dynamco understanding of filter washing processes and the control of organic matter as well as ongoing development of a new process for algae removal using ultrasonic probe technology, which is now being successfully marketed to other companies in the UK water sector.