

# Challenger Infrastructure Fund

Southern Water Market Update

Steve Bickerton - Chief Executive, CIF

Les Dawson - CEO, Southern Water

16 April 2008



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# 1. Investment Highlights

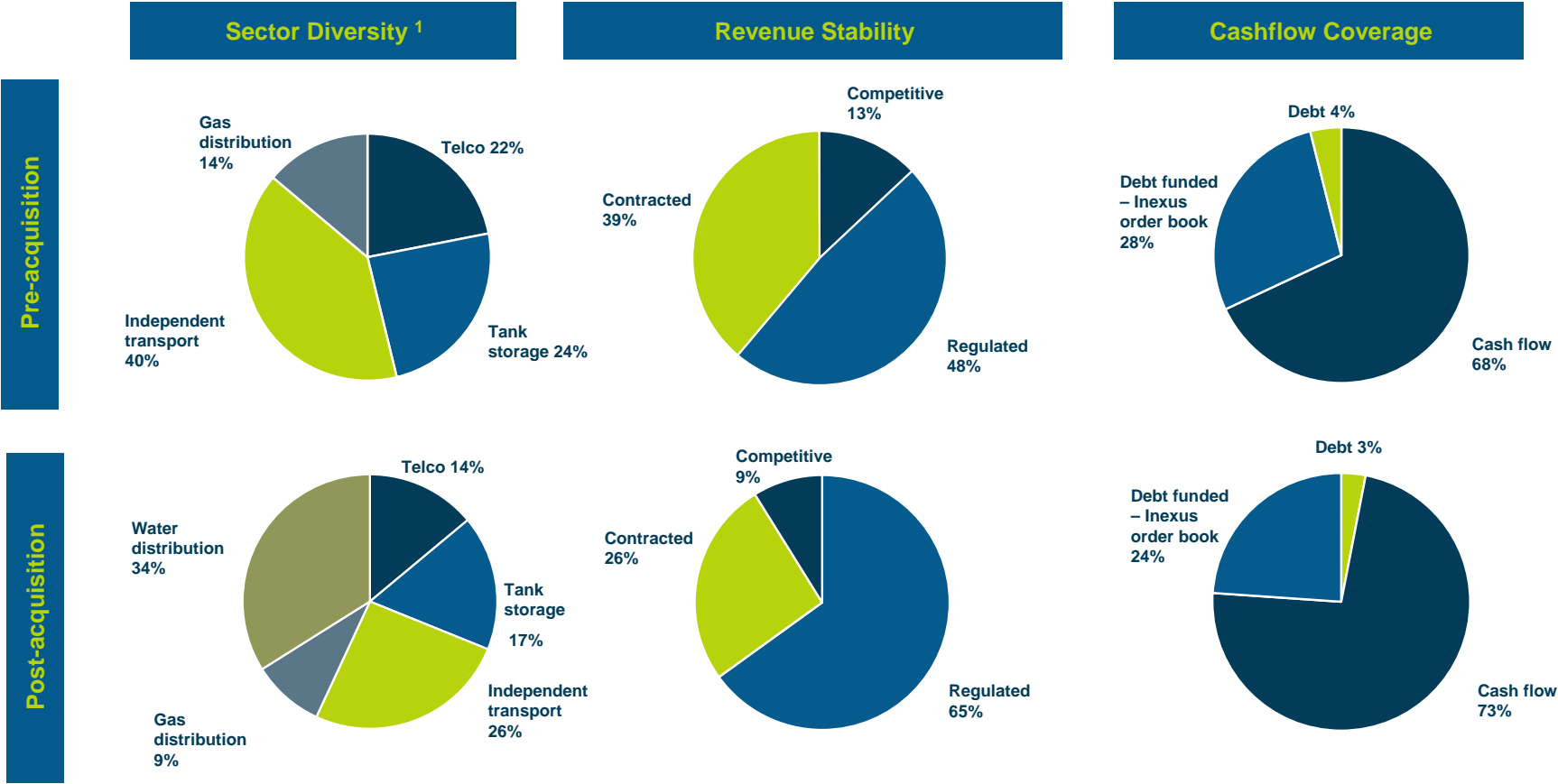
Steve Bickerton - Chief Executive, CIF



# Southern Water meets key criteria

CIF Investment Criteria	SW	Commentary
Regulated industry or near monopoly market position	✓	<ul style="list-style-type: none"> <li>Southern Water operates under a mature and stable regulatory regime                             <ul style="list-style-type: none"> <li>Water companies operate regional licensed monopolies on a 25 years rolling basis</li> <li>The current regime is currently in its fourth 5-year price control period</li> </ul> </li> </ul>
High barriers to entry	✓	<ul style="list-style-type: none"> <li>Exclusive supply licence within appointed areas with 25 year notice period</li> <li>Large capital investment and practical limitations and costs of shipping water long distances</li> </ul>
Strong cash generation and attractive cash returns	✓	<ul style="list-style-type: none"> <li>Focused regulatory asset, generating c. 99% of its EBITDA from regulated businesses</li> <li>31% (real) RCV growth over current regulatory period</li> </ul>
Long-term predictable cash flow	✓	<ul style="list-style-type: none"> <li>Revenues locked-in until 2010</li> <li>5 year periodic reviews, with transparent regulatory framework provide for predictability</li> <li>Minimal exposure to price, demand or market risk</li> </ul>
Growth potential	✓	<ul style="list-style-type: none"> <li>Well placed for large capital allowances in the next period which will further drive growth                             <ul style="list-style-type: none"> <li>Compliance with EU environmental directives with regard to wastewater</li> <li>Upgrading of water network</li> <li>Population growth in south-east of England</li> </ul> </li> </ul>
First class management teams	✓	<ul style="list-style-type: none"> <li>Average of over 20 years experience in the utilities sector</li> <li>Experienced management team focused on improving the performance of the business</li> </ul>
Ownership level	✓	<ul style="list-style-type: none"> <li>Ownership enables two Board nominees and one of two non-executive Board nominee at the Operational board level</li> <li>Consortium of like minded experienced infrastructure investors</li> </ul>

# Key benefits to CIF



1. As a percentage of total Assets Under Management based on Director's fair value as at 31 December 2007 (includes Gas Distribution Networks)



# Acquired at an attractive price

Transaction details	Enterprise Value (£m)
Southern Water enterprise value	4,195
Less: Folkestone and Dover <sup>1</sup>	(15)
Less: Non-appointed business <sup>2</sup>	(28)
Less: Normalised working capital <sup>3</sup>	(27)
<b>Regulated enterprise value</b>	<b>4,125</b>

	Regulated Enterprise Value Multiple		Southern Water Enterprise Value Multiple
Regulated EV	4,125	Southern Water EV	4,195
2008FY <sup>4</sup> regulated capital value	3,240	2008FY <sup>4</sup> EBITDA	456
Multiple	1.27x	Multiple	9.2x

1. Distributions from regulated water company of which Southern Water owns 25%
2. Unregulated revenues (refer to slide 18 for more detail)
3. Relates to the unwinding of billing debtors which is expected to occur prior to March 2008
4. March year end

# 23.4% provides significant exposure

- At acquisition, £155.6m of subordinated debt was put in place with the intention of refinancing with equity post financial close
- In December 2007, Cheung Kong Infrastructure, Li Ka Shing Foundation and Retail Employees Superannuation Pty Limited joined the Greensands consortium by together subscribing for £155.6m of new equity
  - Premium to acquisition price
  - Existing consortium member's interests were proportionately reduced, with CIF's initial 26.6% reduced to 23.4%
- Rights under the Shareholders Agreement not affected

Investor	At acquisition		Current	
	Investment (£m)	Investment (£m)	Investment (£m)	Investment (£m)
CIF	300	26.6%	300	23.41%
JP Morgan Infrastructure Investments Group	360	32.0%	360	28.09%
UBS AG	200	17.8%	200	15.61%
Access Capital Advisers <sup>1</sup>	201	17.9%	201	15.68%
Hermes	50	4.4%	50	3.90%
Paceweald Limited <sup>2</sup>	15	1.3%	15	1.17%
CKI/Li Ka Shing <sup>3</sup>	-	-	125	9.77%
REST	-	-	31	2.37%
<b>Total Equity</b>	<b>1126</b>	<b>100%</b>	<b>1282</b>	<b>100%</b>

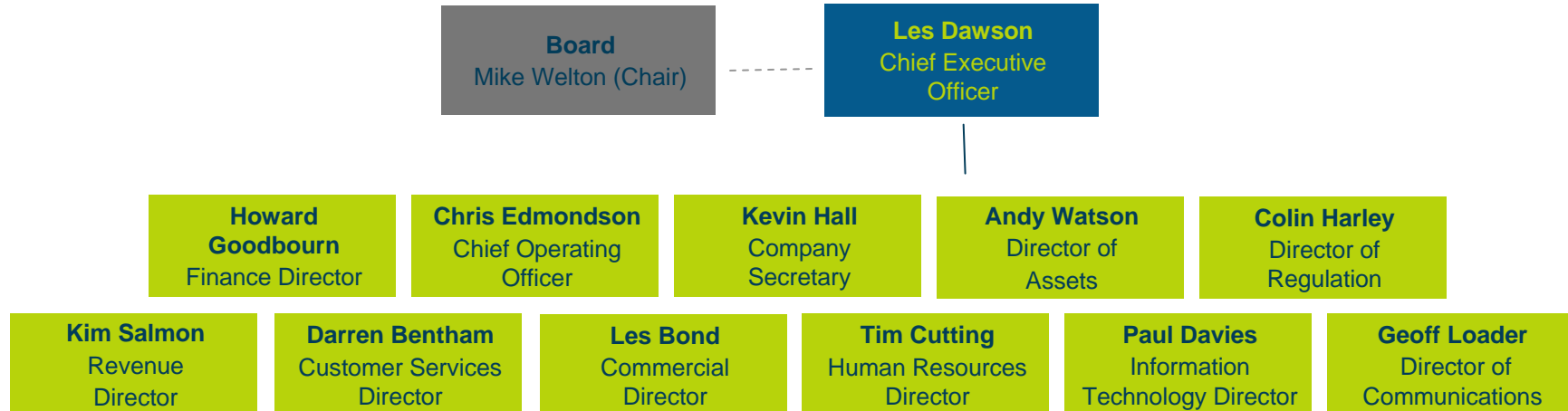
1. Includes seven Australasian superannuation funds advised by Access Capital Advisers

2. Advised by Consensus Business Group

3. Li Ka Shing Foundation (Canada) Limited and Li Ka Shing Foundation

# Experienced management team

- Executive team has an average of 20 years experience
  - Majority in place at the last price determination in 2004
- Strong track record:
  - Capex delivery on schedule
  - Leakage reduced below Ofwat targets
  - Profitable property disposals
  - Successful outsourcing initiatives e.g. capital expenditure
  - Optimisation of tax and financing costs
  - Off-shoring of non-core activities

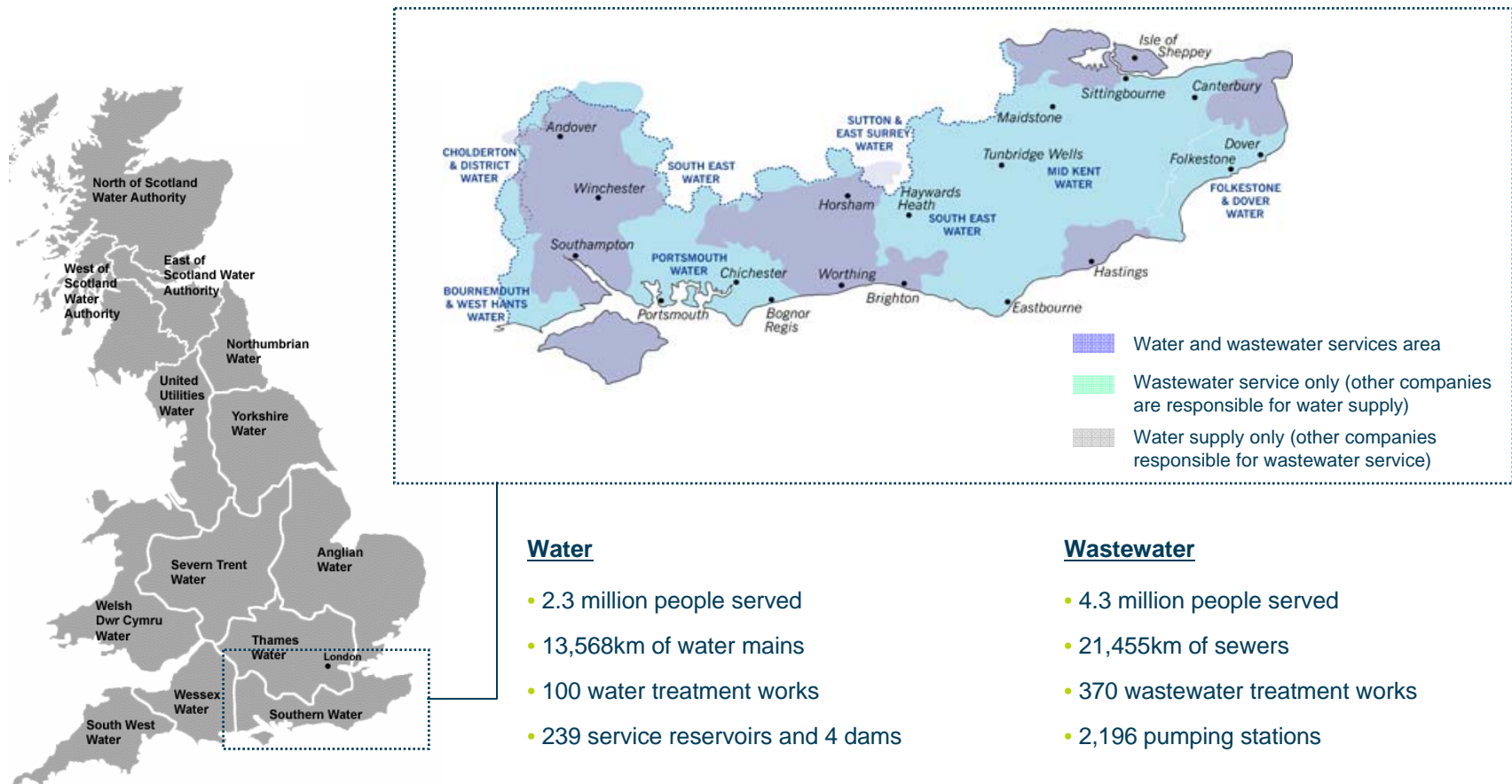


## 2. Business Overview

Les Dawson - Chief Executive Officer, Southern Water



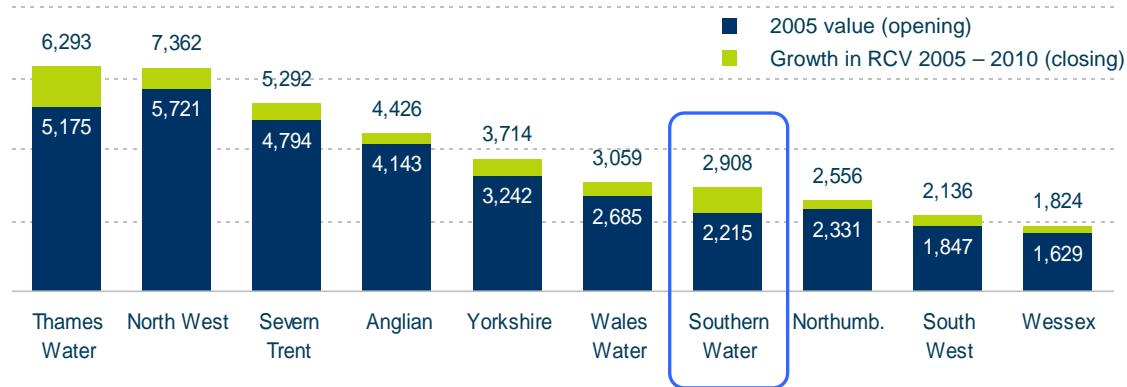
# Service area characterised by coastal waters



Source: Southern Water

# Southern Water is one of 10 UK water & sewerage companies

Opening and Closing Regulated Capital Value (£m, 2003 prices)



<b>Owner</b>	Kemble Water	United Utilities	Severn Trent	Osprey	Kelda	Co-op	Greensands Consortium	NWG	Pennon	YTL
<b>Date Acquired</b>	2006	-	-	2006	-	2001	2007	-	-	2002
<b>Listed</b>	No	Yes	Yes	No	Yes	No	No	Yes	Yes	No

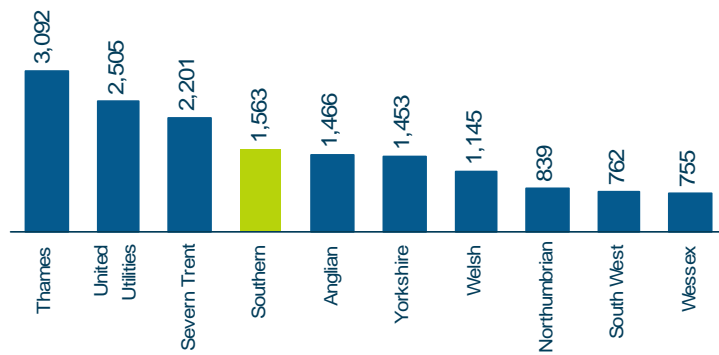
Source: Ofwat Final Determination

# Regulation is a known quantity

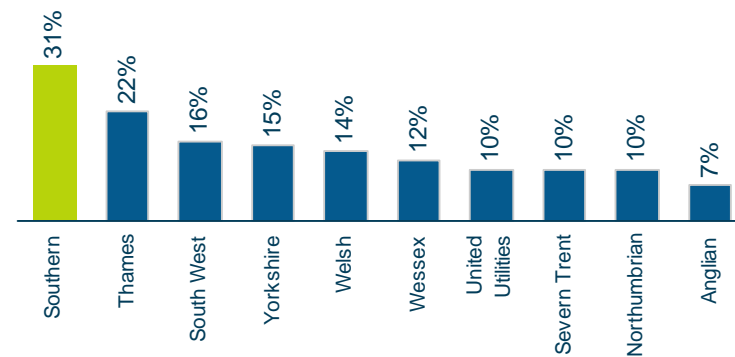
Overview	Comment
Regulatory period	<ul style="list-style-type: none"> <li>5-yearly resets allow for re-alignment of both business and financial costs with market prices</li> </ul>
Price setting	<ul style="list-style-type: none"> <li>Prices for each regulatory period determined using a 'building block' approach</li> <li>Annual tariff adjustment using an RPI-K formula</li> <li>In certain circumstances, intra-period changes to a Determination are allowed</li> </ul>
K-factor	<ul style="list-style-type: none"> <li>Annual average change in prices (can be positive or negative)</li> </ul>
Regulatory capital value (RCV)	<ul style="list-style-type: none"> <li>Adjusted on an annual basis as a result of investment, depreciation and indexation</li> <li>Capital grants or customer contributions are deducted</li> <li>One-off adjustments to RCV at each periodic review are termed log up or log down</li> </ul>
Cost of capital (WACC)	<ul style="list-style-type: none"> <li>WACC is calculated for the industry overall</li> <li>Industry cost of debt utilised</li> </ul>
Capital expenditure	<ul style="list-style-type: none"> <li>Above ground maintenance non-infrastructure (MNI) is paid for through current cost depreciation (CCD); CCD is deducted from RCV but included in the building blocks</li> <li>Infrastructure renewals expenditure (IRE) on the below ground network is averaged over a 15-year period and called the infrastructure renewal charge (IRC); this is included in RCV</li> </ul>
Tax allowance	<ul style="list-style-type: none"> <li>Calculated on a company-specific basis</li> </ul>
Incentives/penalties	<ul style="list-style-type: none"> <li>Outperformance implies outputs are achieved at a lower cost but not to the detriment of quality</li> <li>Efficient under spend can be retained for 5 years from year achieved</li> </ul>

# 2006-2010 Final Determination: key points

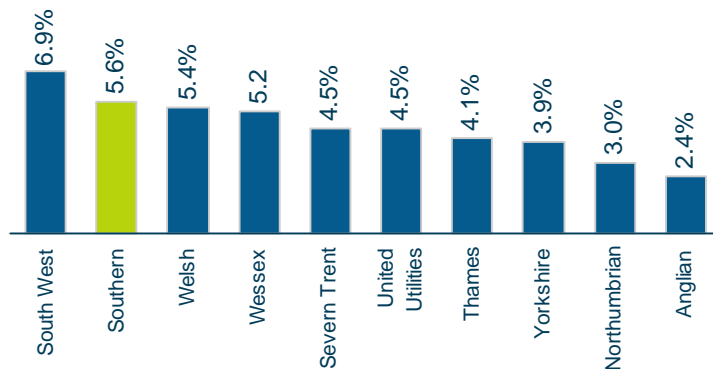
Real Allowed Capex Spend (£m)



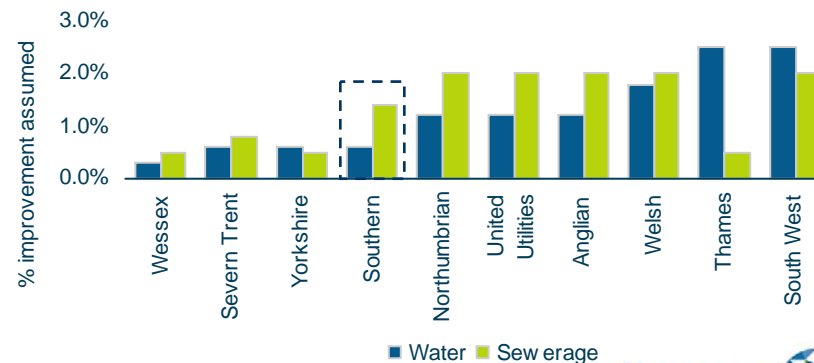
Real RCV Growth (2006-2010)



Real Annual Price Limits (2006-2010, %)



Average Annual Opex Efficiency (%)



Source: Ofwat Final Determination

■ Water ■ Sewerage

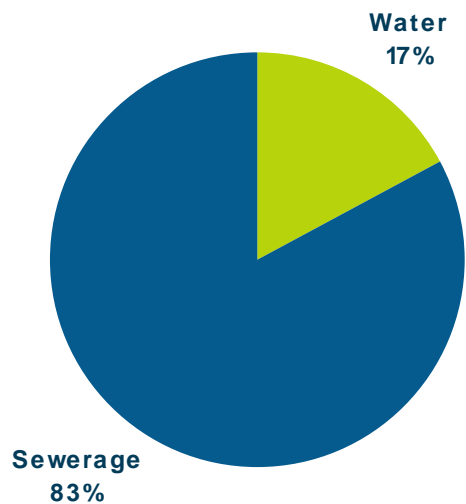


# Limited factors affect regulated revenue

Factor	Comment
Volume	<ul style="list-style-type: none"> <li>• Volume risk only exists with metered domestic and non-domestic customers</li> <li>• ~ 1.04m properties with water – 30% metered domestic properties and 7% non-domestic properties</li> <li>• ~ 1.79m properties with wastewater – 97,000 non-domestic properties</li> </ul>
Extreme weather	<ul style="list-style-type: none"> <li>• Water bans and changed customer usage may impact volumes</li> <li>• Southern estimates lost revenues of £14m in FY06 and FY07, 1.3% of revenues</li> <li>• Fundamental changes in usage are considered at each review in volume assumptions</li> </ul>
Competition	<ul style="list-style-type: none"> <li>• Only large users (&gt; 50 ML p.a) are able to switch suppliers</li> <li>• Southern only has 62 customers &gt;50 ML p.a and to date none have switched</li> <li>• Non-domestic customers represent c4% of revenues which is lower than most large UK water companies</li> <li>• Top 10 commercial customers represented 1% of FY07 revenue</li> </ul>
Inset appointments	<ul style="list-style-type: none"> <li>• Only granted on a greenfield site or to a large user of water and/or sewerage services within an existing Regulated Company's area or where the incumbent Regulated Company consents to the variation</li> <li>• Only 14 inset appointments have been granted in the UK</li> </ul>
Customers switching to meters	<ul style="list-style-type: none"> <li>• Anecdotal evidence suggest potential reduction in consumption upon switching to meters (of up to 10% according to the company)</li> <li>• Mitigated by studies by management showing initial drop reverses as measured bills are on average lower</li> <li>• Ofwat forecasts switching and has stated price limits need to reflect this</li> </ul>
Annual rebalancing	<ul style="list-style-type: none"> <li>• Companies are allowed to annually rebalance within the tariff basket whilst keeping within the overall K adjustment</li> </ul>

# On track to deliver capex program for current regulatory period

## Capital expenditure (net)<sup>1</sup> – 2006-2010



5 year total (2003 prices) = £1,563m

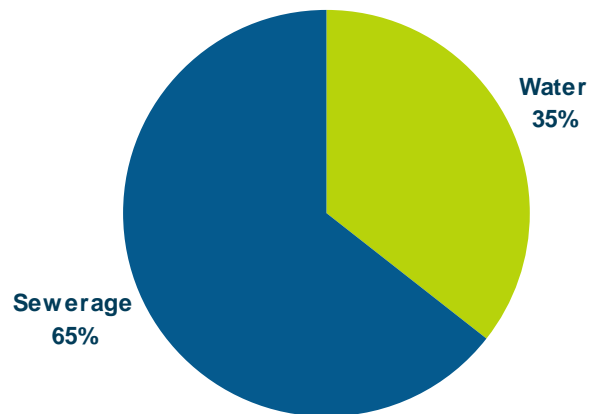
- On track to deliver capex program, excluding Brighton and Hove
- Successful outsourcing arrangements in place for >50% of capex program
  - 42% of capex subject to Single Entity Contracts which cover 255 standalone project with values between £1-5 million
  - Utility Service Contracts comprise small scale works up to £100,000 each
- Excellent relationship with contractors
- Opportunities to agree targeted 'early start' investment with Ofwat in FY09 and FY10
- ~£500m of capex remains to be funded for this regulatory period
  - Strong operating cashflow generation and ~£330m of cash on acquisition
  - Capex facilities available: £180 million capacity, of which £130 million is drawn

Source: Ofwat

1. Capital expenditure is net of grants and customer contributions

# Southern Water benefits from operating efficiencies

## Operating expenditure – 2006-2010



Annual average (2003 prices) = £175m

- Retained efficiencies (opex and capex) are included as part of the building blocks
- Companies are rewarded for efficiency and quality of service to customers
- Savings attributable to efficiency can be retained for 5 years
- Ofwat utilises “comparative competition” data to benchmark the best performers in the industry
- Companies are assessed across four categories
  - Operational expenditure and capital maintenance
  - Water supply and sewerage services

Source: Ofwat

# Regulatory agenda: key issues

Issue	Comment
Cost of capital	<ul style="list-style-type: none"><li>• Balance need for significant capital expenditure against community objectives</li></ul>
Capital expenditure	<ul style="list-style-type: none"><li>• Significant capex program likely to continue given EU environmental initiatives and population growth in the south east of England</li></ul>
Competition	<ul style="list-style-type: none"><li>• Ofwat has power to grant water licences to encourage competition</li><li>• Competition introduced in the servicing of large customers (50 Mld)</li><li>• Southern Water has a lower proportion of non-household revenues than other WaSCs</li></ul>
Customer service	<ul style="list-style-type: none"><li>• Ofwat may either fine companies or reduce tariffs through adjustment to OPA score to penalise companies for poor performance</li><li>• Southern Water rates highly on a number of OPA metrics (e.g. leakage)</li><li>• Customer services issues have been addressed</li></ul>

# Non-regulated activities

- Non-regulated activities included non-appointed activities that form part of the regulated business and other activities that do not form part of Southern Water's regulated asset base
- Non-regulated activities typically account for around 1% of total consolidated EBITDA

Business	Description
Folkestone & Dover	<ul style="list-style-type: none"> <li>• Water only company - 25% equity interest</li> <li>• Purely financial (non-operating) interest</li> <li>• Although regulated, investment does not form part of Southern Water's regulated asset base</li> </ul>
Property	<ul style="list-style-type: none"> <li>• Potential upside from rationalisation of surplus sites and consolidation of sites</li> </ul>
Land searches	<ul style="list-style-type: none"> <li>• Provided to customers when purchasing property to identify the location of mains and sewers</li> <li>• Growth expected through introduction of Home Information Packs</li> </ul>
Homeserve	<ul style="list-style-type: none"> <li>• Commission earned when customers take up insurance against damage to water appliances and associated equipment with Homeserve</li> </ul>
Other	<ul style="list-style-type: none"> <li>• Includes rechargeable and commercial works and developer agreements</li> </ul>

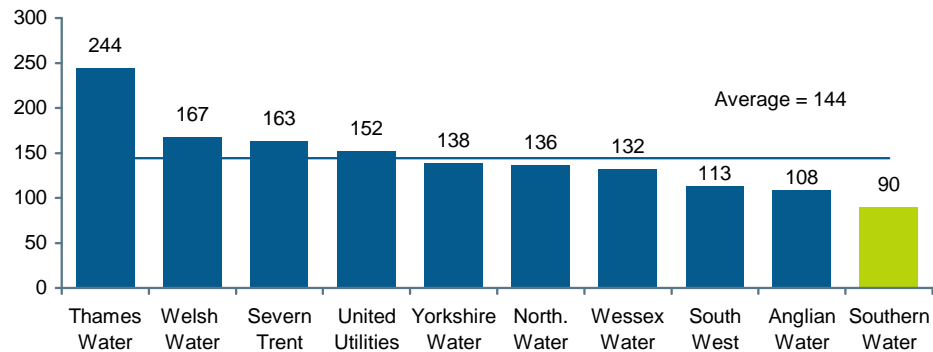
# 3. Operating and Financial Performance

Les Dawson, Chief Executive Officer, Southern Water

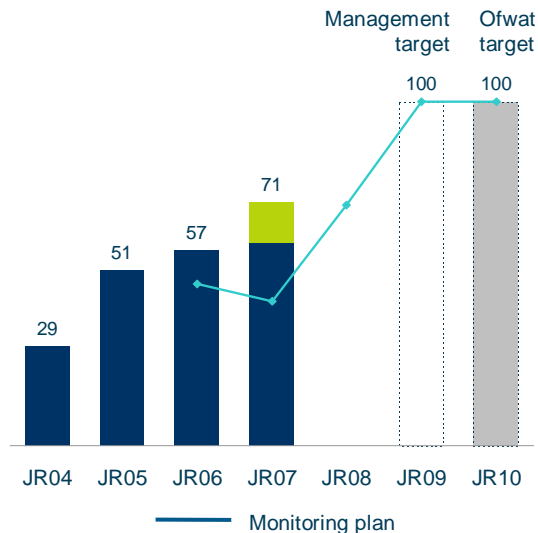


# Southern Water is well placed on key operational metrics

Total leakage comparison of WaSCs (litres/property/day)



Security of Supply Index



- Overall performance assessment (OPA) score is reflected in the K factor
  - One off adjustment to revenues at each price review
  - Southern Water had a zero adjustment at the 2004 review
- OPA measures performance across
  - Customer services
  - Water supply and water quality
  - Sewer flooding
  - Water pressure and interruptions
  - Pollution incidents
  - Sludge disposal
  - Leakage
- Small adjustment expected in 2009 due to customer services issues of £8.3m, which is equivalent to 1.6% of revenues

# Solid financial performance

- FY2006 marked the first year of the current regulatory period, and reflects allowances received in the current price determination
- Consistent EBITDA margin improvement as a result of sales growth and operating cost efficiencies
- Management has identified property surplus to operations; targeted divestment program is expected to continue until 2013, with the majority of proceeds received by 2010

Year ended 31 March (£m)	2005 Actual	2006 Actual	2007 Actual	2008 Forecast
Regulated revenue	468	534	567	618
Non-regulated revenue	7	8	9	7
<b>Total revenue</b>	<b>475</b>	<b>542</b>	<b>576</b>	<b>625</b>
Operating expenditure <sup>1</sup>	(178)	(182)	(174)	(198)
Other income <sup>2</sup>	3	9	19	30
<b>Consolidated EBITDA</b>	<b>301</b>	<b>368</b>	<b>421</b>	<b>456</b>
<i>Revenue growth (%)</i>	<i>4.4</i>	<i>14.1</i>	<i>6.3</i>	<i>8.5</i>
<i>EBITDA growth (excluding property sales)(%)</i>	<i>6.4</i>	<i>20.1</i>	<i>6.4</i>	<i>11.5</i>
<i>EBITDA margin (excluding property sales)(%)</i>	<i>62.7</i>	<i>66.2</i>	<i>69.3</i>	<i>68.2</i>

Source: Southern Water audited accounts (historical) and consortium (forecast)

1. Does not include exceptional expense recorded by Southern Water relating to the provision for Ofwat fine, expected to be paid in 2009FY

2. Property sales surplus to operations (regulated capital value is reduced by 50% at the following review period)

Note: Consolidated EBITDA calculation contains rounding error

# On track to meet 2008FY targets

- The profits earned in the period since acquisition are broadly in proportion to the profits earned for the year to date

Year to date performance (unaudited) (£m)	15 Oct 2007 - 31 Dec 2007 <sup>1</sup>	1 April 2007 – 29 Feb 2008 <sup>2</sup>
Regulated revenue	128	562
Non-regulated revenue	2	8
<b>Total revenue</b>	<b>130</b>	<b>570</b>
Operating expenditure	(40)	(182)
Other income <sup>3</sup>	-	8
<b>Consolidated EBITDA</b>	<b>90</b>	<b>396</b>
<i>EBITDA margin (excluding property sales) (%)</i>	68.6%	68.0%

1. From ownership to CIF half year results
2. Southern Water's year end is March
3. Surplus property sales

# 4. Capital Structure

Les Dawson, Chief Executive Officer, Southern Water



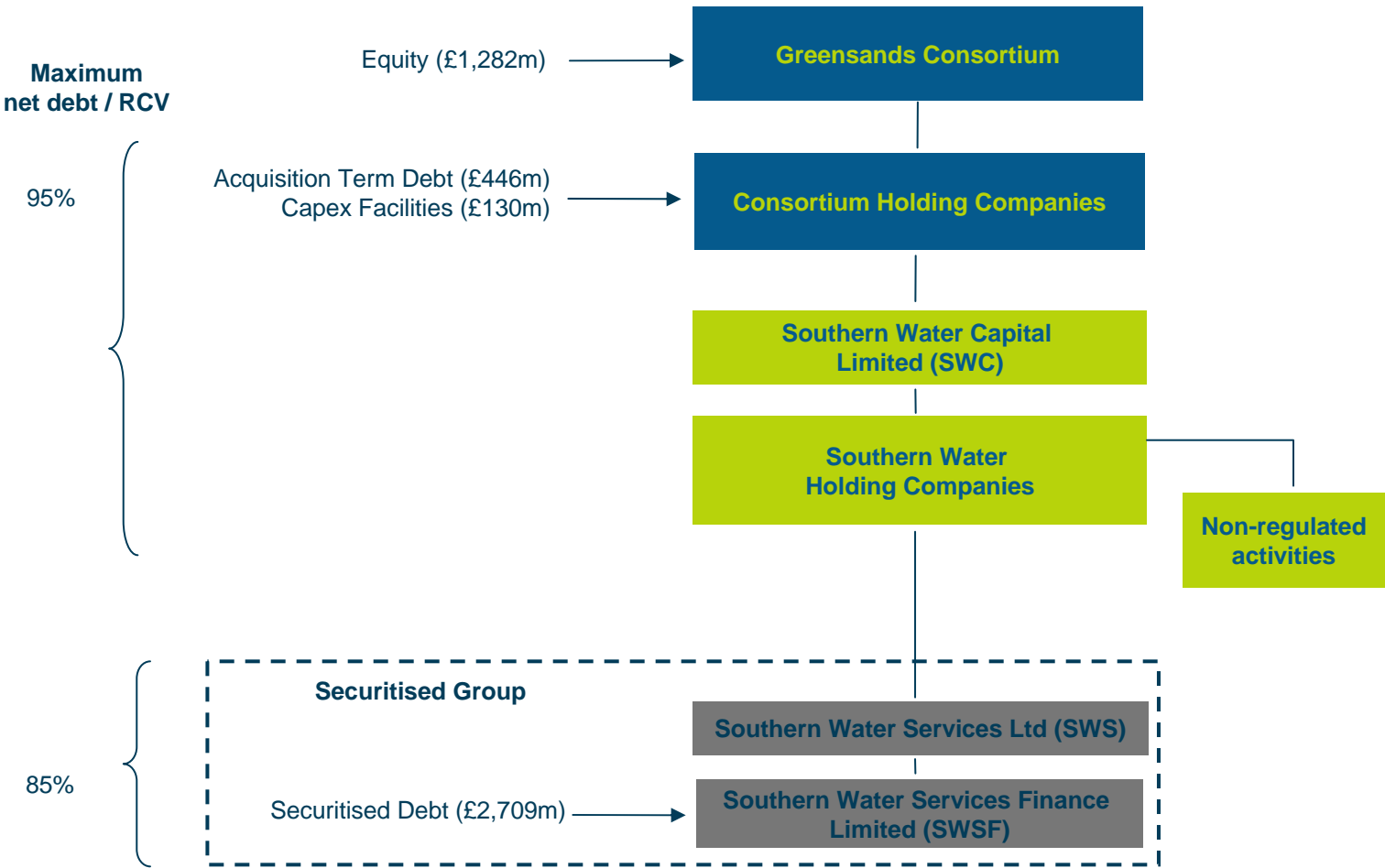
# Capital structure in line with peers

£m	At acquisition	Change	At 31 Dec 2007
<b>Equity</b>	<b>1,126</b>	<b>156</b>	<b>1,282</b>
Securitised Debt	2,700		2,709
Acquisition Debt			
Senior Debt	350	-	350
Junior Debt	226	-	226
Total Acquisition Debt	576	-	576
Subordinated Debt (toggle)	156	-156	-
<b>Total Debt</b>	<b>3,432</b>	<b>-</b>	<b>3,285</b>
<b>Enterprise Value</b>	<b>4,558</b>	<b>-</b>	<b>4,567</b>
Cash	327	20	347
<b>Gearing<sup>1</sup></b>	<b>73.4%</b>	<b>-</b>	<b>69.6%</b>

- At acquisition, existing securitised Opco debt of £2.7 billion remained in place and additional debt of £574 million was raised
- Securitisation structure provides for flexible financing
  - Up to 85% net debt/RCV at operating level
  - Up to 95% net debt/RCV at holding company level (up to 90% senior and 95% junior)
- Subordinated (toggle facility) refinanced with equity in December 2007
- Opco ratings of A-/A3/A- (S&P/Moody's/Fitch) reaffirmed at acquisition

1. Net debt/(net debt plus equity)

# Flexible financing structure



Consortium holding companies
  Southern Water holding companies
  Operating companies

Note: all financial data represents drawn amounts as at 31 December 2007 25



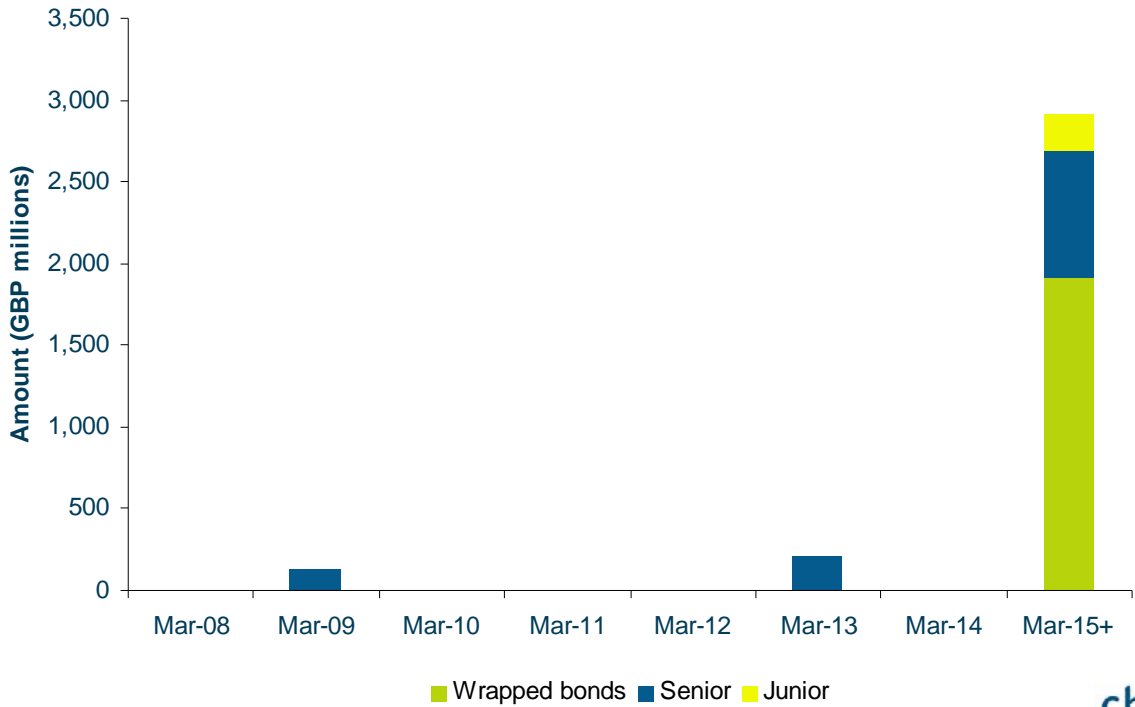
# Low cost funding locked in

- Index-linked debt and swaps provides for low cost funding
  - Average cash cost of debt across all tranches is ~ 4.5%

Type	Available (£m)	Drawn (£m)	Ranking	Maturity (years)	Hedged
<b>Securitised Debt</b>					
Index-linked bond	1,600	1,600	Senior	15-50	Yes
Nominal bond	1,100	1,100	Senior	15-50	Yes
<b>Acquisition Debt</b>					
Term facility	240	134	Senior	1.5	Yes
Term facility	156	156	Senior	5	Yes
Capex facility	110	110	Senior	5	Yes
Term facility	156	156	Junior	7	Yes
Capex facility	70	70	Junior	7	Yes
<b>Total</b>	<b>3,432</b>	<b>3,326</b>			

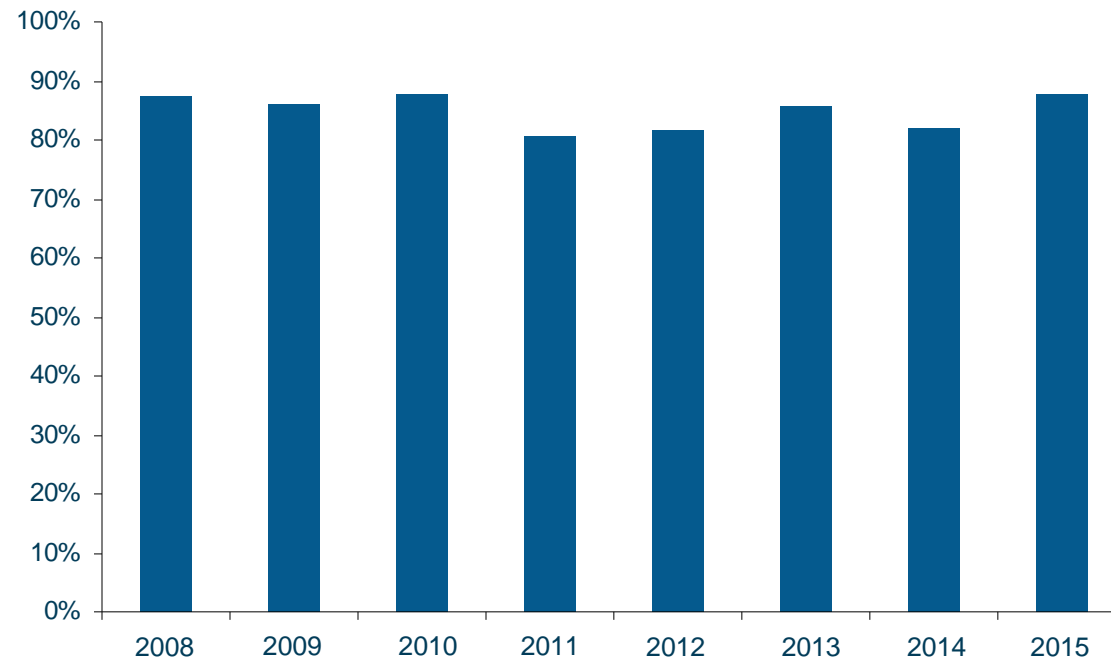
# Debt maturity profile

- ~90% of debt matures beyond 2015
  - Long-dated debt with average maturity of ~27 years
- First refinancing event for Southern Water is the bridge facility (£134m) payable in April 2009
- First tranche of wrapped debt not due for refinancing until 2018
  - ~60% of total debt is wrapped by MBIA and FSA
  - Under securitisation program, no impact on pricing if insurer is downgraded



# Rates are substantially fixed through hedges

- Hedging strategy minimises financial risk and improves headroom on financial covenants
  - Securitised debt is hedged to at least 85% to 2010 and 70% to 2015
  - Acquisition debt hedged using 30-year index-linked swaps
    - Variable nominal rate swapped for a fixed real rate



# Questions

# Contacts

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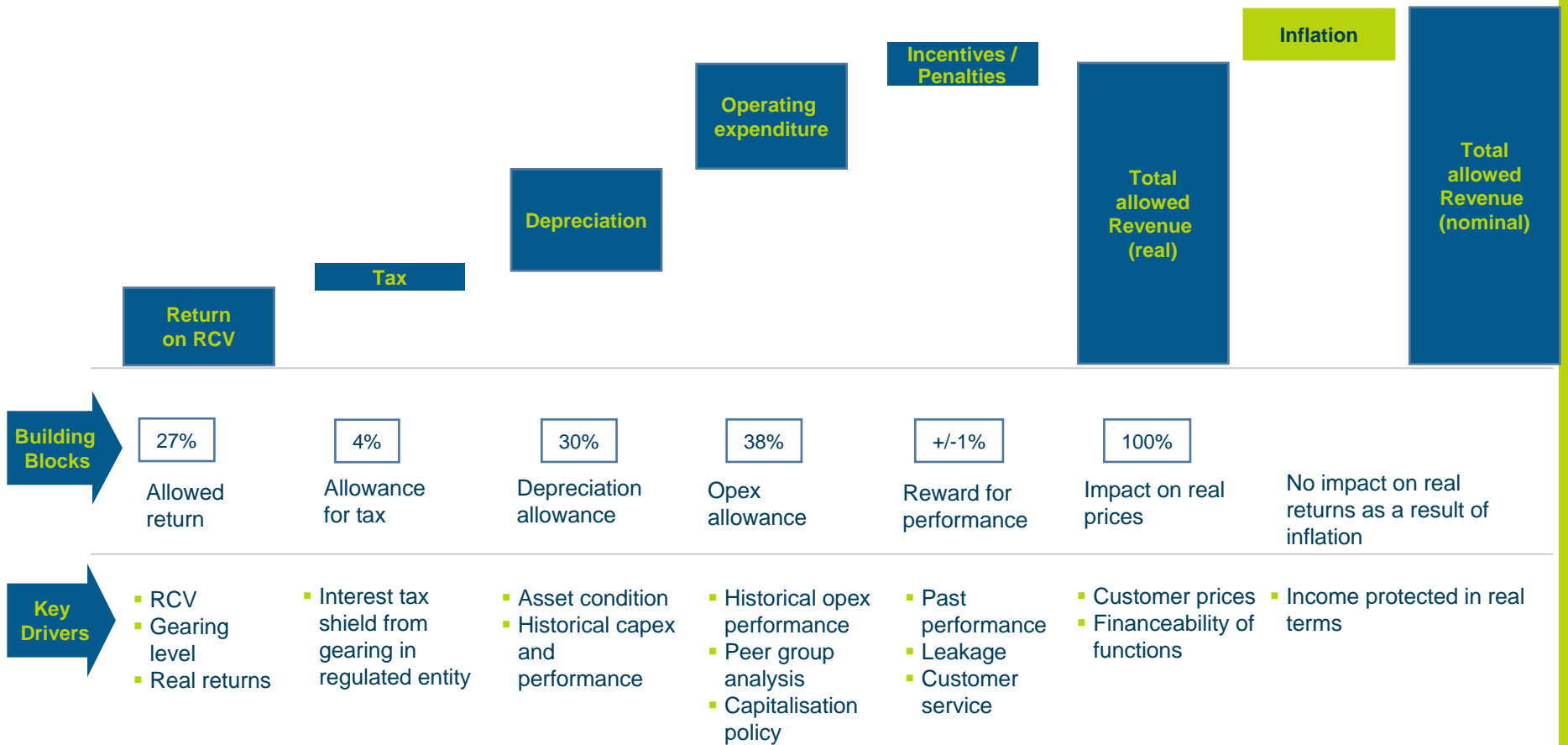
# Appendix A: Regulatory Overview

# Overview of UK water sector

Issue	Description
<b>Industry structure &amp; participants</b>	<ul style="list-style-type: none"> <li>• Industry comprises 10 water and sewerage companies (WaSCs) and 12 water only companies (WOCs) in England and Wales</li> <li>• Scotland and Northern Ireland have different structures</li> </ul>
<b>Company structure</b>	<ul style="list-style-type: none"> <li>• Companies are vertically integrated, owning water resources (boreholes/reservoirs), water treatment plants, distribution networks and supply activities (eg. customer billing) and treatment plants for sewerage</li> </ul>
<b>Legal framework</b>	<ul style="list-style-type: none"> <li>• Principal legislation is the <i>Water Industry Act 1991</i> (as amended by <i>Water Act 2003</i>)</li> <li>• Each company has an instrument of appointment (licence) which contains the terms of its appointment as a water undertaker; rolling 25-year licence</li> </ul>
<b>Economic regulatory framework</b>	<ul style="list-style-type: none"> <li>• The economic regulator is the Water Services Regulation Authority (Ofwat)</li> <li>• Prices for the provision of water and sewerage services are determined by Ofwat at five yearly intervals according to an RPI +/- K formula</li> <li>• Final Determination published in December 2004 for the fourth price control period, 2005-2010</li> </ul>
<b>Other regulatory authorities</b>	<ul style="list-style-type: none"> <li>• The Drinking Water Inspectorate (DWI) in respect of water quality standards</li> <li>• The Environmental Agency (EA) in respect of general environmental laws</li> <li>• Consumer Council for Water (CCW) – a new consumer body with statutory powers</li> <li>• The Office of Fair Trading, the Competition Commission and the European Commission in respect of anti-trust issues</li> </ul>

# Revenue building blocks

Average for all WaSCs (2005-2010)



Source: Ofwat Final Determination

# Building blocks and revenue

Year ending 31 March (2003 avg prices)	2006	2007	2008	2009	2010	Calculation
Opening RCV	2,185	2,294				A
- Depreciation	(144)	(154)				
+ Regulated Capex	240	376				
+ Regulated Infrastructure Renewals Expenditure (IRE)	40	43				
- Infrastructure Renewals Charge (IRC)	(36)	(36)				
+ Capex clawback	9	9				
<b>Closing RCV</b>	<b>2,294</b>	<b>2,531</b>				<b>B</b>
Average RCV	2,239	2,412				$C = (A+B)/2$
Vanilla WACC <sup>1</sup>	5.8%	5.8%				D
Revenue inflation index	1.09	1.12				E
<b>Building Blocks (Current year prices)</b>						
Return on RCV	142	156				$F = C*D*E$
Regulated Opex	187	190				
Current Cost Depreciation (CCD)	156	171				
Infrastructure Renewals Charge (IRC)	40	41				
Tax Wedge	11	15				
Financeability adjustment	0	0				
Other <sup>2</sup>	(1)	(5)				
<b>Regulated Revenue</b>	<b>534</b>	<b>567</b>	<b>618</b>	<b>674</b>	<b>725</b>	

1. Pre-tax cost of debt and post-tax cost of equity

2. Including working capital and other reconciling items

Note: Some calculations contain rounding errors

# Transparent consultation process



	Phase 1 (year 3)	Phase 2 (year 4)	Phase 3 (year 4 / year 5)	Phase 4 (end of year 5)
<b>Description</b>	<ul style="list-style-type: none"> <li>▪ Framework and Issues</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assessment of draft business plans and market research</li> </ul>	<ul style="list-style-type: none"> <li>▪ Decisions and determinations</li> </ul>	<ul style="list-style-type: none"> <li>▪ Implementation of price limits and evaluation of periodic review</li> </ul>
<b>Timing</b>	<ul style="list-style-type: none"> <li>▪ Mid 2007 – mid 2008</li> </ul>	<ul style="list-style-type: none"> <li>▪ Mid 2008 – early 2009</li> </ul>	<ul style="list-style-type: none"> <li>▪ Mid 2009 – end 2009</li> </ul>	<ul style="list-style-type: none"> <li>▪ Early 2010</li> </ul>
<b>Issues and publications</b>	<ul style="list-style-type: none"> <li>▪ Consultation period</li> <li>▪ Ofwat approach to periodic review</li> <li>▪ Reporting requirements for draft plans</li> <li>▪ Release financial models</li> <li>▪ Initial feedback on cost assumptions</li> </ul>	<ul style="list-style-type: none"> <li>▪ Company meetings</li> <li>▪ Draft business plan submissions to Ofwat</li> <li>▪ Publish results of joint customer research</li> <li>▪ Ministers provide guidance on required quality program and other social objectives</li> </ul>	<ul style="list-style-type: none"> <li>▪ Companies submit and publish final business plans</li> <li>▪ Draft Determinations published for consultation</li> <li>▪ Companies meet with Ofwat and ministers add opinion</li> <li>▪ Final Determinations published in Dec 2009</li> </ul>	<ul style="list-style-type: none"> <li>▪ Companies have two months to accept or challenge price limits by reference to Competition Commission</li> <li>▪ New price limits come into effect on 1 April 2010</li> </ul>



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