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By email

Leigh Harrison
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Dear Leigh

Investment into Southern Water

Ofwat welcomes the announcement of the new £1.073 billion investment into the Greensands group which owns Southern Water. We understand the investment will be held in a fund invested in 'super-core' regulated infrastructure which will be advised and represented by Macquarie Asset Management. The investment includes at least £530 million to be invested as new equity into Southern Water, the regulated company. The remaining funds will be used to begin to sort out the vulnerable financial position of Southern Water's holding companies. We have welcomed the engagement with bidders over recent months, and over recent weeks with you and your team as you have finalised the transaction.

We have long been clear, including to the existing shareholders, that very profound changes are required, and much overdue, to improve company performance and to strengthen the financial position of Southern Water. We are pleased to note that you accept that position too.

The Crown Court £90m fine on 9th July, which is additional to the penalty and rebates of £126m resulting from Ofwat's enforcement action in 2019, further reinforces how badly Southern Water has failed its customers, its duties to the environment, and its stakeholders in the past. This reflects performance that pre-dates your ownership. We're pleased to see that you will adopt an attitude of zero tolerance to environmental pollution. And we welcome your intention to support and drive the turnaround of Southern Water's performance, which you've backed with £230 million investment (part of the £530 million equity to be injected into Southern Water) for projects which Southern Water believes will put it in a good place for the start of PR24.

You have recognised that Southern Water's customers deserve better service, and you have set out your ambition for Southern Water to be a well performing business in the next regulatory period and for the company to be able to operate in line with Ofwat's expectations for the whole sector. We appreciate that some aspects of the turnaround may continue into the early years of AMP8, but you expect the turnaround to have made very substantial progress over the rest of AMP7.

While Ofwat doesn't approve or endorse individual initiatives, we are supportive of the direction of travel of the actions you are proposing. We would like to see more ambition in all the targets, in particular on environmental performance and we expect to review these with you within six months, post-completion, when you will be in a position to firm up what is attainable. We need to see the company, with this new investment and a fresh approach from you as new owners, be successful in delivering the turnaround and the much-improved performance that it needs on all fronts. We are encouraged to have heard from you that the Fund is invested for the long term in regulated and similar assets.

From completion, you will assume full responsibility for the company. Southern Water will continue to be accountable for its performance, including against the targets set in PR19. Customers pay less when these targets are not met. As you have recognised, Southern Water has not delivered the service that its customers deserve and has underperformed over a long period. Poor performance is never acceptable for customers, and it is important to recognise that companies have been funded through successive price reviews to meet their statutory and regulatory obligations, including to maintain and improve their infrastructure. Where companies have fallen behind, they remain accountable for catching up. PR24 will address the new forward-looking challenges facing the sector.

In recent years we, and the sector, have made progress in reducing complexity in group structures and in ensuring that the returns that investors earn are more closely linked to the performance of the regulated company for customers. You have confirmed that you support these aims.

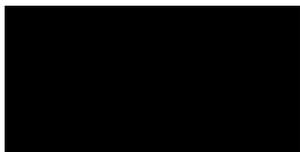
We recognise your desire to see progress in delivery of the turnaround plan rewarded. We recognise that you may accept dividends over the remainder of this AMP only where the company is delivering the turnaround well and you have created capacity for these distributions through the flexibility from your initial equity injection into Southern Water. We also note that you have made your intentions clear that distributions during AMP7 will be below a 4% return on actual equity.

A further Ofwat innovation of recent years has been our Board Leadership and Governance programme. You have indicated your support for the programme and we have discussed the time limited arrangements that are feasible for a company in turnaround, where more active investor engagement is called for. You have highlighted the comments in the recent court judgment about challenging investors to take a more active role in making sure that companies fulfil their duties, which we agree applies particularly in a business turnaround.

However, the track record in the sector over the last 15 years has also demonstrated that there needs to be a balance between engaged equity and the independent governance of the regulated company. We are pleased that in our discussions on board leadership you have recognised the need to strike a balance in this turnaround situation. We also acknowledge your support for the removal of inter-company loans in accordance with good regulatory practice.

You won't be surprised that we will be monitoring the performance of the company closely and we very much look forward to a much-improved position when Southern submits its PR24 plans to us. To re-iterate, however, we welcome the investment and business drive to which you have committed and look for swift progress as and when you take control.

Yours sincerely



Jonson Cox
Chair, Ofwat