

Macquarie Group of Companies

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9 August 2021

Jonson Cox
Chair, Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA



Investing in Southern Water's long-term transformation

Dear Mr. Cox,

I'm writing to confirm that a fund (managed by Macquarie Asset Management) (the "Fund"), signed an agreement today which will result in its acquisition of a majority stake in Greensands Holdings Limited, a company which ultimately owns Southern Water Services Limited ("Southern Water" or the "Company"). I want to thank you for the constructive and extensive engagement our team has had with Ofwat over the recent weeks preceding this agreement.

The UK's water networks continue to require significant investment to upgrade ageing infrastructure and meet challenges from climate change and population growth. As we have discussed, customers of UK water companies are entitled to have high expectations for the essential delivery and maintenance of water and wastewater services in local communities.

However, Southern Water has struggled to meet the challenges of Ofwat's 2014 and 2019 regulatory reviews and has been the subject of repeated regulatory intervention. The most recent of these settlements demanded a step change in the Company's performance to demonstrate far greater focus on delivering value to customers, the public, and the environment.

Furthermore, historical environmental pollution incidents represented unacceptable failings by the Company and culminated in a record fine in the recent crown court sentencing. These cases and other areas of the Company's poor performance highlight the need for faster improvement and change. The unauthorised activities and their impact on customers and the environment do not reflect our goals or values, nor are they consistent with any company entrusted with public and environmental responsibilities. We believe the current management team are committed to improving performance across the board and would all like to see this happen as quickly as possible.

The Fund, combined with Macquarie Asset Management's expertise, believes it can accelerate the transformation of the Company's operations. We agree with the Company's management, board, and existing shareholders that Southern Water must complete an intensive transformation over the remainder of AMP7 and into the beginning of AMP8 to achieve the performance standards which Ofwat and Southern Water's customers rightly

Head Office: 50 Martin Place, Sydney, New South Wales 2000, Australia.

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expect. Southern Water's network needs to be more sustainable and resilient, and its wastewater systems must be robust enough to protect the local environment.

Alongside a continued focus on maintaining and improving the health of the existing network, future challenges will also require Southern Water's asset condition to be improved further, and we look forward to working with you on this topic in PR24.

In developing our plan, we have benefited from detailed engagement with Southern Water's management and its advisers, and we have appreciated the time Ofwat has given to discussions on our future intentions for Southern Water. The Fund comprises long-term institutional investors such as pension funds and insurance companies. In representing these investors, the Fund intends to provide the funding and focus required to realise the urgent transformation in Southern Water by adopting a long-term approach. This significant investment will allow Southern Water to access the resources it needs to improve its performance, financial resilience, and relationship with its customers.

Intentions for and governance of Southern Water

Through its due diligence of Southern Water on behalf of the Fund, Macquarie Asset Management has affirmed the priority actions that Southern Water needs to undertake, with the support of its management team.

The recent environmental cases are distressing to read and there are further investigations ongoing by the Environment Agency regarding performance issues which occurred in that period. Whilst we might say it was under the prior regime, we all acknowledge performance improvement going forward is the focus. We were nonetheless pleased to note the remorse of Southern Water's current management and board for these issues on behalf of the Company. We share their commitment to improve and will support the Company's full cooperation with this important work in an open and transparent manner.

Despite near-term actions to put the performance of Southern Water on an improving path, there may continue to be operational failings until Southern Water's transformation plan takes full effect. However, the frequency and extent of these failings must reduce. This does not change the investigations or processes that still need to run their full course.

The plan to enable the transformation of Southern Water is bold and includes both immediate and long-term intentions:

- The Fund will inject over £1 billion of new equity into Southern Water and its holding companies to recapitalise the ownership structure and make it financially resilient, with none of these proceeds being paid out to existing shareholders.
- This capital injection includes the funding of a circa £230 million upgrade to the infrastructure of Southern Water, which management believes is critical to improving the quality and resilience of water and wastewater services, including to ensure regulatory compliance and both minimise and manage pollution incidents more effectively.
- Southern Water will adopt a sustainable financing strategy and, whilst the transformation plan is taking effect, a conservative distribution policy. The equity injection will provide additional liquidity and make provisions for fluctuations in Southern Water's operational performance. These cash provisions will only be released as distributions to the Company's shareholders as progress is made in delivering operational transformation. Furthermore, the Fund will undertake that these distributions will be below a 4% yield in each year to March 2025.

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- Southern Water's board and committees will continue to conform to good leadership and governance principles. They will retain sufficient independent membership to ensure Southern Water can make decisions in the interests of its customers and other stakeholders. We note the recent court judgement challenged long-term investors to be more present, which we intend to meet whilst respecting the licence provisions and the sector governance guidance. Southern Water will continue considering and reporting executives' pay in line with Ofwat's published expectations and its governance principles and appropriate to the Company's performance, including against its transformation plans.
- Southern Water will honour existing agreements to support its pension deficit funding and will address the remainder of the deficit beyond the pension funding amount included in the PR19 final determination, for the benefit of its scheme members.

We trust that the above, coupled with the public commitment to improve by the Company's management team and board, will address many of the operational shortcomings reported in the recent court judgement. We support the focus the new management team of Southern Water has placed on improving its culture of self-reporting.

Commitment to improving Southern Water's performance

We recognise Ofwat requires water companies to take account of their customers' interests. Therefore, Southern Water's performance will continue to be evaluated against Ofwat's PR19 determination which ends in March 2025, and against subsequent regulatory price controls.

With regard to the existing performance of Southern Water and the intensity of the transformation required, the Fund has, after engagement with the Southern Water management team, confirmed attainable objectives for Southern Water, including:

- **Significant investment:** we will support Southern Water to invest approximately £2 billion over AMP7, of which £230 million is in addition to its regulatory allowances. This investment programme aims to improve Southern Water's treatment works, pumping stations and sewer network which currently cause the most performance issues. This £2 billion investment equates to investing £1,000 per property in Southern Water's customer base.
- **Strengthening a zero-tolerance mindset to environmental pollution:** a commitment to significantly improving Southern Water's environmental track record, which we recognise is one of the worst performing in the UK water sector. The Company is implementing plans to reduce pollution incidents by more than 50% (compared with 2019 pollution incidents) over the next four years. There may be incidents, particularly in the next few years, but we know there will be a very low tolerance for such events amongst management and the board.

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- **Reducing leaks:** via Southern Water's significant investment programme, a commitment to reduce the number of water leaks to move closer to the PR19 ambition.
- **Ensuring affordable customer bills:** during AMP7, a commitment to ensure average water and wastewater customer bills, in aggregate, do not rise by more than inflation. This commitment is in addition to honouring a £123 million customer rebate due to historical incidents.
- **Improving customer service:** an aim to improve Southern Water's customer service from the second worst performing in the UK water sector by addressing the root causes of complaints and enhancing Southern Water's capacity to handle them more effectively.

Macquarie Asset Management and the Fund recognise the need for Southern Water to significantly improve its financial resilience and enhance its operational performance and relationship with its customers. In undertaking this investment, the Fund, on behalf of its underlying investors, will be a responsible long-term steward of Southern Water and believes it can help the Company deliver the transformation it requires.

These intentions and commitments are designed to enable Southern Water to fundamentally become a better company for the benefit of all its stakeholders, customers, and the environment.

Yours sincerely,



Leigh Harrison

Head of Macquarie Infrastructure and Real Assets, part of Macquarie Asset Management
On behalf of the Fund