

By email

Martin Roughead, Director of Regulation
Southern Water
Southern House
Yeoman Road
Worthing
West Sussex
BN13 3NX

25 June 2021

Dear Martin

Proposed Changes to the Financing Structure and Subsidiaries of Southern Water Services Limited

Southern Water Services Limited (“**Southern Water**”) is the holder of an instrument of appointment granted under sections 11 and 14 of the Water Act 1989 (the “Appointment”). Words and expressions defined in the Appointment shall have the same meaning in this letter unless the context otherwise requires.

In a letter dated 23 June 2021 (the “Consent Request Letter”, included as Appendix 1 to this letter), Southern Water has requested our consent in relation to proposed changes to its financing structure pursuant to certain provisions of Condition P of its Appointment.

The purpose of this letter is to record our consent to the specific requests made by Southern Water and to set out any conditions of those consents.

We have not been provided with copies of the relevant revised financing arrangements and in our consideration of the requests for consent, we have relied on the information and assurances contained in the Consent Request Letter. The consents provided in this letter are granted on the basis of the information provided by Southern Water in the Consent Request Letter and our assessment of the specific circumstances of Southern Water at the time.

Accordingly, the consents provided should not be taken as a statement of Ofwat policy as to the provision of consents in other circumstances. Such requests will be considered individually against the guidance we may publish¹.

Background

We note that Southern Water's requests are made in the context of proposed changes to its financing structure. The existing financing structure was implemented in 2003 as part of the refinancing of Southern Water at that time. It comprises Southern Water, its holding companies, SWS Holdings Limited ("**SWSH**"), SWS Group Holdings Limited ("**SWSGH**") and its subsidiary, Southern Water Services (Finance) Limited (the "**Issuer**", and together with Southern Water, SWSH and SWSGH, the "**SWS Financing Group**").

The Issuer has issued bonds (the "**Bonds**") and private placement notes (the "**Notes**") under the existing financing structure of the SWS Financing Group and is also the borrower and principal debtor in respect of certain term facility agreements (the "**Artesian Loans**") and liquidity facilities (the "**Liquidity Facilities**").

The Issuer is a Cayman Island incorporated company within Southern Water's securitisation structure. We understand that Southern Water is proposing to remove the Issuer from the SWS Financing Group and replace it with two new UK incorporated companies:

- i.a newly incorporated UK public limited company (the "**UK Issuer**"), as a subsidiary of Southern Water, to take the place of the Issuer as the issuer, lender and/or principal debtor for the Bonds, USPP Notes and Liquidity Facilities; and
- ii.a newly incorporated UK private limited company (the "**UK DebtCo**"), as a subsidiary of Southern Water, to take the place of the Issuer as the lender and/or principal debtor for the Artesian Loans.



The Consent Request Letter states that the proposed changes reflect Southern Water's desire to simplify its financing structure allowing it to continue to develop consumer and regulator trust and confidence in its business.

In June 2003, we provided consent to certain guarantees and cross default obligations being entered into by Southern Water when the current financing group structure was established. Southern Water is now seeking consent in respect of certain proposed specific guarantees and cross default obligations as set out in the Consent Request Letter, arising out of the proposal to change the financing structure of the SWS Financing Group by replacing the Issuer with the UK Issuer and UK DebtCo. In the event the restructuring is successful and the Issuer is released from its financing obligations, our 2003 consents in relation to the Issuer will cease to apply.

Nature of consents sought

The specific arrangements that Southern Water has requested consent for are as follows:-

- a. Guarantees

Southern Water requests our consent to it guaranteeing the obligations of each of the UK Issuer and the UK DebtCo.

b. Cross-default obligations

Southern Water requests our consent to a new cross-default obligation that applies to it on certain specified events in relation to each of the UK Issuer and the UK DebtCo, which include certain insolvency events arising in respect of the UK Issuer and/or the UK DebtCo, non-payment of amounts due under the Finance Documents (including amounts due under the Bonds, USPP Notes, Liquidity Facilities and Artesian Loans), any other breach of a Finance Document which has a material adverse effect.

The Consent Request Letter confirms the consents requested relate to the proposed changes to the financing structure of the SWS Financing Group and are consistent with the nature of the guarantees and cross-default obligations that we previously granted consent to. The above guarantees and cross default obligations are prohibited without the consent of Ofwat under paragraphs 21.1 and 22.1 of Condition P of the Appointment.

Ofwat's Consent

In accordance with, and for the purposes of paragraphs 21.1 and 22.1 of Condition P of the Appointment and subject to the condition set out below, Ofwat consents to the guarantees and cross-default obligations set out above. As noted, in making our decision we have relied on the information provided by Southern Water in its Consent Request Letter.

For the avoidance of doubt, we note that it is for Southern Water to satisfy itself that, in implementing this restructuring and the particular matters for which we are providing consent, it will remain compliant with its obligations under the Appointment. We do not, in providing this consent, provide any assurance in that respect.

Further, the consents provided in this letter are the only consents granted to Southern Water in respect of the requests made in the Consent Request Letter. Appending the Consent Request Letter to this letter shall not be interpreted as Ofwat consenting to or approving other matters detailed in the Consent Request Letter.

This consent is subject to the following conditions:

- a. that the UK Issuer and the UK DebtCo will each be wholly owned by Southern Water and each have the sole purpose of raising finance on behalf of Southern Water for the purposes of the Regulated Activities;
- b. that there shall be no material changes to the terms of the arrangements described in this letter unless Ofwat's further consent has been obtained for the same;
- c. that once the UK Issuer and UK DebtCo are established and operational, the Issuer will not be used for any future debt issuance; and
- d. that in the event full creditor approval for the substitution of the Issuer with the UK Issuer and UK DebtCo is secured, the Issuer will be removed from the SWS Financing Group at the earliest opportunity.

General Provisions relating to Ofwat's Consent

The consent described above shall take effect from the date of this letter.

Reasons for Consent

Ofwat considers that the consent provided above should be granted because from the information provided, Ofwat is satisfied that the granting of consent is consistent with its statutory duties.

This is on the basis that, as set out in the Consent Request Letter:

- the purpose of these guarantees and cross-default obligations is solely to facilitate the financing of the Appointed Business, such arrangements being confined within the ring-fenced SWS Financing Group and will not result in an increased threat to the financial resilience of the SWS Financing Group compared to the position before the proposed changes;
- the UK Issuer and the UK DebtCo will be established to comply with the licence definition of Financing Subsidiary and will be prevented from carrying on any other activity other than the provision of debt finance to Southern Water
- the proposed changes will not affect Southern Water's ability to meet the requirements of its licence;
- the reorganisation is substantially neutral from a tax, credit rating and gearing perspective;
- the costs of the transaction will not be borne by customers and will be confirmed as such in your Annual Performance Report.

In addition to the above conditions, once the UK Issuer and the UK DebtCo have been incorporated, Southern Water will write to Ofwat confirming the name and company number of each new entity and furnish us with copies of their certificates of incorporation as set out in the consent request letter.

We trust that you will keep us advised of any material changes to the matters or proposals set out in your letter including, without limitation, those which relate specifically to the consents requested and any material change to the basis on which the consent has been granted as set out above.

Yours sincerely



John Russell
Senior Director, Strategy & Planning, Performance & Outcomes

Appendix 1 - Consent Request Letter

Strictly private and confidential

Martin Roughead, Director of Regulation
Southern House
Yeoman Road
Worthing
West Sussex
BN13 3NX

23 June 2020

John Russell
Senior Director of Finance and Governance
Ofwat
21 Bloomsbury St
Fitzrovia
London
WC1B 3HF

Dear John,

Proposed Changes to the Financing Structure and Subsidiaries of Southern Water Services Limited (“SWS”)

I am writing to you about the financing structure of SWS and its subsidiaries, on which we and The Royal Bank of Scotland plc originally corresponded with Ofwat in our letters dated 21 March 2003, 16 April 2003 and 24 May 2003.

In particular, I am writing in relation to proposed changes to the financing structure for which we are requesting Ofwat’s consent. These changes reflect the public commitment made to remove our Cayman Islands incorporated subsidiary that is now unnecessary. Our objective is to deliver a simpler financing structure as part of the drive to increase the transparency of our business and sustain the trust and confidence our customers and Ofwat have in us. The steps we are taking are the conclusion of matters discussed with Ofwat representatives over the past several months.

A considerable amount of preparatory work has been completed by SWS with its advisors. This has included ongoing correspondence with HMRC as well as the three agencies that rate SWS and the debt issued by its subsidiaries. We intend to formally request creditor consent in the near future. Subject to obtaining the requisite consents, this would allow us:

- to inform our customers of this change as part of our broader approach to ensuring transparency and legitimacy;
- to announce clearance to progress the removal of the Issuer in our annual reporting; and
- to remove the Issuer from the financing structure and have it eliminated later this year.

Proposed changes and requested consent

In June 2003, Ofwat provided consent (attached as Annex 1) to the specific guarantees, cross default obligations and inter-company loans entered into by SWS when the current financing structure was established. In substance, we are seeking the same consent in respect of the

proposed changes to the financing structure to meet the commitment to remove the Cayman Islands incorporated subsidiary.

1 Existing financing and corporate structure

As set out in Annex 2, the existing financing structure was implemented in 2003 as part of the refinancing of SWS. It comprises of SWS, its holding companies, SWS Holdings Limited (“**SWSH**”), SWS Group Holdings Limited (“**SWSGH**”) and its subsidiary Southern Water Services (Finance) Limited (the “**Issuer**”, and together with SWS, SWSH and SWSGH, the “**SWS Financing Group**”).

The Issuer has issued bonds (the “**Bonds**”) and private placement notes (the “**Notes**”) under the existing financing structure of the SWS Financing Group and is also the borrower and principal debtor in respect of certain term facility agreements (the “**Artesian Loans**”) and liquidity facilities (the “**Liquidity Facilities**”).

2 Proposed changes to the financing structure

The Issuer is incorporated in the Cayman Islands. The Issuer has been solely resident for tax purposes in the UK since its incorporation as it has always been centrally managed and controlled solely in the UK. Its primary purpose was to help establish the financing structure for the SWS Financing Group. However, the historic technical corporate law requirements for using a Cayman Islands incorporated company are no longer relevant.

In response to customer and Ofwat’s concerns about water companies using complex corporate structures and offshore companies, SWS has decided to simplify its financing structure by removing the Issuer from the SWS Financing Group. SWS believes that taking this action will allow it to continue to develop consumer and regulator trust and confidence in its business.

The creation of a newly incorporated UK public limited company (the “**UK Issuer**”), as a subsidiary of SWS, to take the place of the Issuer as the issuer, lender and/or principal debtor for the Bonds, USPP Notes and Liquidity Facilities. The intention is for the UK Issuer to be a securitisation tax company and, as such, there are limitations on the activities and types of debt instruments it can participate in (one of which is that it cannot have loans, such as the Artesian Loans). Therefore an additional newly incorporated UK private limited company (the “**UK DebtCo**”) will be created, as a subsidiary of SWS, to take the place of the Issuer as the lender and/or principal debtor for the Artesian Loans to complete the proposed changes for the new financing structure. These are summarised diagrammatically in Annex 3.

The requisite creditor consents for the proposed changes can be summarised as a consent for the UK Issuer and the UK DebtCo to accede to the legal agreements that underpin the current financing structure and, separately, consents for the UK Issuer to be substituted in place of the Issuer as the issuer, lender and/or principal debtor for the Bonds, USPP Notes and Liquidity Facilities and for the UK DebtCo to be substituted in place of the Issuer as the lender and/or principal debtor for the Artesian Loans.

The proposed changes will include:

- (a) The incorporation of the UK Issuer and the UK DebtCo.

- (i) The UK Issuer and the UK DebtCo will be established to comply with the definition of a financing subsidiary specified in Condition A3 and their Articles of Association will comply with the requirements in that condition.
 - (ii) The UK Issuer will meet the criteria for a single purpose company established from time to time by the Rating Agencies (although the UK DebtCo will not be required to do so given that it is not expected to raise rated debt).
 - (iii) The UK Issuer and the UK DebtCo will each be both managed and tax resident solely in the UK. Once it is party as debtor to one or more tranche of Bonds, the UK Issuer will be a securitisation company (as defined in the Taxation of Securitisation Companies Regulations 2006 (2006/3296)).
 - (iv) The UK Issuer and the UK DebtCo will each be a “bankruptcy remote” special purpose company, which has never traded nor (save in relation to performing its obligations under the financing documents) carried on any activity and there is no intention that it will do so. The financing documents contain covenants preventing the UK Issuer and the UK DebtCo from carrying on any activity other than performing its obligations under those documents.
 - (v) SWS will subscribe for shares in the UK Issuer and the UK DebtCo. It will pay for these shares in cash.
- (b) The UK Issuer and the UK DebtCo will become a party to the relevant financing documents (with any necessary formalities being fulfilled).
 - (c) The UK Issuer will be substituted as the issuer, borrower and/or principal debtor of the Bonds, USPP Notes and Liquidity Facilities in place of the Issuer. This substitution is dependent on obtaining requisite creditor approval (i.e. from the holders of the Bonds and Notes and the lenders under the Liquidity Facilities) and so there is a risk that the UK Issuer will not be substituted as the issuer, lender and/or principal debtor of all the Bonds, Notes and Liquidity Facilities.
 - (d) The UK DebtCo will be substituted as the borrower and principal debtor of the Artesian Loans in place of the Issuer. This substitution is dependent on obtaining requisite creditor approval (i.e. from the lenders under the Artesian Loans) and so there is a risk that the UK DebtCo will not be substituted as the lender and principal debtor of all of the Artesian Loans.
 - (e) The UK Issuer will be substituted as the lender under the existing intercompany loan agreements in place between the Issuer and SWS.
 - (f) In respect of the loans assigned from the Issuer to the UK Issuer corresponding to the Artesian Loans, the UK Issuer will issue corresponding intercompany loan notes to the UK DebtCo.
 - (g) If the requisite credit approval is not obtained for certain Bonds, USPP Notes, Liquidity Facilities or Artesian Loans then the issuer, lender and/or principal debtor will not change in respect of those Bonds, USPP Notes, Liquidity Facilities and/or Artesian Loans (as applicable) and the Issuer will remain in the SWS Financing Group.
 - (i) Therefore, SWS will initially have no alternative other than to temporarily maintain a financing structure which includes the Issuer to avoid any potential defaults or contractual breaches. SWS will continue to seek consent

to have the UK Issuer or the UK DebtCo (as applicable) substituted in, such that the Issuer can be removed from the SWS Financing Group at the earliest opportunity.

- (ii) Subject to consent being received for the accession of the UK Issuer and the UK DebtCo to the current financing structure, the Issuer will only remain as the issuer, lender and/or principal debtor of historic Bonds, USPP Notes, Liquidity Facilities or Artesian Loans (as applicable) until its removal from the SWS Financing Group and will not be used for future debt issuance.
- (h) Once all creditor approved substitutions outlined in steps (c) to (f) above have occurred, then the Issuer will be released from all the financing documents and transferred out of the SWS Financing Group for dissolution on a solvent basis.

It is proposed that such disposal will be made to Southern Water (NR) Holdings Limited (“**SWNRH**”) (a holding company in the wider Southern Water group) on arm’s length terms for a fair value consideration that will be determined at the time of transfer. It is expected that the majority of the assets of the Issuer will be distributed to SWS prior to the transfer. The consideration payable by SWNRH to SWS will be paid in full at the time of the transfer.

- (i) On completion of the reorganisation of the financing structure, the UK Issuer will be able to issue further bonds and notes throughout the course of future financing and the UK DebtCo will be able to borrow under further loan facilities throughout the course of future financing.

We are unable to form and incorporate into the ring-fence the new companies until we have obtained creditor consent. We will notify Ofwat of the names, registered numbers and date of incorporation of the new companies as soon as they are formed (and will furnish Ofwat with copies of their certificates of incorporation).

Other than the proposed substitutions, there are not expected to be any material amendments to the terms of the Bonds, USPP Notes, Liquidity Facilities and Artesian Loans.

The proposed changes are solely to add the new UK companies to the current structure so to be able to remove the Issuer. There is no intention to change the financial obligations of SWS nor to amend cross default and guarantee provisions, other than to add or remove companies as appropriate. This will also be confirmed to bondholders when their consent is requested for the proposed changes.

We note that there will be a continuation of the existing guarantees and cross-defaults (including the Issuer if it remains in the securitisation structure) with amendments to include the UK Issuer and UK DebtCo, which does not increase the liability of SWS any more than the status quo today.

For SWS, the only changes to existing intercompany loans will be changing the names of its counterparty from the Issuer to the UK Issuer. These intercompany loans result from the lending of external debt, raised by the Issuer, to SWS on the same terms. Following the proposed changes these balances will be held by the UK Issuer instead of the Issuer.

It is expected that the reorganisation is substantially neutral from a tax, credit rating and gearing perspective and, indeed, more recent sets of bonds issued by the Issuer have a provision built into them which actually contemplates a substitution in the manner described

in this letter. SWS will bear the cost of the proposed changes, which are estimated currently to be no more than [REDACTED] in total – this is not expected to have an impact on customers.

Notwithstanding the proposed changes outlined above, certain features that are part of the security and covenant package under the existing financing structure will not change, save for the substitution of the UK Issuer and the UK DebtCo for the Issuer and any required conforming changes in order to implement the transaction (to the extent creditor consent is obtained); for your reference we have set out more details on this below:

- [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
- [REDACTED]
[REDACTED]
[REDACTED]
- [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

- [REDACTED]
- [REDACTED]

3 Regulatory considerations

The proposed changes have certain regulatory aspects, which can be divided into those about which SWS must satisfy itself and those for which it is seeking consent from Ofwat.

In relation to the first, SWS must satisfy itself that the changes to its financing structure would not undermine the adequacy of its financial resources and facilities, management resources, and systems of planning and internal control, including satisfying itself that, following the changes, it would be able to submit a certificate in the ordinary course under Condition P30 of its licence.

We refer to our letter dated 24 March 2003. SWS remains of the view that, in undertaking the changes set out herein, it is continuing to conduct its Appointed Business as if it were substantially its sole business, for the purpose of Condition P1.1.

In relation to the second category, matters for which we seek consent, we note your letter dated 19 June 2003, attached as Annex 1, in which you confirmed that the cross-default and guarantee arrangements to be entered into by SWS, SWSH, SWSGH and the Issuer as part of the financing arrangements, would not breach paragraph 6.11(1)(i) of Condition F.

We consider the proposed changes to the financing structure of the SWS Financing Group do not substantively change the nature of the cross-default and guarantee arrangements that were previously granted Ofwat's consent. As advised previously, the purpose of these cross-default and guarantee arrangements is to facilitate the financing of the Appointed Business, such arrangements being confined within the ring-fenced SWS Financing Group. As such, the consents required in relation to the proposed changes are consistent with the consents previously provided by Ofwat in 2003 (in relation to the original structure).

Since SWS, the UK Issuer and the UK DebtCo will effectively be entering into a new cross-default and guarantee arrangement as part of the substitution process then Condition P21.1 and P22.1 of SWS's licence would apply. Therefore, Ofwat's consent is required for the proposed changes to the financing structure of the SWS Financing Group in respect of the cross-default and guarantee arrangements under paragraphs 21.1 and 22 of Condition P.

The specific arrangements that required SWS to enter into agreements for which consent is required are as follows:

(a) Guarantees

SWS will guarantee the obligations of each of the UK Issuer and the UK DebtCo (supported by an indemnity in respect of losses incurred in relation to the relevant guaranteed obligations).

(b) Cross-default obligations

There will be a new cross-default obligation applicable to SWS on certain specified events in relation to each of the UK Issuer and the UK DebtCo (e.g. if certain insolvency events occur in respect of the UK Issuer and/or the UK DebtCo, non-payment of amounts due under the Finance Documents (including amounts due under the Bonds, USPP Notes, Liquidity Facilities and Artesian Loans), any other breach of a Finance Document which has a material adverse effect etc).

I believe that it is in the interests of customers for such consents to be granted as these will enable SWS to deliver a simpler financing structure as part of the drive to increase the transparency of our business and sustain the trust and confidence our customers and Ofwat have in us.

I confirm that the change in the structure will not result in an increased threat to the financial resilience of the SWS Financing Group compared to the position before the proposed changes and representations will be made to investors and creditors to that effect when seeking their consent.

Finally, I believe that the proposed changes will not result in an increased threat in the ability of SWS to meet its licence requirements. We have engaged with all three agencies that rate SWS and the debt issued by its subsidiaries to seek their confirmation, prior to formally requesting creditor consent, that the proposed changes do not impact the current ratings and outlooks.

4 Requested consent

We shall keep you updated as to any material amendments to the proposals outlined above and changes to anticipated timing for the creditor consent request.

Following consideration of this letter, I should be grateful if you would confirm that you do not have any objections to the proposals outlined above and provide an indication as to when Ofwat will be able to provide formal consent to the changes regarding cross-default and guarantee arrangements.

Please let me know if you require any further information at this stage and please do not hesitate to contact me should you have any queries.

Yours sincerely



Martin Roughead
Director of Regulation

Annex 1

Received 2010 *SG*

Certified to be a true copy of the original.

Gordon/Hastings



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3609

RESTRICTED - COMMERCIAL

R Bartlett
Head of Corporate Securitisation Financial Markets
The Royal Bank of Scotland
135 Bishopsgate
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19 June 2003

Dear Richard

We received a report on 14 May 2003 from our financial consultants, Deloitte and Touche (Deloitte), setting out the results of their review in relation to the refinancing of Southern Water. We asked them to undertake an independent review of the financing plan and in particular to consider its impact on the future financial flexibility of Southern Water Services Limited (SWS). This review was undertaken on the basis of the version of the financial model that was shared with Deloitte at the end of April and the Implementation Plan dated 4 April 2003. You also had a meeting with Deloitte on the 28 April where you explained the commercial background to the financing proposition.

We subsequently received modified proposals, as set out in your letter to Keith Mason of 24 May 2003, for the reorganisation of the Southern Water group prior to its proposed securitisation together with an Annex showing a modified structure for the group following the proposed securitisation. In that letter you state that the revised proposals do not involve any material variations to the amount or terms of the mezzanine debt, preference shares or ordinary equity of the Southern Water Group. Nor do they impact on the amount or nature of funding to be raised pursuant to the securitisation.

Deloitte have undertaken a second review of the latest financial model for the Southern Water Group. They have confirmed that although the revisions lead to a lower level of (cash) post-maintenance interest covers in the first two years, average (cash) PMICRs are more comfortable, both in the base case and for the model sensitivity scenarios.¹ Furthermore they do not believe that the changes materially affect the likelihood of default under the structure. The PMICR definition as used to

¹ You have explained that the lower level of cash post-maintenance interest cover in 2003-04 and 2004-05 in the revised model is a result of revised management assumptions on expected capital maintenance expenditure in these years. This is above what was allowed for in price limits in 1999. The improved ratio post 2005 is in part a result of an expectation that Ofwat will allow an increase in capital maintenance expenditure at PR04.



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determine trigger levels does not use cash maintenance, but CCD and IRC instead. The minimum level of this "non-cash" PMICR has improved in the revised model. They are therefore able to confirm that the conclusions set out in their original report remain valid.

Ofwat view's on higher leverage

Our views on higher leverage are well known. We are concerned that companies retain sufficient financial flexibility to enable them to respond to events in the future and finance future capital programmes. In addition we have concerns about the effect of reduced equity on the power of incentives. In assessing the robustness of the proposed financial structure for Southern Water Group, we have considered the following issues:

- **what is the level of equity participation in the structure?**
- **how robust is the financial structure?**
- **will the regulated company remain able to access the capital markets readily and at reasonable rates to finance both present and prospective capital programmes?**
- **are customers protected from taking on additional risks?**

Equity participation in the structure

We are concerned about the level of equity in highly geared structures. Both because of the effect of reduced shareholder equity on the power of incentives and because equity provides a cushion against cost shocks and the risk of underperformance. This equity cushion can take various forms including; the headroom for further borrowing as indicated by the regulated asset ratio (RAR)², the availability of additional equity funding, the level of cash and accounting reserves and the level of free cash flow generated by the regulated business.

Level of gearing

Following the issue of the securitised bonds by JVCo (step 14 in your implementation plan) and discharge of all outstanding obligations arising out of the acquisition structure put in place by First Aqua Holdings Limited from Scottish Power, SWS's investment grade debt gearing is expected to be a maximum of around 81% of RCV. Immediately after the securitisation, on this measure, gearing is expected to be around 80%. This is not out of line with the level of gearing that we have seen in other 'thin equity' structures. However for this transaction, only around £50m of the "equity" is in the form of ordinary equity shares. This is equivalent to just 2% of RCV. The balance is to be made up of £260m of preference shares of two classes and £233m of mezzanine debt.

² RAR is defined as total debt/regulatory capital value

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19 June 2003

'Quasi equity' status of financial instruments

We have not previously seen this type of layered structure you propose featuring in the refinancing of a water and sewerage company although some of the refinancings for the smaller water only companies have involved the issue of mezzanine debt.

You have explained that the layered structure and the use of mezzanine finance has arisen from commercial negotiations and the final structure proposed reflects the underlying risk being taken (and hence the level of return to reward that risk) by holders of the different financial instruments. We have sought re-assurance from our consultants with regard to the level of exposure of equity capital under the refinanced structure. We sought confirmation that the preference shares and the mezzanine debt are fully subordinated to the senior debt and have characteristics similar to equity.

Deloitte's review has concluded that the mezzanine debt and the preference share instruments are effectively subordinated relative to the senior debt and hence has confirmed their 'quasi equity' status. In coming to this conclusion on the status of the mezzanine debt, Deloitte's had regard to the following:

- subordination of the mezzanine debt (both senior and junior) is in the form of cashflow and security subordination;
- that the restricted payment clause is important in achieving cashflow subordination of the mezzanine debt;
- the mezzanine debt is excluded from permitted payments during a standstill period (senior debt is not);
- the provision in the mezzanine facility agreement for the roll-up of interest in the event of repayment difficulties (until final maturity of the loan). This provision means that the mezzanine debt would not be deemed to be a fixed debt obligation under the Companies Act test (relating to the obligation that a company must be able to pay its obligations as they fall due.)

By their nature preference shares will be subordinated within the allocation of cash revenues to the senior debt. Again the restricted payments clause is important in confirming this cashflow subordination.

On this basis the level of gearing as measured by RAR does not exceed the level seen in other refinancings in the water sector.

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Mr R Bartlett
19 June 2003

Entrenched rights

There is a particular issue with regard to a provision in the Security Trust and Intercreditor Deed. This gives the holders of the mezzanine debt and preference shares a right to veto the raising of additional debt, should that debt result in a senior net debt RAR of greater than 90%. This right potentially gives the mezzanine lenders additional negotiating leverage (something that is unavailable to genuine equity). This entrenched right could be of concern in the event that the company found itself in circumstances where it needed to raise additional finance to resolve short term difficulties but was prevented from doing so by the mezzanine lenders.

In your letter of 24 May you have said that the rights would no longer apply if an 'Event of Default' takes place. These are the more serious of trigger events where the Southern Water's management are required to take corrective action. We have now received a summary of the 'Events of Default' as set out in the Common Terms Agreement. One of the events of default is triggered on the senior debt RAR – where it exceeds 0.950:1. This would appear to still leave the holders of the mezzanine debt and preference shares some negotiating leverage to veto additional senior debt where the taking on that debt would result in gearing between the 90% and 95% level.

Whilst not a 'show stopper', we would be more comfortable if the entrenched right was modified to become inapplicable if an Event of Trigger takes place. This would potentially give earlier relief from any possible veto by the mezzanine lenders of a refinancing agreed by the senior debt and ordinary shareholders that might take senior debt up to the 95% level.

Subject to the particular issue raised above with regard to entrenched rights, we are reassured that when considering the question of the exposure of equity capital the mezzanine debt and preference shares can be considered 'as quasi equity' as opposed to debt. This is regardless of the fact that under accounting standard FRS4 it is likely that the mezzanine debt will be reported as a liability.

Overall robustness of the financial structure

Our principal concern where companies propose to introduce higher gearing is that the company must remain able to access the capital markets readily and at reasonable rates to finance both present and prospective capital programmes. This will be driven by a number of factors including the strength of the underlying financial projections, the level of reserves inherent in the structure and the range of sources of new capital that the company has access to.

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19 June 2003

In terms of potential access to future funding, our view, supported by our advisors, is that the position for the Southern Water Group falls between that of Glas Cymru and the Anglian structure. This is because the equity participation of SWS's ultimate owners is more remote than under the Anglian structure so SWS is less likely to be able to call on equity for new finance. Potentially it will have to rely more (than for example Anglian) on access to the debt markets should it have a further call for financial resources.

However, the following factors may mitigate this:

- The number of 'Trigger Events' has been developed giving the potential for closer control over the Southern Water Group by senior lenders than with other structures;
- The key financial ratios (i.e RAR and cash interest cover) lie within the range of similar refinancings. The level of these ratios are indicative of the scope for access to future debt finance (please see comment below with regard to financial ratios and Ofwat's methodology for PR04).
- The level of reserves (which form part of the equity cushion in the business) are in line with other refinancings. Under the proposal SWS will have immediate cash reserves of £150m and a 10% Operations and Maintenance facility. The ratio of RCF/net debt that measures retained cashflow after distributions to shareholders (in this case including the mezzanine debt and preference shares) is also in line with other refinancings. This is a further element of the equity cushion.
- Stress testing of the model to show the impact of variations to the base assumptions indicate that the cashflow should be able to withstand more severe sensitivity scenarios than those undertaken by you.
- In the event that Southern Water Group were unable to access the capital markets (for example in the wake of negative sentiment affecting utilities in general) and therefore it could only finance expenditure requirements from existing cashflows, the view of Deloitte is that the financial structure proposed for Southern Water is less vulnerable than other highly geared structures.

We will also need to see that the credit ratings for this structure collaborate the view that the mezzanine debt, preference shares and ordinary equity is subordinated to the senior debt in the structure.

With regard to the level of financial ratios we wanted to register formally our the approach at the 2004 review with regard to financeability and the highly geared structures. We will set the indicators on an industry-wide basis having regard to prevailing market conditions and our view of an appropriate capital

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structure. As at the 1999 review we will not have regard to particular companies' actual covenants where these are out of line with the package of indicators adopted for the industry as a whole, nor will we make any special allowance for highly geared companies.

Are customers protected from taking on additional risk?

For previous transactions we have sought licence amendments designed to protect customers from taking on additional risk.

Southern Water's licence already contains the current standard ring fencing provisions including the requirement to maintain investment grade corporate credit rating. We believe that this provides a measure of protection that the company will be able to access future finance.

We have issued a consultation paper on the issues arising out of the change ownership of Northumbrian Water Limited (NWL). We have raised the issue of whether licence modifications are desirable in that case to further strengthen the ringfence around the regulated companies' cashflows. We await the views of respondents on this issue. Depending on these we have said that we would also need to consider the licences of the companies, particularly those that are highly geared. We would welcome your views on this issue.

Overall conclusion

To date we have only reviewed the financial projections based on the cash flow position and the accounting consolidation for the Southern Water Group. On the basis of these projections our view is that we should not object to your proposals and that you should be allowed to proceed to test whether you can secure the financing required. This view is subject to a number of conditions:

- Southern Water Services Limited must confirm that the rights proposed for bondholders do not impede the Director General's duties under the Water Industry Act 1991; and
- Southern Water Services Limited must obtain an investment-grade issuer credit rating before the transaction is complete.

Because the financial model we have seen is for the Southern Water Group there is a caveat to this conclusion. We still need to understand more fully the impact of the proposed transaction on Southern Water Services Limited. Although the projections for the standalone company may not be materially different, SWS is legally the regulated entity. However, the change in the implementation plan whereby SWS will no longer be paying a special dividend as mechanism for upstreaming cash to re-pay the existing bridge facility should improve the level of accounting reserves in SWS, than otherwise would have been the case.

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Our conclusion above is therefore subject to a review of the specific financial position of Southern Water Services Limited. We now have a copy of the 'Red Offering Circular'. We are reviewing whether this contains sufficient information on the position of SWS to enable us to do this.

Regulatory Issues and requested consents

Intercompany Loan between SWS and SWHL

As part of the arrangements to facilitate the initial refinancing and future financing of Southern Water Services an intercompany loan of £811m will be required between SWS and SWHL. This is to provide the funding to discharge outstanding obligations arising out of the acquisition structure.

We have had reassurance from Southern Water Services (and RBS) that SWS would not seek to rely on the existence of this intercompany loan to support the creditworthiness of Southern Water Services. Nevertheless, such a loan would be prohibited under Condition F6.11(1) of Southern Water's licence, without the consent of the Director General.

Our initial view in the context of the arrangements as you have discussed with us and as set out in the documentation that you have shared with us and on the understanding that all such loans will bear interest on a commercial basis, we would not regard the making of these loans to be in breach of Condition F6.11(1).

We will need to confirm this view in light of the arrangements set out in the Offering Circular and our further review of the specific projections for SWS mentioned above.

Cross defaults obligations/guarantee

As we understand from your letter of 16 April you have modified the financing structure (to follow the Glas Cymru model) such that Southern Water Services will no longer guarantee the obligations of its holding companies. This will help preserve the ring-fenced nature of SWS. Guarantees provided by the holding companies are supported by its own assets (i.e shares in SWS).

Southern Water Services will however guarantee the obligations of JVCo, the issuer of the securitisation bonds and the issuer will guarantee the obligations of SWS.

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The refinancing will therefore require cross-default obligations between Southern Water Services and JVCo. Such cross-default obligations would be prohibited under Condition F6.11 (1)(i) of Condition F of Southern Water's licence, without the consent of the Director General.

The principal purpose of these guarantees is to facilitate the refinancing of the regulated business. Our initial view in the context of the arrangements as you have discussed with us and set out in the documentation that you have shared with us is that that we would not regard these particular arrangements to be in breach of Condition F6.11(1)(i).

We would welcome confirmation that JVCo will not carry out any business not connected with the regulated business.

We will need to confirm this view in light of the arrangements set out in the Offering Circular and our further review of the specific projections for SWS mentioned above.

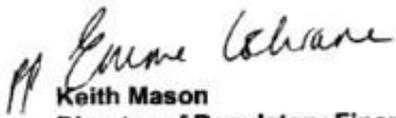
Special dividends

We note from your letter of the 24 May that the £350m special dividend which was to be paid by SWS as part of the previous proposed structure is no longer required under the modified structure.

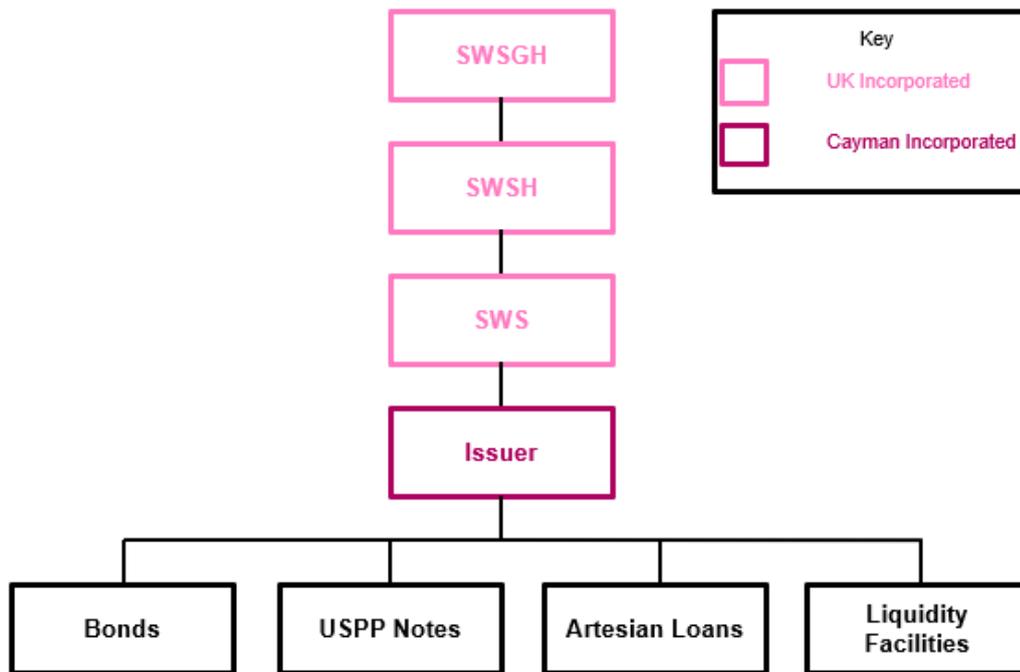
I will respond separately to Andrew Stubbs' response to the draft version of this letter that was sent to you on 10 June in which he addresses some of the issues raised in this letter. But I believe that the only outstanding issue will relate to the review of the projections for Southern Water Services Limited.

I am copying this letter to Stuart Derwent at Southern Water.

Yours sincerely


Keith Mason
Director of Regulatory Finance

Annex 2 SWS Financing Group

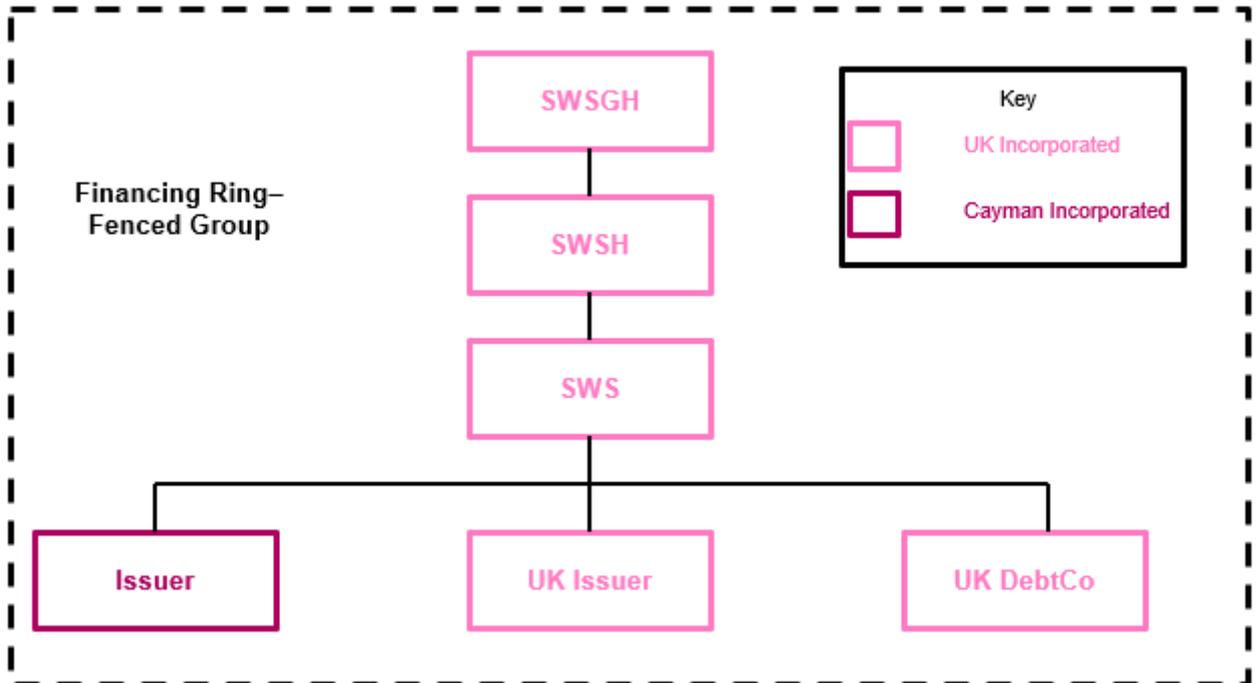


Annex 3 Proposed Steps

A number of steps need to occur as part of the proposed changes to the financing structure of the SWS Financing Group. Those steps are set out diagrammatically below together with a brief overview of these steps.

Step 1

Step 1 is to establish the UK Issuer and the UK DebtCo under SWS.

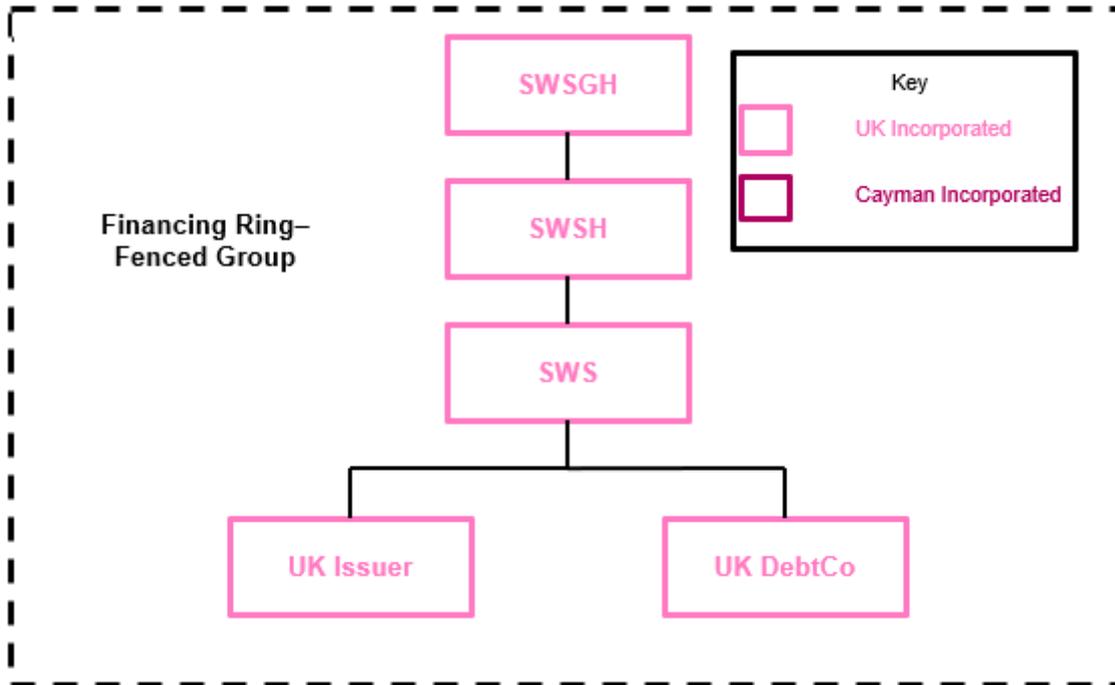


Step 2

Step 2 is to substitute the UK Issuer in place of the Issuer as the issuer, lender and/or principal debtor for the Bonds, USPP Notes and Liquidity Facilities and to substitute the UK DebtCo in place of the Issuer as the lender and principal debtor for the Artesian Loans, in each case to the extent creditor consent is obtained.

Step 3

Step 3 is to release the Issuer from all the financing documents¹, following which it will be disposed of and dissolved on a solvent basis.



¹ Release being contingent on creditor consent for each substitution being obtained.