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Ofwat
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MACQUARIE

Response to consultation on proposed modifications to strengthen the ring-fencing licence conditions

Dear Ofwat,

Further to the response by Southern Water, we wanted to express our position on Ofwat's 'consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers' (the "**Consultation**").

We disagree with the proposed change to the cash lock-up trigger and with the proposed changes to the dividend policy.

Subject to an acceptable PR24 framework on risk-return and financeability, we could be supportive of the proposal that appointee companies should maintain at least two investment grade credit ratings.

We are broadly supportive of the proposed change that any rating changes are notified to Ofwat, subject to complying with law and regulation on disclosure of non-public information, and also that such notifications are for transparency rather than for approval.

We continue to welcome transparency on derivatives and pensions. As you know, we disagree with Ofwat's historic and current position with regards to the treatment of derivatives within the allowed cost of capital and would welcome further engagement on this to ensure recovery of efficiently incurred costs.

In a 'joint note' agreed between Macquarie Super Core Infrastructure Fund SCSp ("**MSCIF**") – acting by its manager, Macquarie Asset Management Europe Sarl ("**MAMES**") – and Ofwat:

- MSCIF highlighted that *"SWSL is currently rated Baa3 (Moody's) and BBB+ (negative) with both S&P and Fitch. MSCIF aims for investment grade credit ratings in each of its portfolio investments and Southern Water is no exception. MSCIF expects that the Moody's credit ratings of Southern Water should improve by AMP8, noting that a credit rating action is a decision reserved for the credit rating agency and subject to certain factors outside of MSCIF's control."*;

- As each rating agency states in their public credit ratings reports, and as we discussed prior to the investment into Southern Water, credit ratings are a function of several factors, including, inter alia, leverage, cash flow ratios, and regulatory risk. In the case of Southern Water, cash flows in AMP7 are particularly weak, due to factors such as ODI penalties, revenue rebates, and non-recognition of historic derivative. These factors were known and acknowledged at the time of our entry and prevent an improvement in the credit rating during AMP7 and potentially into AMP8;
- Ofwat acknowledged that the transformation of Southern Water would take some time, potentially into the early years of AMP8;
- We would note that *"Taking account of the equity injection into Southern Water, where there is evidence of improving performance, Ofwat expects to be able to acknowledge these dividend arrangements as acceptable in the circumstances of a turnaround in AMP7."*

MSCIF's investment was made with a joint understanding of the position and evolution of the credit rating of Southern Water, and with a joint expectation that the fund (which includes pension savings) could receive dividends. To date, we would highlight that only £17.5m of dividends has been paid from Southern Water to its holding companies, and with no dividends paid to shareholders.

As such, in addition to the points made in the Southern Water response – including the KPMG paper attached to it – Ofwat's proposed change to the cash lock-up trigger and proposed change to the dividend policy would undermine that. We believe this could have negative and wide implications for the sector more broadly, which we believe would not be in the interest of customers.

Separately, the sector is likely to require greater investment in the future, for areas such as improving water resilience, reducing water leakage, continuing the reduce pollution incidents, and being part of the solution to reduce storm overflows. Even if reducing leverage at the appointee level would improve the credit ratings of an appointee company – which may not be the case, as we highlight above – we would question whether this is the optimal use of capital, compared to additional investment into the above areas. Moreover, the proposed change to the cash lock-up trigger and dividend policy would reduce the likelihood of such equity capital being injected and/or increase the cost of financing. We believe each of these factors would be detrimental to customers.

We would welcome further engagement with Ofwat, including how we are progressing on the 5 areas in the 'joint note' where we did discuss and commit to how we could improve financial resilience:

- deter SWSL from entering into speculative swaps, or swaps with mandatory breaks materially before their maturity date;
- support removal of the intercompany loan shortly after completion;
- acknowledge the pension trustee and the Pension Regulator as key stakeholders for SWSL, and expecting SWSL to honour existing agreements with regard to pension deficit funding;
- supports the expectation that Southern Water should continue to assess long-term viability over a period of at least nine years; and
- support Southern Water removing the Cayman Islands financing company.