

November 2022

Southern Water: Conclusions on Change of Control

About this document

On 3 August 2022 we published a [consultation on the change of ownership for Southern Water Services Limited \(the Consultation\)](#) which resulted from our consideration of a change in the ownership and control of Southern Water Services Limited (**Southern Water**).

The Consultation closed on 14 September 2022. It set out:

- Our assessment of the ownership structure of Southern Water.
- Our assessment of the new owners identified as an Ultimate Controller as well as their capacity to be an owner of a regulated water company¹.
- Our understanding of how the governance arrangements, which are relevant considerations in identifying the new Ultimate Controllers of Southern Water, have changed following the change of control.
- Our considerations in identifying the new Ultimate Controllers of Southern Water.

In this document, 'Southern Water: Conclusions on Change of Control', we summarise the responses to the Consultation and provide our views on the issues raised.

¹ For the purpose of this document, a reference to a water company or company means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991

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1. Background

On 9 August 2021 Southern Water announced that a fund managed by Macquarie Asset Management (**MAM**) had agreed to acquire a majority stake in Greensands Holdings Limited (**Greensands**), the ultimate parent company of Southern Water.

The transaction completed in September 2021 and saw Macquarie Supercore Infrastructure Fund SCSp (**MSCIF**) inject c.£1.073 billion of new equity into Greensands. This included c.£530 million invested as new equity into Southern Water with the remaining investment used to strengthen the financial resilience of other companies within the Greensands group. From this date, MSCIF became the entity with legal control over Greensands and therefore Southern Water. The Consultation included a corporate structure diagram of Southern Water following the acquisition by MSCIF. The owners can be summarised as follows:

Owners of Southern Water as of September 2021

Owner	Percentage owned
Macquarie Super Core Infrastructure Fund SCSp (MSCIF)	62%
Funds managed by JP Morgan Asset Management	15%
Funds managed by UBS Asset Management	8%
Hermes Infrastructure funds	8%
Minority owners	7%

Following completion of the transaction, in November 2021, MSCIF syndicated part of its equity interest (by disposing of a portion of its indirect shareholding in Wight Ventures S.à r.l) to funds managed by AMF Pensionförsäkring AB (11.45% interest in Wight Ventures S.à r.l), MR Ergo (6.97% interest in Wight Ventures S.à r.l) and Retail Employees Superannuation Pty Limited as the trustee for Retail Employees Superannuation Trust (13.28% interest in Wight Ventures S.à r.l) (together the Co-Investors). MSCIF has retained full control over the affairs of Wight Ventures S.à r.l. Following these changes MSCIF Luxembourg GP S.à r.l remains as General Partner (**GP**) and Macquarie Asset Management Europe S.à r.l (**MAMES**) remains as Manager with responsibility for managing the investment under the supervision of the GP as outlined in the consultation.

In the Consultation, we provided some commentary about the incoming owners, set out that we did not consider it necessary to introduce changes to Southern Water's licence as a result of the change of control, and identified both MSCIF, acting by its general partner MSCIF Luxembourg GP S.à r.l and MAMES as Ultimate Controllers of Southern Water.

2. Summary of the responses received in relation to each question

In respect of our general approach to changes of control at regulated companies, we consider that shareholders of water companies have an important role to play. Among other things, they must hold senior management to account for performance and ensure the company is focused on delivering a high quality service to customers that is resilient in the long term. As a consequence, it is important that we assess changes in the shareholdings of companies that we regulate. Although we do not have formal powers to approve or reject new owners, in the interests of customers we aim to ensure that any Ultimate Controller of a water company has the integrity, and the operational and financial capability to provide such an essential public service.

The principles we apply in assessing a change of control mean we do not carry out change of control consultations in all instances. In this instance, our decision to carry out a consultation reflects the complexities associated with identification of the Ultimate Controllers and our long-standing concerns with Southern Water's performance.

Some of the responses received raised issues in relation to a number of matters which were outside the scope of the Consultation and Ofwat's regulatory role, nonetheless, we note the concerns: points were raised about the privatisation of the water industry, private equity investor ownership and complex corporate structures beyond the regulated company. With regard to comments on the timing and distribution of the Consultation, it is our normal practice to consult after the transaction has completed once we have been able to assess the structures that are in place and we publish all consultations on our website.

The Consultation set out the following questions:

Consultation questions

1. Do you have any views on our commentary about the incoming owners?
2. Do you agree that it is not necessary to place additional requirements in the licence of Southern Water in respect of the change of control?
3. What are your views on our identification of the Ultimate Controllers?

We received four responses to the Consultation; all from individuals. A copy of the responses can be found at Appendix A1.

The responses to the questions raised in the Consultation are considered below:

2.1 Assessment of the incoming investors of Southern Water

Respondents' views

Two respondents provided views on our commentary about the incoming owners. They were concerned about the history of MAM as owners of a water utility.

While one respondent acknowledged that the cash injection from MSCIF was 'welcomed in order to keep Southern Water afloat', the respondent was concerned that MAM has no experience of improving services in the water industry and that in several of England's water companies, ownership by private equity funds has been associated with a rise in gearing alongside dividend pay-outs to shareholders.

The other respondent also referenced the increase in debt and dividend levels at Thames Water while MAM was an owner. The respondent added that during this time Thames Water was issued with record fines for sewage leaks and the pension fund went into deficit. The respondent said that MAM's previous history suggests that investor returns will be MAM's priority rather than the long term social and environmental welfare of the water company's operations.

Our response

The Consultation acknowledged concerns about MAM's performance as a shareholder of Thames Water, and that there has been public criticism of the way in which Thames Water was being managed during MAM's ownership, both at the time and since.

However, there have been significant changes to the way in which the water sector is regulated since MAM's ownership interest in Thames Water. Southern Water and its owners are required to comply with the current licence requirements and their behaviour will need to take account of current regulatory expectations for the sector.

Changes in regulation include the introduction of our Board Leadership, Transparency and Governance principles alongside objectives in company licences. We have placed expectations on companies on a range of issues that include: financial resilience, dividend policies and performance related executive pay. For instance, when setting executive pay and declaring dividends, we have been clear to the industry that we expect each company to take appropriate account of performance for customers and the environment.

We have made clear to MAM our expectations of companies and investors as custodians of essential public infrastructure. We have also highlighted the steps we have taken to strengthen the regulatory ring-fence protections since the Thames Water investment was sold. MAM confirmed that it recognises the high expectations that are placed by customers, regulators and other stakeholders on water companies as providers of essential water and wastewater services to local communities.

In a public letter to Ofwat², MAM confirmed it recognises "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".

We continue to monitor Southern Water closely and to hold it and its investors to account in delivering its performance transformation.

Southern Water, like all regulated water companies, is still required to meet its stretching PR19 performance targets, and in addition must continue to comply with the undertakings it provided in 2019 following the conclusion of Ofwat's enforcement investigation into the company's operation of wastewater treatment works and associated regulatory reporting³. The operational and financial performance of Southern Water and other water companies will continue to be published annually in our [service delivery report](#) and our [monitoring financial resilience report](#).

2.2 The need to place additional licence requirements on Southern Water

Respondents' views

Two out of the four respondents commented on whether it is necessary to place additional requirements in the licence of Southern Water in respect of the change of control. One respondent said that stronger financial requirements which would ensure that customers do not lose out to the interests of private investors are essential. This respondent added that the Consultation needed to be more specific around how pay-outs to executives and investors will be tied to performance.

The other respondent said that in order to facilitate greater transparency of operations, we could call for full disclosure of financial flows to equity funds and to General Partners as well as disclosure of the identity of the investors in the investment fund.

Our response

In addition to the significant changes made to regulation and governance since MAM were previously owners of a water utility which were set out in 2.1, companies have an existing

² [Letter from Macquarie Group to Ofwat Chair, Jonson Cox re. Investing in Southern Water's long-term transformation](#), 9 August 2021

³ Ofwat, [Investigation into Southern Water's wastewater treatment sites and the company's reporting of relevant compliance information to us](#), 10 October 2019

obligation to submit an annual performance report (APR) to Ofwat alongside their statutory annual report and accounts. APRs are available on each company's website and provide regulatory accounting information and details about the company's performance.

Companies are required to disclose all funds that are taken out of the regulated company by way of dividends to other group companies in their APRs, regardless of how those funds are subsequently used.

Further, at PR19 we set an expectation for all companies to transparently disclose how dividends and executive pay align with performance in their APR. We monitor these disclosures closely. Where we consider that companies have not provided adequate explanations, we engage directly with the relevant company about our concerns. Our assessment of dividend policies and their application forms part of our annual ['monitoring financial resilience' report](#) which is published on our website. Companies are also required by their licences to meet the objectives of our Board Leadership, Transparency and Governance principles, and explain how they are doing so in their annual reporting.

As part of our ongoing programme of work, in July 2022 we published a [consultation on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers](#); this followed our December 2021 discussion paper on [Financial resilience in the water sector](#). Among the issues set out in these papers was a reminder for companies to increase transparency about their financing arrangements, their ownership and group structure and their assessment of risks to their long term viability. All companies including Southern Water supported our ambitions to improve transparency. The consultation on proposed modifications to strengthen the ring-fencing licence conditions also seeks to introduce an updated dividend condition into company licences which would require companies to take account of performance for customers and the environment when paying dividends.

2.3 Our identification of the Ultimate Controllers

Respondents' views

One of the four respondents commented on our identification of Ultimate Controllers, stating that it is unclear who the Ultimate Controller of the company is.

Our response

An Ultimate Controller is defined in Southern Water's licence as “any person which, whether alone or jointly and whether directly or indirectly, is, in the reasonable determination of Ofwat, in a position to control or in a position to materially influence the policy or affairs of the Appointee or any Holding Company of the Appointee”.

Our approach to assessing the new owners of Southern Water was set out in the Consultation. As part of our assessment we reviewed the relevant Macquarie group structure documents and details of the relevant management agreements.

In the Consultation we set out that there is no individual investor who is able to exert significant influence on MSCIF and who in our view is required to provide an Ultimate Controller undertaking at this time. Where large institutions are tasked to manage the funds of other underlying investors, if those underlying investors do not have day to day control of the fund and cannot influence its decisions, then we consider that the institution that manages the investment has the requisite influence and control over the regulated company to meet the definition of Ultimate Controller set out in Southern Water's licence. Accordingly, we are content we have identified the correct Ultimate Controllers: MSCIF (acting by its general partner MSCIF Luxembourg GP S.à.r.l.) and MAMES.

3. Next steps

No further steps need to be taken in relation to the change of ownership at Southern Water following the Consultation and conclusions.

We continue to monitor and engage closely with Southern Water. We set stretching performance targets for regulated water companies and we will continue to hold Southern Water to account for delivery against its PR19 plan, enforcement undertakings and for the turnaround of its business.

We are currently considering responses to our July 2022 consultation [on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers](#). We expect to publish a decision document in early 2023.

A1 Responses to the Consultation

[REDACTED]

From: [REDACTED]
Sent: 12 August 2022 16:23
To: Financial Resilience
Subject: CHANGE OF CONTROL OF SOUTHERN WATER

Follow Up Flag: Follow up
Flag Status: Completed

Dear Sir,
I object to Southern Water (or any UK water companies) being privately owned. Privatising a public service company where there is no competition is pointless. Southern Water, along with all UK water companies, should be re-nationalised.

Cheers

[REDACTED]

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We welcome responses to the following questions.

1) Do you have any views on our commentary about the incoming owners?

While the consultation does highlight some of the concerns of Macquarie and their past adventures in the water sector, the conclusion talks only of “significant experience”. It does not highlight that this experience is one of a parent company failing to ensure that customers and the environment are looked after, nor does it highlight that concerns were raised about the £2bn debt that Thames Water were left in as a result of the sale while investors saw returns which some estimated were double what was expected.

The consultation does not highlight Macquarie’s use of investment raised through a Cayman Island subsidiary.

The company has no experience of improving services in the water industry- only worsening them, this should have been clearer. In 2021 the head of Ofwat highlighted Southern and Thames Water as leaving a dark shadow over the sector- the new owners of southern have a direct relationship with Thames Water’s poor performance and as such there should be high level of concern around the capability of Macquarie to improve Southern’s poor performance.

Macquarie’s ownership of Thames Water was not only very relevant but also very poor- this should have been highlighted more.

2) Do you agree that it is not necessary to place additional requirements in the licence of Southern Water in respect of the change of control?

No. The Environmental agency performance report of all water companies 2021 highlighted Southern water as one of worst performers in the sector.

Macquarie have a poor record within the UK water industry- their handling of the sale of the £2bn debt burden left for Thames Water should raise alarm bells. Stronger financial requirements which would ensure that customers don’t lose out to the interests of private investors are essential. The consultation uses very vague terms and needs to be more specific around how payouts to executives and investors will be tied into performance. This is an opportunity for the regulator to ensure that with new owners comes new and increased responsibility, not a repeat of record executive bonuses following years of poor operational performance.

2) What are your views on our identification of the Ultimate Controllers

N/A

Consultation response, Change of Ownership for Southern Water Services Limited, Ofwat
financial.resilience@ofwat.gov.uk

While I welcome the opportunity to take part in this consultation on the change in ownership of Southern Water, I would welcome clarification as to why this is taking place a year after the company was taken over by a Luxembourg-based private equity fund. Moreover, many Southern Water customers would also be glad to comment on the ownership of their water company but the details of this consultation have not been widely disclosed. If notification was in a more public place such as on the home page of the Southern Water website there would likely have been far more responses.

I would like to raise the following concerns in relation to the points raised in the consultation document:

1. Track record of the incoming owners

The consultation indicates that Ofwat is required to consider the new owner's relevant experience in delivering and managing or investing in the infrastructure sector. Macquarie's history as owners of Thames Water should raise concerns regarding their approach to investing in England's water sector. During their period of control of Thames, Macquarie introduced new mechanisms of generating shareholder returns including loading acquisition debt onto the water utility via a Cayman Islands subsidiary. During the period of Macquarie ownership of Thames, the company's net debt rose by 230% to over £10bn while the company paid out £2.5bn in dividends. The company was issued with record fines for sewage leaks and the pension fund went into deficit. Additional shareholder returns were made from the sell-off of ownership stakes during the ten-year ownership period but these amounts are not disclosed. The full returns made by the Macquarie European Investment Fund (MEIF) from their ownership of Thames Water is not known to outsiders.

While the regulator has obtained commitments by Macquarie that they understand their responsibilities as owners of Southern Water, their previous history suggests that investor returns will be their priority rather than the long term social and environmental welfare of the water company operations.

Furthermore, scrutiny of the company is compromised by the complex corporate structure with funds routed via tax havens. While they may have removed the Cayman Island subsidiary from the corporate structure, the fact that the equity stake is held via a Luxembourg fund, such that the identity of the Ultimate Controller is a question to be put to consultation, illustrates that having private equity funds as equity shareholders inevitably leads to greater corporate complexity.

2. Additional requirements are needed in the regulatory framework

The consultation makes the point that it was the poor financial resilience of Southern Water which ultimately meant that an equity injection was needed and which led to the intervention by Macquarie. Southern Water was in trouble last year and the regulator is right that this is not a 'sound basis to finance the operation of a regulated monopoly provider of essential services' (p. 17). The consultation references the case study on Southern Water which is documented in Ofwat's 2021 discussion paper on financial resilience. But while the

criticisms point to the highly indebted corporate structures, there is little analysis of *why* these outcomes have occurred. More forensic analysis of who made what decisions and for what reason in the history of Southern Water would be helpful in determining how the company's future could be made more secure.

The company has a very low credit rating but only £230m, out of the £1.073bn equity injection into Greensands will reach Southern Water's operations. Most of it has gone to propping up debts at the parent and holding company. Continuing with this shaky and opaque investment structure seems unlikely to bring around a significant turn around in company performance.

In order to facilitate greater transparency of operations, the regulator could call for full disclosure of financial flows to equity funds and to General Partners as well as disclosure of the identity of the investors in the investment fund.

3. Closed-end funds are problematic as equity shareholders in essential infrastructure

The consultation points out that ownership by closed end investment funds has the potential to raise challenges where additional equity is required to strengthen the financial resilience of the regulated company or finance investment programmes. In several of England's water companies, ownership by private equity funds is associated with a hike in gearing alongside dividend pay-outs to shareholders. General Partners are incentivised to maximise the value of the investing fund and that will take priority over the long-term health of the water utility.

4. Ofwat needs to attend to social equity and transparency as well as financial resilience

Private equity investment has been problematic for financial resilience but regulation also needs to be attuned to issues of fairness and transparency. The water system is regressive if it generates income for the world's wealthiest from the payment water bills that many struggle to pay. Ofwat research in March 2022 – prior to the onset of the current cost of living crisis - finds that just over half of water bill payers believe they will struggle to pay a utility bill in the coming year.¹ So the fairness and transparency of water bills is just as important as financial resilience. Ofwat needs to be sure that all the costs that we pay are fully justified, and we need far greater transparency of what funds flow where and for what purpose in order to assess if this is a socially equitable system for providing water.

To conclude, overall, my impression is that Southern Water was in a shaky state in 2021 and the cash injection from MSCIF was welcomed in order to keep the company afloat. But my concern is that putting a new private equity General Partner investor in charge of Southern Water is not going to change the ethos or direction of the water utility, and the underlying issues will continue.

14 September 2022

¹ <https://www.ofwat.gov.uk/wp-content/uploads/2022/05/Cost-of-living-report-Final.pdf>

[REDACTED]

From: [REDACTED]
Sent: 12 August 2022 18:06
To: [REDACTED]
Subject: Consultation on southern water

Hi

Thank you for the opportunity to comment on the change of ownership.

I wish to object to the transfer on the following grounds.

1. It's credit rating is poor (according to moody). This is in breach of ofwat own requirements to ensure financial stability. The refinancing arrangements, including swaps, look iffy and need to be clarified before the takeover can proceed. Before, in order to understand the true financial position of the company.

2. It is unclear who is the ultimate controller of the company. A holding company with limited partnership in Luxembourg is a joke if you think that provides enough clarity on the ultimate controller.

I guess you will just roll over though and agree to anything the company wants and this was a wasted effort.

Kind regards [REDACTED].

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**Ofwat (The Water Services Regulation Authority)
is a non-ministerial government department.
We regulate the water sector in England and Wales.**

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