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## Consultation under sections 8 and 13 of the Water Industry Act 1991 on proposed modification to South West Water's licence and termination of Bournemouth Water's licence

### About this document

This document invites comments on our proposal that South West Water Limited (South West Water) should replace Bournemouth Water Limited (Bournemouth Water) as the water supplier for Bournemouth Water's area. The proposal is made with the support of the boards of both South West Water and Bournemouth Water.

Under Section 8, of the Water Industry Act 1991 ('the Act'), we are able to terminate a company's licence and vary the licence of another company to supply the area previously by the company whose licence has been terminated.

This document sets out the consequential modifications to South West Water's conditions of appointment (licence) we intend making as a result of the above proposal. Section 13 allows us to modify the conditions of a company's licence if it agrees to the change we are proposing to make.

This document is a Notice under sections 8 and 13 of the Act.

### Responding to this consultation

We invite stakeholders to comment on our proposed modification by **14 March 2016**. You can email your responses to [financeandgovernance@ofwat.gsi.gov.uk](mailto:financeandgovernance@ofwat.gsi.gov.uk) or post them to:

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We will publish responses to this document on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

## Background

On 16 April 2015 Pennon Group plc (the parent company of South West Water) announced that it had acquired the entire issued share capital of Bournemouth Water Investments Limited (the parent company of Bournemouth Water) from Sembcorp Holdings Limited. This constituted a merger between South West Water and Bournemouth Water under section 32(b) of the Act and as such was referred to an inquiry group established by the Competition and Markets Authority ('CMA').

On 5 November 2015 the CMA published its final findings that the merger did not prejudice Ofwat's ability to make comparisons between water enterprises under the Act. It concluded that the merger has not prejudiced, and may not be expected to prejudice, the ability of Ofwat in carrying out its functions by virtue of the Act to make comparisons between different water enterprises.

Following the CMA's findings, South West Water informed us to that it wished to operate as a single licensed company covering the existing South West Water and Bournemouth Water areas. This would be achieved by the termination of Bournemouth Water's licence and the variation of South West Water's licence which is the proposal being consulted on through this notice.

The board of South West Water has pledged to its customers, amongst other things, to:

- ensure that South West Water and Bournemouth Water customers will not be worse off as a result of the merger;

- continue to engage with customers to ensure the benefits to customers resulting from the merger are transparent and demonstrable – progress and delivery against its pledges in respect of the merger will be published and scrutinised by the independent Customer Challenge Groups of the merged South West Water and Bournemouth Water;
- return the small company premium on the cost of finance (which was part of the 2014 price determination for Bournemouth Water), reducing customer bills for Bournemouth Water by £1 from April 2016; and
- maintain a tariff differential between South West Water and Bournemouth Water.

In addition, the impact of merger specific savings should reduce South West Water and Bournemouth Water customer bills through existing regulatory mechanisms.

The South West Water board has also pledged to work with us to adopt a new 'modular' licence as soon as practically possible. We are considering the options for modularising companies' licences as set out in our forward programmes in previous years and will work with all companies and other stakeholders to achieve this. However, we will look to South West Water to be an early adopter of such a licence if appropriate. Any changes related to modularisation will take place after the changes proposed in this consultation.

The company has announced that it will be establishing a new retail non-household business which will be legally separated for market opening in 2017. We will work with South West Water to address the implications for its licence of this. This will also be subject to separate consultation.

## **The changes we are proposing**

We are proposing to terminate Bournemouth Water's licence and vary South West Water's licence to include the area currently supplied with water by Bournemouth Water. This change will require some consequential changes to South West Water's licence and we will also use the opportunity to make some further changes as set out below.

### **General changes (all conditions where necessary)**

We will take this opportunity to update terms and references throughout the licence where necessary, for example we will update references to the 'Director' to 'the Water Services Regulation Authority' and 'Competition Commission' to 'Competition and Markets Authority'. We will also update references to legislation to ensure that they are to the most up to date, relevant legislation. This does not change the

meaning of the licence as the updated terms and references already apply although they do not appear on the face of the licence.

## **Price limits and charges (conditions B and E)**

On 12 December 2014, we determined new price controls for South West Water and Bournemouth Water for five years from 1 April 2015 for wholesale activities and household retail activities and for two years for non-household retail activities.

As set out above, South West Water has pledged to maintain a tariff differential between the South West Water and Bournemouth Water areas. However because there will be only one licensed company, the constraint on the total amount that can be recovered from customers will need to be set at the company level. This will require a change to condition B to ensure that South West Water cannot recover more in aggregate than the separate price controls for South West Water and Bournemouth Water would have allowed.

This will be a transitional provision which will apply until 31 March 2020 for wholesale and household retail activities and 31 March 2017 for non-household retail activities because after these times only one set of price controls will be set for the merged company.

Condition E of South West Water's licence, in common with other companies, requires that there is no undue discrimination or preference shown to different classes of customers. However we will include a provision in condition E which will ensure that the South West Water is able to maintain a tariff differential between the South West Water and Bournemouth Water areas without breaching this condition. However it will still be required to ensure that there is no undue preference or discrimination within those two areas. This provision will remain in place until 31 March 2020.

## **Codes of practice for customers (Conditions G and H)**

South West Water's licence currently contains requirements for the company to produce codes of practice for customers (condition G) and on debt recovery (condition H). We propose simplifying these conditions by merging them into one condition (a new condition G) and making the wording more straightforward. The revised wording will also focus the accountability of the company on its customers rather than Ofwat while still retaining the ability for us to step in if we need to.

## **Reporting of information (condition M)**

The South West Water board has pledged to continue to report separately on the regulatory performance relating to the South West Water and Bournemouth Water areas until at least 2020. We are proposing to amend this condition to allow us to require separate reporting for the two areas where we consider it is necessary for us and other stakeholders. This will be a transitional provision up until 31 March 2020.

## **Fees (conditions N and R1)**

Condition N of South West Water's licence sets out the fees it must pay in relation to the costs of Ofwat and the Consumer Council for Water (CCWater). Condition R1 covers amounts payable specifically in relation to the opening the non-household retail market in 2017. The amounts payable under both conditions are calculated in relation the proportion of industry turnover which each company contributes, calculated on a backward looking basis. We need to amend these conditions to ensure that the amount which South West Water pays takes account of both its own historic turnover and that of Bournemouth Water. This will ensure that it pays its appropriate share going forward.

## **Ring fencing (conditions F, K and P)**

Bournemouth Water's licence contains the most up to date suite of ring fencing conditions although South West Water's does not. These conditions help make sure that the company and its customers are protected from adverse impacts from the wider group of which it is part. We want to ensure that Bournemouth Water's customers continue to benefit from the same level of protection that they do now. It is also appropriate that the existing customers of South West Water benefit from the same level of protection available to customers of most other companies. In order to enable this to happen we propose to modify South West Water's licence to include the most up to date suite of ring fencing conditions available.

However, having worked with South West Water, we are proposing to do this in a different way from the approach we have previously taken. We intend this to be a blueprint that will eventually be rolled out for other companies.

In order to make these conditions easier to navigate and therefore more easily understood we are proposing that all ring fencing conditions within the licence (including the limited number that South West Water already has) should sit within one condition in the licence. This will be a new condition P (which is not currently used in South West Water's licence). This will require consequential amendments to

South West Water's existing conditions F and K to move the existing ring fencing provisions in its licence from here into the new condition.

We are proposing that the following, additional ring fencing requirements, are added to South West Water's licence. The company must:

- conduct its regulated business as if it is the sole business of the company and a separate public limited company;
- ensure that there is an undertaking in place from its ultimate controller (currently Pennon Group plc) that the ultimate controller will:
  - provide such information as South West Water needs to comply with its obligations under the Act and its licence; and
  - not take any actions which would cause South West Water to breach those obligations;
- act at all times in a manner best calculated to ensure that it has in place adequate systems of planning and control (and to certify this annually);
- where its ultimate controller is not listed, use all reasonable endeavours to maintain a listing of a financial instrument (this will not apply to South West Water on implementation as Pennon Group plc is currently listed);
- provide information about the costs of any associated company providing services to it as Ofwat reasonably requests;
- not, without Ofwat's consent and with certain exceptions, give a guarantee or loan to an associate company or enter into a cross-default obligation;
- have in place a dividend policy which means that dividends declared or paid should not impair the company's ability to finance the regulated business and act as an incentive to reward efficiency and management of economic risk; and
- ensure that it (and any associated company which issues corporate debt on its behalf) maintains an issuer investment grade credit rating.

In the case of this last point, South West Water does not currently have any debt that requires a credit rating. We have agreed with the company that it would not be value for money to obtain one at the present time. We have proposed that it can pursue an equivalent, alternative approach and this will be written into its licence. South West Water must submit a certificate to Ofwat that, in the opinion of its board, it would be able to maintain an issuer investment grade credit rating. This opinion must be accompanied by a statement of the main factors, including financial ratios and other information, which the board has taken into account in giving its opinion.

In addition to this, for the first time, we will place a requirement in the licence in relation to our [board leadership, transparency and governance principles](#). Given this enhanced requirement on the company we will allow the company to appeal any revision to these principles to the Competition and Markets Authority.

Companies have been meeting these principles on a voluntary basis since 1 April 2015. We explained when we published the final principles in January 2014 that we would need to update companies' licences to bring them into line with companies' practices. This proposed amendment reflects this.

The requirement to comply with the principles will be in place of the requirement which exists in other companies' licences that, in acting as if their regulated business is the sole business of the company and as a separate public limited company, they should have regard to certain things. This is because the things which they should have regard to, such as a certain board composition and the UK Corporate Governance code, have been superseded by what is set out in the principles.

There will not be a requirement, as exists at other companies, for South West Water to obtain an undertaking from its ultimate controller to have no less than three independent non-executive directors on its board. This is because our expectations in relation to board composition are set out in the principles.

We are therefore not seeking to place an additional regulatory burden on the company but are instead allowing the company to meet requirements in this area in a more flexible way that better reflects current practice relevant to the water sector.

We are also placing a new requirement on the board of South West Water to inform us of any circumstance which may materially affect its ability to carry out its regulated activities. This is to help provide us with early warning of any situation that may potentially impact on the delivery of services to customers and to be able to step in if appropriate.

We will look for opportunities at other companies to introduce the updated requirements set out above.

**Any representations or objections to the proposals set out above should be raised with us using the process set out at the start of this document.**