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Trust in water

Change of control – general policy and its application to Thames Water

About this document

This document is a consultation on the issues arising out of the change of control of Thames Water Utilities Limited ('Thames Water'), as well as a broader consultation highlighting some of the issues we are considering as part of our continuing sector wide work to explore how companies' licences can be reformed to help ensure that water companies put customers' interests at the heart of what they do.

It sets out:

- Our approach to, and licence changes related to, a change of control of a water (and/or wastewater) company¹ (an "Appointee").
- Some further areas of the licence which we think could be improved.
- Our assessment for Thames Water following recent changes of ownership and control.
- The proposed modifications to the conditions of the Instrument of Appointment ('licence') of Thames Water following the recent change of control.

Under section 13 of the Water Industry Act 1991 ('WIA91'), the Water Services Regulation Authority ('Ofwat') may modify the conditions of a water company's licence if the company consents to the modifications. Before making modifications under section 13 of the WIA91, Ofwat must give notice in accordance with that section. In respect of the licence held by Thames Water, this document (including attached Appendix A3) is a Notice under section 13.

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. Introduction

Our goal is a thriving water sector that holds the trust and confidence of customers and wider society and recognises the importance of focusing on delivering customers' interests. However, the corporate behaviour of some companies, along with significant service failures, has damaged that trust and companies need to act to get the sector back in balance. In a letter to water and wastewater and water only companies on 13 April², we set out some of the first steps Ofwat is taking to improve the regulatory regime to support this aim. This consultation is one of those steps.

We expect a number of changes will be needed, and we are continuing to explore how companies' licences can be reformed to help ensure that water companies put customers' interests at the heart of what they do. This document is a consultation on the issues arising from the change of control of Thames Water, but we have broadened the consultation to highlight some issues that we think are relevant across the sector.

These will not be the only areas of the licence that need to be explored. However, in advance of a wider discussion, including on the proposal for a principles-based licence condition, we have already identified a number of areas where licences can be improved, and we want to begin to understand stakeholders' views now. Where our thinking is well progressed, we are seeking stakeholders' views on specific proposals for enhancements that we would like to make to licences of all companies. Our thinking is at an earlier stage in other areas but we have highlighted some issues in this document on which we would also welcome stakeholders' views.

We have also taken the opportunity to review our overall approach to assessing changes of control. This takes into account specific issues we identified as part of our assessment of the recent changes in the ownership and, as a consequence, control of Thames Water and wider developments in the sector and beyond.

Finally, we propose specific modifications to Thames Water's licence.

² <https://www.ofwat.gov.uk/publication/implementation-letter-sent-to-water-company-ceos-from-rachel-fletcher-13-april-2018/>

Table 1 summarises the issues covered in this document.

Issue	Where it is discussed
Our general approach to, and process for, change of control assessments.	Section 2
Notification and information requirements in relation to changes of control	Section 2.1
Principles for identifying Ultimate Controller(s).	Section 2.2
Enforcement of Ultimate Controller undertakings	Section 2.2
Changes to the ring fencing conditions	Section 3
The change of shareholders at Thames Water, including which of the new and/or existing shareholders are now Ultimate Controllers of Thames Water.	Section 4
The proposed modifications to Thames Water's licence.	Section 5 and Appendix A3

2. General regulatory issues arising from changes in control and the need for licence modifications

In this chapter we set out the principles we followed when assessing the change of control at Thames Water. We will follow these principles when assessing future changes of control and recognise the benefit of providing greater clarity and guidance to the industry and future investors on our general approach.

This chapter also explains some specific issues (identified as part of our assessment for Thames Water) that apply to **all companies** relating to:

- notifying Ofwat about changes of control and the provision of information related to such changes.
- the identification of Ultimate Controllers and the enforcement of undertakings given by Ultimate Controllers.

For Thames Water we are taking the opportunity now to address these issues through the proposed licence modifications set out in Section 5.

Shareholders of water companies have an important role to play by, amongst other things, holding senior management to account for performance and ensuring the company is focused on delivering high quality service to customers that is resilient in the long term.

As a consequence, it is important that we assess changes in shareholdings of the companies we regulate and, where appropriate, use our power to modify licence conditions. 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.

Our aim is to take a proportionate approach when there is a change of control of an Appointee. After reviewing relevant information, we will carry out an internal assessment of any potential issues and will carry out a public consultation in certain circumstances.

We intend to adhere to the following principles when there is a change to the Ultimate Controller of a water company:

- When a change of control occurs, or is about to occur, we expect companies to notify us and provide us with relevant information (we set out our expectations on notification and information requirements below).

- We will conduct an internal assessment on all changes of control to identify and evaluate any potential issues. We will take a proportionate approach when considering the actions and requirements we place on companies.
- We expect to conduct a public consultation under circumstances such as:
 - where we think there are any concerns with the suitability of the current licence conditions and they need updating;
 - where the identification of Ultimate Controllers is complex; or
 - where we identify any other concerns that we consider require to be brought to the attention of wider stakeholders via a public consultation.

We will notify water companies in advance on whether we intend to conduct a public consultation and will discuss any potential licence modifications we propose to make.

2.1 Proposed licence modifications linked to notification and information requirements arising from a change of control

Notification requirements

We need to ensure that we can identify and address any regulatory issues arising from a change of control and make any required licence changes in a timely manner. We have identified some circumstances where we may not be notified and believe there would be value in a consistent approach.

We intend to introduce in due course a new licence condition in all licences that requires the Appointee to inform us when it becomes aware of a change, or an upcoming likely change, that could be a change of control. This would include informing us of a submission for merger clearance to the Competition and Markets Authority and/or the European Commission. We are consulting on these proposed modifications for Thames Water in this document.

Questions:

- What are your views on the introduction of notification requirements on change of control into the licence information requirements

We have a duty to act in a way which we consider is best calculated to secure that the functions of Appointees are properly carried out. Therefore, we must be satisfied that any prospective controller has the integrity and the operational and financial capability to assume that role. We also want to be satisfied that any change of control does not compromise effective management of the Appointee.

In order to carry out a change of control assessment, including assisting us in determining which parties are Ultimate Controllers (and hence will need to provide undertakings), we usually ask for some information about incoming shareholders. The precise information we seek will depend on individual circumstances and can vary. In broad terms, the information we request (see Appendix A2 for more detail) covers:

- General background (corporate and organisational structures.)
- Actual or perceived conflicts of interests
- Economic and financial standing.
- Technical and professional capacity to run a regulated water utility.
- Understanding of the regulatory environment and how they will comply with their statutory and regulatory requirements.
- Any legal or financial claims an investor or member (as relevant) is subject to.
- Any financial investigation by an accredited UK (or equivalent) regulator.
- Proposed corporate structure of the Appointee and its associated businesses, including the holding company.
- The latest shareholders' agreement.
- Any other information that may be relevant to the particular incoming shareholder.

Currently there is no direct requirement for an Appointee or its shareholders to provide this information when a change of control occurs or is proposed. Therefore, to date Ofwat has typically relied on the goodwill of Appointees and investors to provide this information. We believe it would be more expedient and transparent to introduce an explicit obligation in Appointees' licences for the Appointee to provide Ofwat with any information that we may reasonably require in relation to a change of control so that:

- we can satisfy ourselves that an incoming controller has the integrity and the operational and financial capability to secure the functions of a water and wastewater undertaker; and
- both Ofwat and the relevant water company clearly understand who the new Ultimate Controllers are and from whom undertakings should be sought.

Questions:

- What are your views on the proposed obligation to provide us with information?
- What are your views on the information that may be helpful for our assessment of change of control?

2.2 Ultimate controller undertaking and proposed licence modification

The Ultimate Controller undertaking is a legally enforceable obligation provided by the Ultimate Controller(s) of the Appointee. All Appointees need the active co-operation of their owners in carrying out their functions. Appointees have a condition in their licences that requires them to obtain legally enforceable undertakings from their Ultimate Controllers. The entities giving the undertakings are currently required to:

- provide the Appointee with any information it needs to comply with its licence;
- refrain from any action that may cause the Appointee to breach any of its obligations under the Water Industry Act 1991 and its licence; and
- maintain a minimum number of independent non-executive directors on the board of the Appointee.³

These undertakings help to protect customers by strengthening the ability of the Appointee to comply with the conditions of its licence and to maintain its autonomy as a standalone business.

We reviewed current arrangements in relation to Ultimate Controller undertakings and identified key issues which we consider below:

- identification of the Ultimate Controllers; and
- enforcement of the undertakings.

Identification of the Ultimate Controllers

An Ultimate Controller is defined in the licence as **“any person which, whether alone or jointly and whether directly or indirectly is, in the reasonable determination of the Water Services Regulation Authority, 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”**.

³ This limb is not present in those licences where the Appointee is required to meet the Board Leadership, Transparency and Governance Principles.

In many cases identifying who the Ultimate Controller or Controllers are is straight forward as there is a clear controlling interest, for example where there is a clear majority or controlling shareholder with supermajority rights⁴.

Where ownership is more dispersed, it is important to ensure that any shareholder or another party that can **materially influence** the Appointee offers the protections of the Ultimate Controller undertakings⁵.

We require Appointees to seek legal undertakings from anyone who we consider has **material influence** in line with the definition of Ultimate Controller set out in the Appointee's licence. Our intention is to capture any shareholder or another party who could materially influence the policy or affairs of the Appointee.

We take a case-by-case approach and do not consider there is a single definition of material influence when identifying Ultimate Controllers. We will take into account the specific circumstances and governance arrangements of each Appointee including those set out in a shareholders' agreement (if any). Examples of the circumstances that we are likely to consider as conferring material influence are:

- An ability to appoint a director onto the Appointee's board.
- Existence of any special voting or veto rights at the Appointee level or holding company level where they relate to the Appointee.
- Any arrangement allowing one or more shareholders to influence the Appointee's board.

Except in circumstances where the Appointee's UK holding company is also the sole Ultimate Controller (as is currently the case with the listed water companies) there will be a requirement for an undertaking to be provided by both the Appointee's UK holding company and its Ultimate Controller(s).

In addition to the above, we recognise that internal governance arrangements within companies (such as shareholding agreements or changes in director affiliation) are not static and might be subject to change even if the owners of the Appointee remain

⁴ Meaning a provision in company's governing by-laws (and/or a shareholders agreement) which mandate that the consent for specified decisions or actions require a higher percentage of shareholder votes than a simple majority.

⁵ For example, a number of minority shareholders could exercise *material influence* by having the ability to approve or veto certain decisions. For some critical decisions where a qualified majority or a consensus is required, this might create a risk that the direction of the Appointee would be influenced by a group of minority shareholders.

the same. We, therefore, expect Appointees to regularly review the identity of its Ultimate Controllers, including the governance arrangements which might affect the identity and/or number of parties which wield material influence and to inform us when there are any changes in Ultimate Controller.

Enforcement of the undertaking

The licence requires the Appointee to procure legally enforceable undertakings from its Ultimate Controller(s), but it does not require the Appointee to enforce an undertaking. The purpose of this undertaking is to protect the integrity of the Appointee and therefore the Appointee needs to have a clear obligation to enforce the undertaking in its interest.

We, therefore, propose to insert an additional provision into the existing licence condition to require the Appointee to comply with any direction from Ofwat to enforce an undertaking.

Questions:

- What are your views on the proposed obligation to require the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller's undertaking?

3. Changes to ring fencing conditions

This chapter sets out some areas of the licence which we think can be improved. Specifically, we think we can strengthen the financial ring fencing framework for the sector. Where our thinking is well progressed, we are seeking stakeholder views on specific proposals for enhancements that we would like to make to licences of all companies. For others, our thinking is at an earlier stage but, we recognise the benefits of sharing our early thinking with stakeholders.

These will not be the only issues that need to be explored and there will be further opportunity to share views and engage with our thinking.

Bringing all companies to the same standard of ring fencing provisions

Currently, the exact wording and coverage of the conditions varies between licences, reflecting the fact that changes to the provisions have been updated at different times, most usually as a result of an opportunity to update the licence when a change of control has taken place.

The set of ring fencing provisions proposed for Thames Water (as set out in Section 5.1 and detailed in Appendix A3, including the updates discussed in Section 2) represents the most up to date provisions that we would seek for all companies. This includes bringing all the ring fencing conditions and related provisions such as cash lock up and conduct of the appointed business into a single licence condition.

As part of the ring fencing conditions, we have begun to introduce a requirement to meet the **Board Leadership, Transparency and Governance (BLTG) principles**. Customers expect companies that provide an essential public service to demonstrate the highest standards of governance and leadership, and we think this should be reflected in all companies' licences through this requirement. We will look at this issue further when we review, and consider updates to, the BLTG principles shortly.

Question:

- What are your views on bringing all the licences up to the same standards, including introducing a requirement to meet the BLTG principles?
- Are there aspects of the most up to date provisions which you think we need to revisit or amend?

Further strengthening the ring fencing provisions

We are assessing whether there are other aspects of the ring fencing conditions that could be strengthened. We recognise that over time corporate and financial structures, business practices and expectations change. Consequently, we are considering whether there are additional or stronger approaches to the conditions that we need to implement. This will be developed further over the coming months through further engagement with stakeholders and alongside our review of the BLTG principles, but here we highlight some of the issues we are considering:

a. Maintaining Credit ratings

Most Appointees' ring fencing conditions include a requirement to maintain an investment grade credit rating. For most Appointees there is also a provision whereby if an Appointee is on the lowest investment grade rating and has been placed on a negative watch/outlook, a cash 'lock up' is triggered. This means the Appointee cannot release any funds to its holding company or other associated businesses, including paying dividends, without Ofwat's consent. The form and wording of these provisions vary across water companies. We intend to make these provisions consistent as part of our wider drive to bring all company ring fencing conditions to the same standard. The provisions proposed for Thames Water (as set out in Section 5.1) reflect the current highest standard required in licences. However, we also want to assess whether these provisions should be updated further to improve financial resilience and protect customers.

b. Reporting of material issues

Most licences include a requirement for the Board of the Appointee to inform Ofwat when they become aware of any circumstances that may materially affect the Appointee's ability to carry out its regulated activities. We are considering whether this requirement adequately captures all relevant circumstances of which Ofwat needs to be aware and the timeliness of when Appointees are required to report and whether it should be strengthened.

c. Minority cross shareholdings

Some investors have (minority) shareholdings in multiple water companies which have not been reviewed by any regulatory authority due to the size of their shareholdings and/or turnover falling below the prescribed thresholds for the special

water merger regime or any other merger regime.⁶ These multiple shareholdings may create a risk for potential conflicts of interest if confidential information relating to one Appointee becomes available to another Appointee. This ultimately could affect customer interests. We want to ensure that companies take appropriate steps to manage potential conflicts.

d. Conduct of the appointed business

Under either the licence conditions or the BLTG principles, water companies are expected to operate the business as if:

- it is their sole business - which requires the Appointee's management to manage the company's affairs independently of the holding company; and
- it is a publicly listed company - which imposes reporting and transparency requirements equivalent to those of a publicly listed company.

We want to ensure that this important principle, to ensure the autonomy of the Appointee as a standalone business, is properly understood and implemented.

Question:

- What are your views on how the ring fencing conditions need to be further updated? In particular, in relation to:
 - Maintaining an appropriate credit rating and how and when the lock-up conditions are triggered?
 - Whether there needs to be a more explicit requirement to inform us of particular events affecting the Appointee?
 - Managing potential conflicts of interest where there are cross-shareholdings?
 - Safeguarding the autonomy of the Appointee?
 - Any other issues?

⁶ The special merger regime applies when two or more water enterprises (each with a turnover that exceeds £10 million) merge with each other. The special merger regime was amended by the Water Act 2014 to require Ofwat to give an opinion to the Competition and Markets Authority of the merger impacts in phase 1 of a merger investigation

4. Thames Water – background and assessment of the incoming owners

In this section we provide an overview of the recent changes to the shareholder structure of Thames Water. We also assess the capacity of the new group of investors to be the owners of a regulated water company.

4.1 Overview of changes in Thames Water shareholding structure

In March 2017 the sale of a 26.3 per cent stake by Macquarie managed funds in Kemble Water Holdings Limited (“Kemble”), the holding company of Thames Water, was announced. OMERS, a Canadian pension fund, and the Kuwait Investment Authority (“KIA”), a sovereign wealth fund, acquired 17.54% and 8.8% of these shareholdings respectively. The sale and purchase was completed on 31 May 2017.

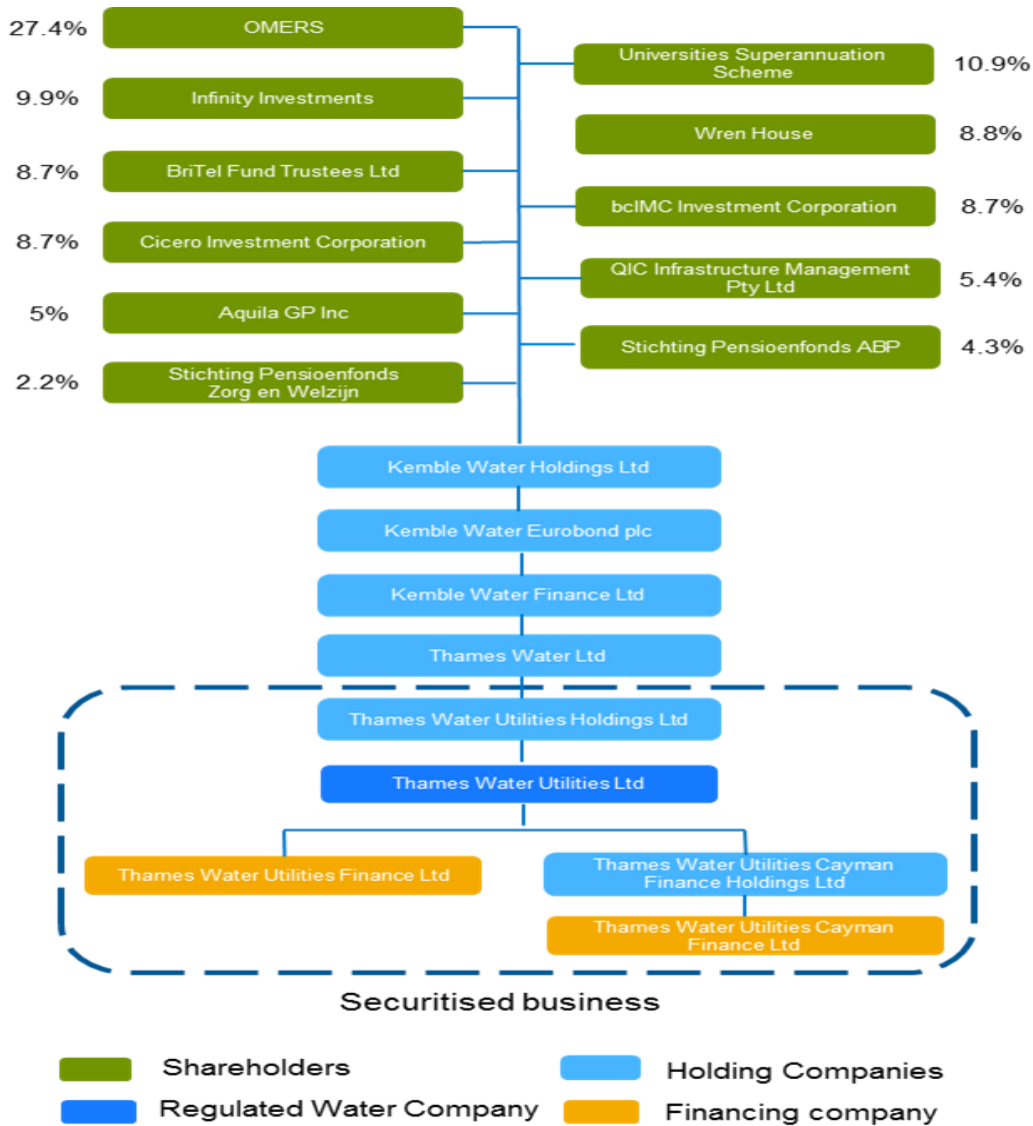
In addition to the above, there have been a number of other changes to the shareholder structure of Thames Water since the Macquarie sale. Smaller shareholders, including AMP, BriTel, AIMCo and QSuper have either divested or reduced their shares in Kemble. This has allowed OMERS to acquire over time an additional circa 10% stake in Kemble and another new shareholder, the Universities Superannuation Scheme (USS) acquiring a circa 11% stake in Kemble.

As a result of various transactions OMERS became the largest shareholder in Kemble. The acquisition fell within the jurisdiction of the EU Merger Regulation. The European Commission cleared the merger on 8 December 2017 and concluded that OMERS exercised control over Kemble.

The latest Thames Water shareholding structure is presented in Diagram A.

We also understand that OMERS is in the process of acquiring an additional 4.36% stake in Kemble. Once approved, this will result in some further changes to the shareholding structure illustrated in Diagram A.

Diagram A: Latest shareholding structure of Thames Water



These multiple transactions left Thames Water (for a time) under the terms of the Kemble shareholders agreement without a lead investor, making it harder to determine who else is an Ultimate Controller in addition to Kemble. The question is whether any of the shareholders, in addition to OMERS who are in our opinion an

Ultimate Controller⁷, are, individually or jointly, Ultimate Controllers of Thames Water and thus should be providing undertakings. We explore this further in Section 5.

4.2 Assessment of the incoming investors' and capacity to be an owner of a regulated water company

We set out our change of control assessment in relation to the new shareholders of Thames Water, based on the responses received to the questions set out in Appendix A2 which each of OMERS, KIA and USS have provided.

Incoming investors

OMERS

Established in 1962, OMERS, rated AA+ by Standard & Poor's, is one of Canada's largest pension plans, with a diversified global portfolio of C\$85 billion in net assets comprising public markets, private equity, infrastructure and real estate investments. It provides defined pension benefits to local government employees, retirees and beneficiaries throughout the Province of Ontario, Canada. OMERS primary pension plan is a large Canadian public employee pension plan regulated by the Financial Services Commission of Ontario. OMERS Infrastructure Management Inc. ("OIM"), owned by OMERS provides investment advice and management services to the OMERS Administration Corporation ("OAC") with respect to global infrastructure investment opportunities, in sectors including energy, transportation and government regulated services. OAC is the trustee and administrator of the OMERS primary pension plan (and trustee of the pension funds). The OMERS shareholding in Kemble is held through Farmoor Holdings BV, a wholly owned subsidiary of OMERS registered in The Netherlands.

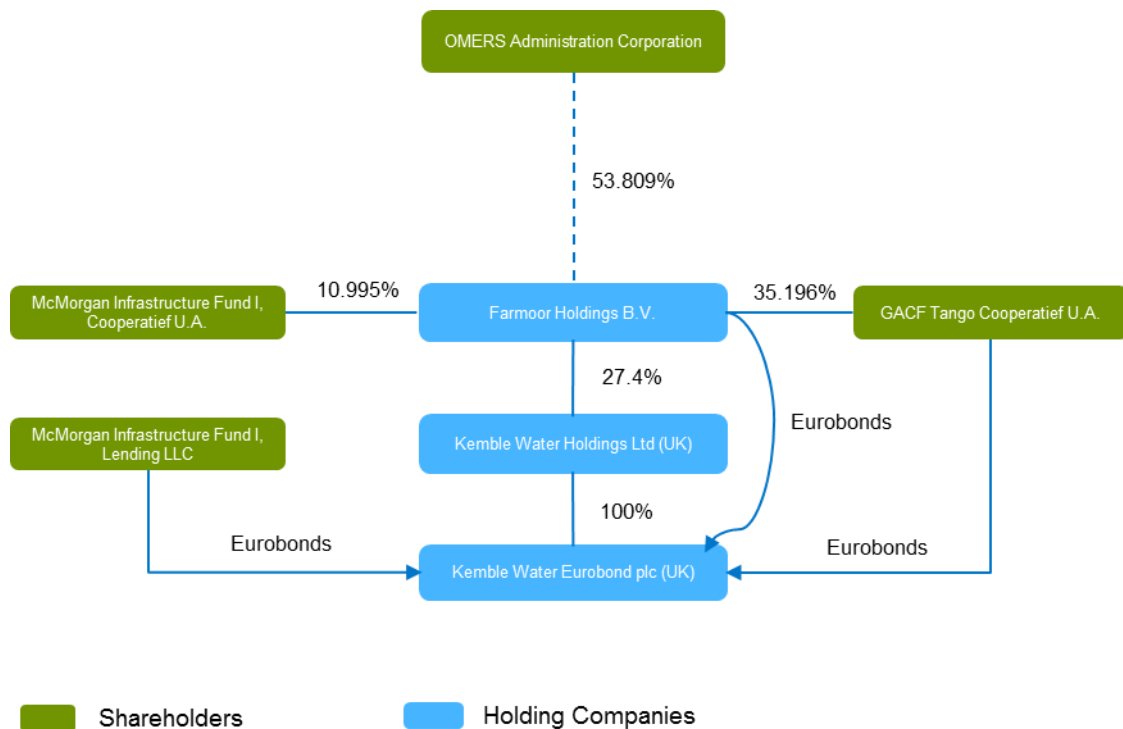
OMERS investment was not made as part of a consortium and the 17.54% interest in Thames Water acquired from Macquarie is separate to that made by the KIA. It has acquired further shareholdings and, in total, OMERS currently holds 27.4% of the company shares and is expected to increase its equity stake up to 31.76%, following completion of the acquisition of an additional 4.36% stake in mid-2018.

Part of the above shareholdings are not directly owned by OMERS. Specifically, OMERS owns a 53.809% stake in Farmoor Holdings B.V., a Dutch registered

⁷ OMERS has agreed to provide the required undertaking.

company, which holds the shares in Kemble. The remaining 46.191% shareholding is owned by the Global Alternative Co-Investment Fund I (“GACF”) and McMorgan Infrastructure Fund I, LP (“McMorgan”). Both of these funds are members of a contractual, co-investment arrangement known as the Global Strategic Investment Alliance (“GSIA”), which is an infrastructure co-investment programme established by OMERS and managed by OIM. The beneficiaries of the funds that form the GSIA are not actively involved in the management of the Farmoor’s interest and therefore, do not have any control over Kemble and Thames Water. Therefore, we regard OMERS as the controller of the entire 27.4% share in Thames Water that it currently either directly owns or manages via OIM.

Diagram B: OMERS structure



Kuwait Investment Authority

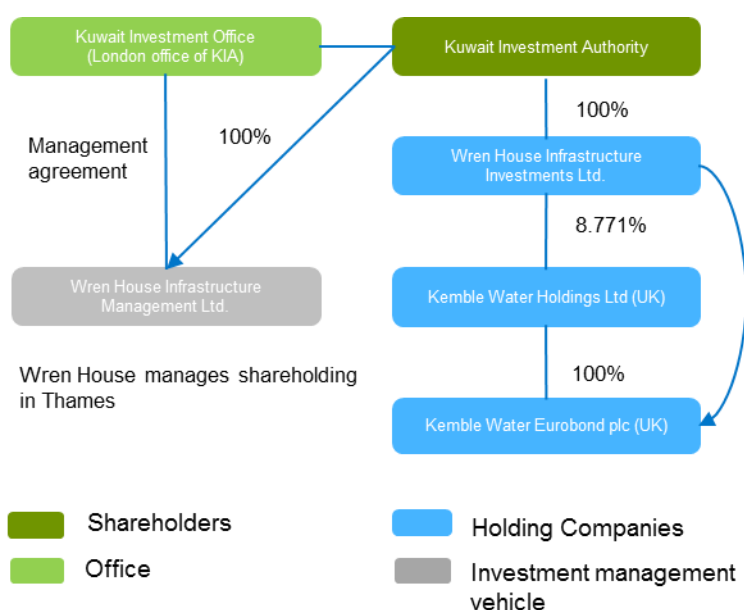
The KIA is a long-established sovereign wealth fund responsible for the management and administration of Kuwait's General Reserve Fund and the Future Generation Fund, as well as all other funds entrusted to it by the Kuwait Minister of Finance for and on behalf of the State of Kuwait. The KIA is rated Aa2 by Moody's Investors Service, Inc.

The 8.772% interest in Kemble and an equivalent proportion of Eurobonds issued by Kemble Water Eurobond plc has been acquired by Wren House Infrastructure

Investment Limited. The investment is managed by Wren House Infrastructure Management Limited (“Wren House”).

Wren House is based in London, and is fully owned by the KIA as a stand-alone company under English law with an investment management relationship governed by a management agreement between Wren House and the Kuwait Investment Office. Wren House has been assigned responsibility for building partnerships, sourcing and execution of transactions, as well as asset management.

Diagram C: KIA structure



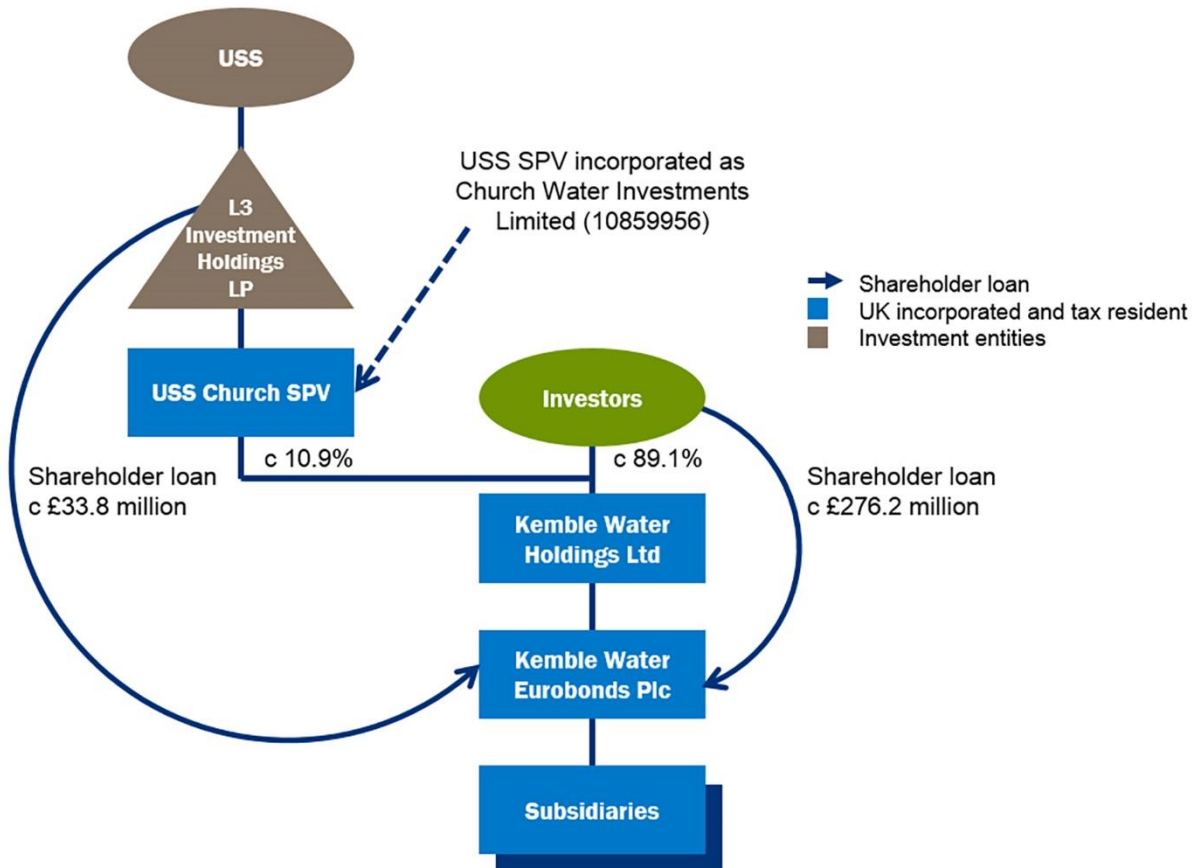
Universities Superannuation Scheme (USS)

The USS is the largest private pension scheme in the UK, ranked in the top 10 largest corporate pension funds globally, and is the principal pension scheme for universities and other higher education institutions in the UK. The scheme represents c.390,000 members and had assets under management of c.£61bn as of 31 March 2017. Universities Superannuation Scheme Limited (‘USSL’) is the sole corporate trustee responsible for the management and administration of the scheme, and USS Investment Management Limited (‘USSIM’) is the wholly owned investment management subsidiary of USSL.

USS, has advised that while it has no shareholdings in other UK regulated water companies it has participated in loans made to both South East Water and Affinity Water and in derivative transactions with Yorkshire Water. USS has confirmed that neither the loans or derivative transactions carry voting rights or provide access to

information on these companies beyond that received by any other ordinary credit provider and no conflict of interest is considered to exist. USS's investment in Kemble is through Church Water Investments Limited which is UK registered and tax resident.

Diagram D: USS structure



The capacity to be shareholders of appointed water companies

We want to be satisfied that acquisitions do not compromise the effective management of the regulated companies. As a result, we requested the three incoming shareholders, namely OMERS, KIA (Wren House) and USS to provide us with the relevant information to facilitate our change of control assessment, as specified in Section 2 of this consultation.

Experience in the infrastructure sector

Based on the information we have received, we believe that the new shareholders have proven experience as long-term investors in critical UK infrastructure, as evidenced by current investments in London City Airport, Associated British Ports, SGN (Scottish Gas Networks), Belfast International Airport, High Speed 1, Heathrow Airport and NATS (the UK's provider of air traffic control services).

Outside the UK, the new shareholders have additional significant experience as investors in major regulated utilities in Canada, the USA, Australia, Spain, Sweden, Finland and the Czech Republic.

OMERS and Wren House have said in public statements in respect of their shareholdings in Thames Water that their primary focus is to “support management’s goal to ... deliver a high quality customer experience and value for money both now and in the future”, and will “support Thames Water’s ongoing £4.5 billion capital investment programme – for the 2015 to 2020 regulatory period – the largest in the UK water industry”.

Corporate governance and management of Thames Water

The current⁸ Thames Water board of directors has 13 board members:

- An independent Chairman
- Five independent non-executive directors
- Four investor non-executive directors
- Three executive directors

⁸ As at 27 April 2018

Table E: Current members of the Thames Water Board of Directors

Director	Role	Affiliation
Ian Marchant	Chairman	Independent
Steve Robertson	CEO	Executive
Brandon Rennet	CFO	Executive
Nick Fincham	Strategy & Regulation Director	Executive
Nick Land	Senior Non-Executive Director	Independent
Lorraine Baldry	Non-Executive Director	Independent
Dame Deirdre Hutton	Non-Executive Director	Independent
Ian Pearson	Non-Executive Director	Independent
Ed Richards	Non-Executive Director	Independent
Christopher Deacon	Non-Executive Director	QIC, bclMC, PGGM, ABP
Kenton Bradbury	Non-Executive Director	OMERS
Guy Lambert	Non-Executive Director	Infinity, CIC
Greg Pestrak	Non-Executive Director	Wren House, USS

It is currently unclear whether any changes are likely to the composition of Thames Water's board, but we would expect that there may be changes in director affiliations given the ongoing sale by one investor of a minority shareholding in Kemble.

In addition, we understand that Thames Water under its new chair Ian Marchant is undertaking a review of governance arrangements. We expect the new structure to be in line with our BLTG principles and to ensure that Thames Water is capable of fulfilling its statutory and licence obligations, including independent operation of the Appointee.

Economic and financial standing

Based on the responses received to the questions set out in Appendix A2 which each of OMERS, KIA and USS have provided, we have reviewed the information in relation to economic and financial standing of three incoming investors. None of the investors have reported being subject to any financial investigations or to have any legal or financial claims against them which might have a material impact on the investor's financial standing. We have not independently verified the investors' statements.

Conflicts of interest

Other than disclosed above none of the new investors have reported any interests in other Appointees.

Conclusion

Our change of control assessment has not found any issues associated with the new investors that have purchased shares in Kemble and thereby Thames Water, based on the information we have received to date. Therefore, we do not see a need to introduce additional protections in the licence as a result of the new ownership structure.

However, we do consider that some modifications are needed to update Thames Water's licence. We set out our views in relation to this in Section 5.

Questions:

- Do you agree with our assessment of the incoming investors of Thames Water?
- What are your views on the ability of the new investors of Thames Water to run a regulated water utility?
- Do you have any concerns with the new investors of Thames Water that might affect the ability of Thames Water to fulfil its statutory duties and obligations under its licence?

5. Thames Water - regulatory issues arising from changes in control and proposed licence modifications

In Sections 2 and 3 we discuss, and seek views on, a range of issues which we think should be applied to the whole sector. Given the change in control of Thames Water, we are taking the opportunity to enhance their licence now, and this section sets out the immediate changes that we intend to make to its licence.

We discuss the proposed changes in general terms in Section 5.1 below and provide the indicative, specific drafting changes to the current licence of Thames Water in Appendix A3.

We have also considered the identification of the Ultimate Controller(s) of Thames Water under the new ownership structure in Section 5.2 and identify in Table F those parties from whom Thames Water should obtain legally binding undertakings.

Thames Water has indicated that, subject to Board approval, it is willing in principle to accept the proposed licence modifications of the nature referred to below.

5.1 Proposed licence modifications

Structure of the regulatory ring fence licence conditions

As we explained in Section 3, we want to ensure that all companies have the most up to date ring fencing conditions. We therefore want to update Thames Water's ring fencing licence conditions, introduce a consolidated new Condition P into their licence and move related definitions to Condition A.

Board Leadership Transparency and Governance Principles

As we explain in Section 3, we propose introducing a licence requirement as part of the updated condition P, to require Thames Water to meet the BLTG principles. We propose the inclusion of the current up to date version of this provision in Thames Water's licence. As noted in section 3 above, we will be reviewing the BLTG principles shortly.

Enforcement of Ultimate Controller undertakings

We also propose introducing, to address the issue of the Ultimate Controller undertaking enforceability which we discuss in Section 2, additional wording to Thames Water's licence to require them to comply with a direction from Ofwat to enforce the legal undertakings it has procured from its Ultimate Controllers.

Change of control notification requirements

As noted in Section 2, we consider it important to be notified when a change of control within the water sector takes place or is likely to take place, including submission for merger clearance from competition authorities.

We would like this to happen before the change of control occurs so that we could consider any implications for the Appointee.

We propose introducing a requirement as part of the new consolidated Condition P in Thames Water's licence, requiring the Appointee to inform us, if it becomes aware that arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the Appointee and also when the Appointee becomes aware that a merger control filing is to be submitted to the Competition and Markets Authority or the European Commission.

Change of control information requirements

As per our reasoning in Section 2.1, we are proposing to introduce a requirement for Thames Water to provide us any information that we may reasonably require when there is an actual or potential change to the Ultimate Controller(s) of the Appointee. The current information requirements are set out in Appendix A2.

Credit rating requirements

As noted in Section 3, the licence condition in relation to credit rating requirements and cash lock up is inconsistent across different licences in terms of both content and wording. To bring Thames Water's licence to the current highest standard we propose a change to the licence condition to require the Appointee to have an investment grade credit rating, as opposed to asking for the Appointee to use 'all reasonable endeavours' to ensure it has an investment grade credit rating.

Question:

- What are your views on the proposed modifications of Thames Water's licence?

5.2 Identification of Ultimate Controllers

We have considered the identification of the Ultimate Controller(s) of Thames Water under the new ownership structure and the existing Kemble shareholders' agreement.

As noted in Section 2, we do not see the size of shareholdings as the only way *material influence* can be exercised. In the case of Thames Water, we see multiple parties potentially qualifying as Ultimate Controllers of the Appointee which may change depending on any review of the governance arrangements. Based on the current arrangements, we consider that the following parties are potential Ultimate Controllers:

- Parties who can nominate a director directly to the Thames Water board – under the current arrangements this requires at least a 17.3762% shareholding in Kemble;
- Parties who can nominate a director on the Kemble board – which under the current shareholder arrangements requires at least a 8.7% shareholding in Kemble - and have the ability to either positively or negatively influence decision making on reserved matters (mostly critical decisions such as Appointee business plan submissions);

Based on the above, we have determined that the following parties, as set out in Table F, are Ultimate Controllers of Thames Water and we expect Thames Water to obtain from each a legally binding Ultimate Controller undertaking.

Table F: Likely Ultimate Controllers of Thames Water under the current shareholders agreement

Owner	Description	Percentage
OMERS	Canadian pension fund	27.4 (+4.3)
USS	British pension fund	10.9
Infinity	Abu Dhabi sovereign wealth fund	9.9
Wren House	Kuwait sovereign wealth fund	8.8
BriTel	British pension fund	8.7
CIC	Chinese sovereign wealth fund	8.7
bclMC	Canadian pension fund	8.7

In addition, we note that control and material influence might also be exercised on a joint basis by shareholders taking coordinated actions. In the case of Thames Water, since the above shareholders have a cumulative share of 78.6% and the

extraordinary majority required for reserved matters is 75%, no other investors could influence decisions negatively on a joint basis, unless it entered into an agreement with one of the parties listed in Table F.

Thames Water is currently undertaking a review of its governance arrangements. Our assessment above is based on the current arrangements, for which we expect UC undertakings to be in place. We will take account of any changes to arrangements once they are implemented and at that time would expect Thames Water to have undertakings which reflect the UCs in the new arrangements.

Questions:

- What are your views on our assessment of the Ultimate Controllers under the current arrangements?

6. Responding to this consultation and next steps

We would welcome any comments on this document. Please send your responses to FinanceAndGovernance@ofwat.gsi.gov.uk. You can also submit your response by post to:

Change of Control
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

The closing date for this consultation is 8 June 2018. We will publish responses to this consultation on our website at 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 have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ with which public authorities must comply and 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. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons that the contents of those written responses remain confidential.

Following the consultation and careful consideration of stakeholders’ responses, we currently expect to publish our decision in July 2018.

Consultation questions

We welcome responses to the following questions, particularly responses which consider how trust and confidence can be rebuilt in this sector by putting customers at the heart of company and investor considerations.

- 1) What are your views on the introduction of notification requirements on change of control into the licence information requirements?
- 2) What are your views on the proposed obligation to provide us with information?
- 3) What are your views on the information that may be helpful for our assessment of change of control?
- 4) What are your views on the proposed obligation to require the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller's undertaking?
- 5) What are your views on bringing all the licences up to the same standards, including introducing a requirement to meet the BLTG principles?
- 6) Are there aspects of the most up to date provisions which you think we need to revisit or amend?
- 7) What are your views on how the ring fencing conditions need to be further strengthened? In particular, in relation to:
 - a. Maintaining an appropriate credit rating and how and when the lock-up conditions are triggered?
 - b. Whether there needs to be a more explicit requirement to inform us of particular events affecting the Appointee?
 - c. Managing potential conflicts of interest where there are cross-shareholdings?
 - d. Safeguarding the autonomy of the Appointee?
 - e. Any other issues?
- 8) Do you agree with our assessment of the incoming investors of Thames Water?
- 9) What are your views on the ability of the new investors of Thames Water to run a regulated water utility?
- 10) Do you have any concerns with the new investors of Thames Water that might affect the ability of Thames Water to fulfil its statutory duties and obligations under its licence?
- 11) What are your views on the proposed modifications of Thames Water's licence?
- 12) What are your views on our assessment of the Ultimate Controllers under the current arrangements?

A1 - Thames Water – other shareholders

In this appendix we provide some information on the other current shareholders of Thames Water.

The BT Pension Scheme (“BTPS”) 8.7% is one of the largest UK occupational pension schemes. Britel Fund Trustees Limited acts as custodian trustee of the BTPS and is supported/managed by Hermes GPE which invests in and advises on infrastructure, private equity and credit products on behalf of its clients and is specialised in co-investments, primary fund and secondary investments. Hermes is authorised and regulated by the UK’s Financial Conduct Authority, and is currently a wholly owned subsidiary of the BT Pension Scheme is one of Europe’s leading independent specialists in global private markets.

Infinity Investments S.A 9.9% is a wholly owned subsidiary of the Abu Dhabi Investment Authority (ADIA), which manages an estimated US\$828bn on behalf of the Emirate of Abu Dhabi. ADIA manages a global investment portfolio that is diversified across more than two dozen asset classes and sub-categories.

British Columbia Investment Management Corporation (“bcIMC”) 8.7% with a global portfolio of more than C\$121.9 billion is one of Canada’s largest institutional investors. It invests on behalf of public sector clients in British Columbia and its activities help finance the retirement benefits of more than 538,000 plan members, as well as the insurance and benefit funds that cover over 2.3 million workers in British Columbia. bcIMC is one of Canada’s largest institutional investors within the capital markets.

Cicero Investment Corporation (“CIC”) 8.7% a subsidiary of the China Investment Corporation, a sovereign wealth fund, which is a vehicle to diversify the Peoples Republic of China’s foreign exchange holdings and seek maximum returns for its shareholder within acceptable risk tolerance.

QIC 5.4% is a global diversified alternative investment firm offering infrastructure, real estate, private equity, liquid strategies and multi-asset investments. It is one of the largest institutional investment managers in Australia.

Aquila 5.0% is a leading US infrastructure management firm and a wholly owned subsidiary of Fiera Infrastructure Inc., a leading investor across all subsectors of the infrastructure asset class.

Stichting Pensioenfonds ABP 4.3% is a pension plan sponsor. The firm provides its services to employers and employees in the government and education sectors. It invests in the public equity markets.

A2 - Information checklist for change of control assessment

When change of ownership occurs, we ask the incoming investors to provide the following:

(a) General information about the investor including:

- Date of company registration and registration information (name, address, company number and also that for its ultimate holding company if applicable), (if the investor is a consortium then this information is required for each member and should include the proposed percentage shareholding of each member of a consortium).
- An organisation chart showing the investor's (or, if applicable, the consortium's) corporate and financial structure.
- The name and contact details for one person who will act as the point of contact with Ofwat during the consultation process.
- An explanation of any relationships with (i) existing licensed undertakers and/or (ii) water supply licensees in England and Wales.
- Any potential conflicts of interests.

(b) Information on the investor's economic and financial capacity (if the investor is a consortium then this information is required for each member), including:

- a copy of their audited accounts for the most recent two years; or
- a statement of their turnover, profit & loss account and a cash flow for the most recent year of trading; or
- a statement of their cash flow forecast for the current year and a bank letter outlining the current cash and credit position; or
- alternative means of demonstrating financial status, such as compliance with debt covenants/requirements⁹.

(c) Information on investor's technical and professional capability, including evidence that it has recent relevant experience of delivering, managing or investing in:

- Major infrastructure projects in the UK or another country in a sector which is regulated; or

⁹ If applicants cannot provide one of the listed documents then they may seek clarification regarding the appropriateness of alternative documentations.

- A company or companies in the UK or another country in a sector which is regulated; and
 - Equity investment in aggregate of at least £500m¹⁰ in (i) in major infrastructure projects and/or (ii) companies.
- (d) Investor (and if a consortium, each member), must provide a statement that it has not been subject to a financial investigation by an accredited UK (or equivalent) regulator. If it is/has been subject to such investigation, please provide details.
- (e) Investor (and if a consortium, each member), must provide details of any legal or financial claims an investor or member (as relevant) is subject to which could have a material impact on the investor or member (as relevant) financial standing.
- (f) Investors to submit a statement to Ofwat that includes information on:
- Their understanding of the regulatory environment and their confirmation that they will comply with all statutory and regulatory requirements;
 - How they will meet their obligation as a shareholder of a licenced water company;
 - How they will support management, and supplement management capacity;
 - Their board governance arrangements.
- (g) Investors will, if a refinancing of the Appointee is planned, provide to Ofwat a financing plan. We expect the plan should take into consideration the following factors:
- Corporate structure and security arrangements, which may be reflected in appropriate company or legal documentation.
 - Strength of equity commitment, including investor credit rating or letters of credit or similar support.
 - Terms, conditions and expected returns of equity/shareholder loan capital, which may be supported by relevant investor documentation.
 - Target credit rating and sufficiency of the financing plan to achieve this, which may be supported by views from rating agencies or financial advisers.
 - Use (quantum and timing) of bank, bond (public distribution or private placement), mezzanine debt or similar.
 - Fee and pricing indications for each class of debt, which may be supported by statements from financing banks or lead arrangers.

¹⁰ For the purposes of these criteria, major infrastructure projects means infrastructure projects with a capital value in excess of £100 million and companies means infrastructure companies with assets with a capital value in excess of £100 million.

A3 – Proposed modifications to Thames Water’s licence

We propose to make the following modifications to Thames Water’s licence.

Condition A

We propose adding the following to Condition A:

2. In construing these Conditions:

...

(3) references to a liability shall be taken to include the creation of any mortgage, charge, pledge, lien or other form of security or encumbrance, the making of a loan and the taking on of a debt; and

(a) references to a loan shall be taken to include the transfer or lending, by any means, of any sum of money or rights in respect of such sum.

3. Unless the context otherwise requires, in these Conditions:

“Credit Rating Agency” means:

- (a) Standard and Poor’s Ratings Financial Services LLC (or any of its subsidiaries);
- (b) Moody’s Investors Services Incorporated (or any of its subsidiaries);
- (c) Fitch Ratings Limited; or
- (d) any reputable credit rating agency which has been notified to the Appointee by the Water Services Regulation Authority as having comparable standing to Standard & Poor’s Ratings Group, Moody’s Investors Services Incorporated and Fitch Ratings Limited in both the United Kingdom and the United States of America;

“Cross-Default Obligation” means a legal obligation contained in an agreement or arrangement where the Appointee’s liability to pay or repay any debt or other sum arises or is increased or accelerated due to the default of any person other than the Appointee;

“Financing Subsidiary” means a subsidiary company of the Appointee:

- (1) (a) which is wholly owned by the Appointee; and

(b) the sole purpose of which, as reflected in the company’s articles of association, is to raise finance on behalf of the Appointee for the purposes of the Regulated Activities; or
- (2) Which the Water Services Regulation Authority has agreed in writing will be considered a Financing Subsidiary.

“Holding Company” has the meaning set out in section 1159 of the Companies Act 2006;

“Investment Grade Rating” means an Issuer Credit Rating recognised as investment grade by a Credit Rating Agency;

“Issuer Credit Rating” means a credit rating assigned to an issuer of corporate debt by a Credit Rating Agency;

“Lowest Investment Grade Rating” means:

- (a) an Issuer Credit Rating of BBB- by Standard & Poor’s Ratings Financial Services LLC or Fitch Ratings Limited or an Issuer Credit Rating of Baa3 by Moody’s Investors Services Incorporated or such Issuer Credit Rating as may be specified from time to time by any of these credit rating agencies as the lowest Investment Grade Rating; or
- (b) an equivalent rating from any other Credit Rating Agency;

“Ring-fencing Certificate” means a certificate, submitted to the Water Services Regulation Authority by the Appointee, which states that, in the opinion of the Board of the Appointee:

- (a) the Appointee will have available to it sufficient financial resources and facilities to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted;
- (b) the Appointee will have available to it sufficient management resources and systems of planning and internal control to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted; and
- (c) all contracts entered into between the Appointee and any Associated Company include the necessary provisions and requirements in respect of the standard of service to be supplied to the Appointee, to ensure that it is able to carry out the Regulated Activities;

“subsidiary” has the meaning set out in section 1159 of the Companies Act 2006;

“Ultimate Controller” means any person which, whether alone or jointly and whether directly or indirectly, is, in the reasonable determination of the Water Services Regulation Authority, 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;

“United Kingdom Holding Company” means a Holding Company which is registered in the United Kingdom and which is not a subsidiary of any company registered in the United Kingdom;

Condition P

We propose to modify the existing Condition P in the following way:

Replace the existing Condition P wording with the wording presented below.

Condition P: Regulatory ring-fence

1 Introduction

1.1 The purpose of this Condition is to ensure that:

- (a) the Appointed Business is conducted as if it is substantially the Appointee's sole business and it is a public limited company separate from any other business carried out by the Appointee;
 - (b) the Appointee retains sufficient rights and assets and has in place adequate financial resources and facilities, management resources and systems of planning and internal controls;
 - (c) any transfers or transactions entered into by the Appointee do not adversely affect the Appointee's ability to carry out the Regulated Activities;
- and
- (d) the Appointee demonstrates that it is complying with the requirements of this Condition.

2 Conduct of the Appointed Business

2.1 The Appointee must, at all times, conduct the Appointed Business as if the Appointed Business were:

- (a) substantially the Appointee's sole business; and
- (b) a public limited company separate from any other business carried out by the Appointee.

2.2 The Appointee must meet the corporate governance principles issued by the Water Services Regulation Authority and revised from time to time.

2.3 The Appointee will demonstrate, in an appropriate manner, how it is meeting the principles referred to in paragraph 2.2.

3 The Role of the company's Ultimate Controller and United Kingdom Holding Company

3.1 The Appointee must ensure that, at all times:

- (a) there is an undertaking in place which is given by the Ultimate Controller of the Appointee in favour of the Appointee; and
- (b) where the United Kingdom Holding Company of the Appointee is not the Ultimate Controller of the Appointee, there is an undertaking in place which is given by the United Kingdom Holding Company of the Appointee in favour of the Appointee.

3.2 The Appointee must ensure that any undertaking given pursuant to paragraph 3.1 provides:

- (a) that the person giving the undertaking must, and must procure that each of its subsidiaries other than the Appointee and its subsidiaries:
 - (i) provides to the Appointee such information as is necessary to enable the Appointee to comply with; and
 - (ii) does not take any action which may cause the Appointee to breach any of,

its obligations under the Water Industry Act 1991 or under these Conditions;
and

3.3 Where:

- (a) an undertaking required to be given by a person in accordance with paragraph 3.1 is not in place; or

- (b) there has been a breach of the terms of such an undertaking by the person that gave it and that breach has not been remedied,

the Appointee must not enter into any new contract or arrangement with such a person or the subsidiaries of such a person other than subsidiaries of the Appointee, without the prior written approval of the Water Services Regulation Authority.

3.4 The Appointee must provide to the Water Services Regulation Authority such certified copies of any undertaking given pursuant to paragraph 3.1 as are requested by the Water Services Regulation Authority.

3.5 The Appointee must immediately inform the Water Services Regulation Authority in writing if the Appointee becomes aware that:

- (a) an undertaking given by a person pursuant to paragraph 3.1 has ceased to be legally enforceable; or

- (b) there has been a breach of the terms of such an undertaking by the person that gave it.

3.6 The Appointee shall inform the Water Services Regulation Authority as soon as reasonably practicable if the Appointee becomes aware that:

- (a) arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the Appointee; or

- (b) arrangements have been put into effect which might be considered to have led to a change to the Ultimate Controller(s) of the Appointee; or

- (c) any person intends to submit a merger control filing to the Competition and Markets Authority or the European Commission with respect to an actual or potential change of control of the Appointee.

3.7 The Appointee must provide to the Water Services Regulation Authority any information that it may reasonably require for the purposes of its assessment of any such actual or potential change to the Ultimate Controller(s) of the Appointee.

3.8 The Appointee must comply with any direction given by the Water Services Regulation Authority to the Appointee to enforce the terms of an undertaking given to it pursuant to paragraph 3.1.

4 Assets, rights and resources

4.1 The Appointee must, at all times, act in a manner which is best calculated to ensure that it has in place adequate:

- (a) financial resources and facilities;
- (b) management resources; and
- (c) systems of planning and internal control,

to enable it to carry out the Regulated Activities. The above requirements must not be dependent upon the discharge by any other person of any obligation under, or arising from, any agreement or arrangement under which that other person has agreed to provide any services to the Appointee in its capacity as a Relevant Undertaker.

4.2 The Appointee must ensure that, as far as reasonably practicable, it has available to it sufficient rights and resources other than financial resources so that if, at any time, a special administration order were to be made in relation to it, the special administrator would be able to manage the affairs, business and property of the Appointee in accordance with the purposes of the special administration order.

4.3 For the purposes of paragraph 4.2, the Appointee is not required to amend the terms of any legal obligation which has been transferred to it in accordance with a scheme made under Schedule 2 to the Water Industry Act 1991.

4.4 Where rights and resources which are required to be made available pursuant to paragraph 4.2 are made available by a Group Company, the Appointee must ensure that if, at any time, a special administration order were to be made in relation to it, the rights and resources would be available to the special administrator for the purpose set out in paragraph 4.2.

5 Listing of financial instruments

5.1 If the Ultimate Controller of the Appointee is not listed on the London Stock Exchange or on another exchange that the Water Services Regulation Authority agrees is of similar standing the Appointee must comply with paragraph 5.2.

5.2 The Appointee must use all reasonable endeavours to maintain the listing of a financial instrument, whose market price should reflect the financial position of the Appointed Business, on:

- (a) the London Stock Exchange; or
- (b) with prior agreement of the Water Services Regulation Authority, another exchange of similar standing,

unless the Water Services Regulation Authority, following an application by the Appointee, determines that market conditions are such that it would be inappropriate for the Appointee to maintain the listing of such a financial instrument.

6 Transfer Pricing and Cross-Default Obligations

6.1 The Appointee must ensure that:

- (a) every transaction between the Appointed Business and any Associated Company is at arm's length, so that neither the Appointed Business nor the Associated Company gives a cross-subsidy to the other; and

- (b) the Appointed Business neither gives nor receives any cross-subsidy from any other business or activity of the Appointee.

in accordance with Regulatory Accounting Guideline 5 (Transfer Pricing in the Water and Sewerage Industry) published by the Water Services Regulation Authority and revised from time to time.

6.2 The Appointee must provide the Water Services Regulation Authority with any information about the costs of an Associated Company which provides services to the Appointee which the Water Services Regulation Authority reasonably requires.

6.3 The Appointee must not, without the prior approval of the Water Services Regulation Authority:

- (a) give a guarantee in relation to any liability of an Associated Company;
- (b) make a loan to an Associated Company; or
- (c) enter into an agreement or other legal instrument incorporating a Cross-Default Obligation.

6.4 The Appointee must not continue or permit to remain in effect an agreement or other legal instrument incorporating a Cross-Default Obligation unless:

- (a) prior approval has been given by the Water Services Regulation Authority; or
- (b) the Cross-Default Obligation would only arise on a default by a subsidiary of the Appointee and the Appointee ensures that:
 - (i) the period for which the Cross-Default Obligation is in effect is not extended;
 - (ii) liability under the Cross-Default Obligation is not increased; and

- (iii) no change is made to the circumstances in which liability under the Cross-Default Obligation may arise.

6.5 The Appointee shall not, without the consent of the Water Services Regulation Authority and otherwise than in compliance with its directions concerning the valuation of the asset and the treatment of the consideration in the Appointee's accounts, transfer to any Associated Company to which paragraph 6.1 applies any right or asset to which paragraph 4.2 applies.

7 Credit Ratings and “Cash Lock-Up”

7.1 The Appointee must demonstrate its ability to service its debt obligations by complying with paragraph 7.2

7.2 The Appointee must ensure that it and any Associated Company which issues corporate debt on its behalf maintains, at all times, an Issuer Credit Rating which is an Investment Grade Rating.

7.3 The “Cash Lock-Up” provisions set out in paragraph 7.4 apply in any circumstances where:

- (a) the Appointee does not hold an Issuer Credit Rating which is an Investment Grade Rating;

- (b) the Appointee holds more than one Issuer Credit Rating and one or more Issuer Credit Ratings held by it is not an Investment Grade Rating; or

- (c) any Issuer Credit Rating held by the Appointee is the Lowest Investment Grade Rating and:

- (i) the rating is on review for possible downgrade or is on “Credit Watch” or “Rating Watch” with a negative designation; or

- (ii) otherwise where the rating outlook of the Appointee as specified by the Credit Rating Agency which has assigned the Lowest

Investment Grade Rating has been changed from stable or positive to negative.

- 7.4 Where paragraph 7.3 applies, the Appointee must not, without the prior approval of the Water Services Regulation Authority, transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company, other than where:
- (a) the Appointee makes a payment to an Associated Company which is:
 - (i) pursuant to an agreement entered into prior to the circumstances referred to in paragraph 7.3 arising, which provides for the goods, services or assets to be provided on an arm's length basis and on normal commercial terms; and
 - (ii) properly due in respect of the goods, services or assets;
 - (b) the Appointee transfers, leases, licenses or lends any sum, asset, right or benefit to any Associated Company (excluding a dividend payment, a distribution out of distributable reserves or a repayment of capital), where:
 - (i) the transaction is on an arm's length basis on normal commercial terms; and
 - (ii) the value due in respect of the transaction is payable wholly in cash and is paid in full when the transaction is entered into;
 - (c) the Appointee makes a repayment of, a payment of interest on or payments in respect of fees, costs or other amounts incurred in respect of:
 - (i) a loan made from a Financing Subsidiary to the Appointee, provided that the Financing Subsidiary continues to be an Associated Company of the Appointee; or

- (ii) a loan made prior to the circumstances referred to in paragraph 7.3 arising which is otherwise in accordance with these Conditions, provided that payment in respect of such a loan is not made earlier than provided for in accordance with its terms;

or

- (d) the Appointee makes a payment for group corporation tax relief or for the surrender of Advance Corporation Tax, calculated on a basis not exceeding the value of the benefit received, provided that the payment is not made before the date on which the amounts of tax subject to the relief would have become due.

8 Dividend Policy

8.1 The Appointee must, at all times, have in place a dividend policy which effectively embodies:

- (a) the principle that dividends declared or paid should not impair the ability of the Appointee to finance the Appointed Business; and
- (b) the principle that dividends should be an incentive which is expected to reward efficiency and the management of economic risk,

and has been approved by the Board of the Appointee.

8.2 The Appointee must ensure that any dividends are declared or paid in accordance with the current dividend policy made in accordance with paragraph 8.1.

9 Ring-fencing Statement and Certificate

9.1 The Appointee must publish with its audited accounts for each twelve month period a statement as to whether or not (as at the end of the period) the Appointee has available to it sufficient rights and resources other than financial resources, as required by paragraph 4.2

- 9.2 No later than the date on which the Appointee is required to deliver to the Water Services Regulation Authority a copy of each set of accounting statements prepared under Condition F, the Appointee must submit a Ring-fencing Certificate to the Water Services Regulation Authority.
- 9.3 Where the Board of the Appointee becomes aware of any activity of the Appointee or any Group Company which does not form part of the Regulated Activities, and which may be material in relation to the Appointee's ability to finance the Regulated Activities, the Appointee must:
- (a) inform the Water Services Regulation Authority; and
 - (b) within fourteen days of becoming aware of the activity, submit a new Ring-fencing Certificate to the Water Services Regulation Authority.
- 9.4 Where the Board of the Appointee becomes aware of any circumstances which would change its opinion such that it would not give the opinion contained in the Ring-fencing Certificate, the Appointee must inform the Water Services Regulation Authority of this in writing.
- 9.5 Whenever the Appointee submits a Ring-fencing Certificate to the Water Services Regulation Authority, the Appointee must submit a statement of the main factors which the Board of the Appointee has taken into account in giving its opinion for the Ring-fencing Certificate.
- 9.6 A Ring-fencing Certificate must be:
- (a) signed by all directors of the Appointee on the date of submission; or
 - (b) approved at a meeting of the Board of the Appointee, convened in accordance with the Appointee's articles of association, in which case the Ring-fencing Certificate must:
 - (i) be signed by a director of the Appointee or the Appointee's company secretary; and

- (ii) have appended to it a certified copy of the minutes of the approval.

9.7 Each Ring-fencing Certificate shall be accompanied by a report prepared by the Appointee's Auditors and addressed to the Water Services Regulation Authority, stating whether they are aware of any inconsistencies between that Ring-fencing Certificate and either the statements referred to in sub-paragraph 9.3 of condition F or any information which the Auditors obtained in the course of their work as the Appointee's Auditors and, if so, what they are.

10 Reporting of Material Issues

10.1 Where the Board of the Appointee becomes aware of any circumstance that may materially affect the Appointee's ability to carry out the Regulated Activities the Appointee must inform the Water Services Regulation Authority as soon as possible.

11 References to Competition and Markets Authority

11.1 The Appointee may notify the Water Services Regulation Authority, within one month of receiving notice that a revision is to be made to the corporate governance principles referred to in paragraph 2.2, that it disputes the revision, and in that case:

(a) the question of whether the revision is appropriate shall (unless the Water Services Regulation Authority withdraws the decision to make it) be referred by the Water Services Regulation Authority to the Competition and Markets Authority for determination; and

(b) the revision shall not take effect unless the Competition and Markets Authority determines that it shall.

Removal of paragraphs from other conditions

We also propose removing the following paragraphs:

Condition F

1.1(3), 1.1(4), 1.1(4A), 1.1(6), 6.1, 6.8 to 6.12 and all paragraphs in 6A

Condition K

All paragraphs in 3.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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