

Northumbrian Water Limited (NWL)

Response to Ofwat's consultation on change of control - general policy and its application to Thames Water

- 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?**

In principle, we support Ofwat having a proportionate approach when there is a change of control of an Appointee.

The consultation states 'we [Ofwat] 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'. In our view this is an extremely broad provision and may capture requests that the Appointee is unable to satisfy due to factors outside its control. We are therefore not supportive of this change as currently proposed.

We believe that the majority of the areas that Ofwat has requested as set out in section 2.1 of the consultation paper continue to be appropriate and reasonable, as long as they relate to the entities within the regulatory ring fence. We do not believe it appropriate to extend the matters listed in section 2.1 to include the suggestion of information on proposed refinancing of any acquisition, given the commercial sensitivity of such information. Whilst we note Ofwat states that it has 'relied on the goodwill of Appointees and investors to provide this information', it would be helpful to understand if there are instances where this has not been supplied, to better understand why Ofwat now feels the need to codify this matter as an obligation.

We also note the statement that 'we [Ofwat] 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'. We are very concerned how such a general process could work in practice. It is not clear to us if Ofwat's intention is to introduce a pre-approval "vetting process", but if it is to introduce such a licence condition under which any change of control is subject to prior regulatory approval, then we would object to this. Perhaps as an alternative, Ofwat could consider introducing a pre-approval process for potential investors, which would establish them as acceptable owners independently of any transaction. This would then mean there would be no increase in completion risk for sellers, and Ofwat could be comfortable that future owners are acceptable, and address some of the additional concerns we have set out below.

We are concerned regarding the practicality of Ofwat's intention to introduce in due course a new licence condition that 'requires the Appointee to inform [Ofwat] when it becomes aware of a change of control, or an upcoming likely change'. It may not be easy in practice to accurately determine when such an 'upcoming likely change' threshold would be triggered and any difference in interpretation between the Appointee and Ofwat risks an automatic licence breach. We also believe that there may be some significant issues around public disclosure, confidentiality, and commercial sensitivities, particularly for listed companies and we suggest Ofwat may wish to obtain some legal advice on this

important matter, which could then be shared with the Appointees. We note Ofwat's suggestion that this could, perhaps, include informing Ofwat of any submission for merger clearance to the Competition and Markets Authority and/or the European Commission, and it would also seem sensible to expect prospective investors rather than companies to inform Ofwat at such a stage. We are also confused how such a proposal would impact on the well-established process when a sale transaction occurs, whereby it is accepted that a buyer normally takes the regulatory approval risk. The process now being suggested in the consultation would create significant complications to any sale process, and potentially lead to a protracted and costly process that buyers may be reluctant to undertake.

In relation to a potential obligation to require the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller's undertaking, we need to better understand what the process would be if the Board of the Appointee disagreed with any enforcement direction issued, and what would be the envisaged appeal procedure, under such a situation for us to consider this item further.

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?

In principle, we agree that all licences could be brought to broadly the same standards albeit with some exceptions.

In particular, we do not support introducing a requirement to fully meet the Board Leadership, Transparency and Governance (BLTG) principles as we do not believe full compliance is appropriate for a company with NWL's specific characteristics. The current Ofwat guidance outlines the objective to "have corporate governance standards commensurate with those of companies listed on the LSE", notwithstanding that NWL is not a listed company. The guidance appropriately sets out a 'comply or explain' approach to governance rather than a binding absolute licence condition requiring absolute compliance. As Ofwat has, very helpfully, recognised in applying its existing BLTG principles, some of them are not aligned to the way a private company with a single owner would be organised. As such we strongly believe the current 'comply or explain' approach should be maintained.

Companies have already set out their governance principles and codes. We feel that these give companies flexibility to organise their governance appropriately, without the inflexibility of a licence requirement.

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?

Ofwat proposes replacing the requirement for companies to use all 'reasonable endeavours' to maintain an investment grade credit rating, with a requirement to have an investment grade credit rating.

Effectively this could create a "cliff-edge" situation whereby a company that loses its investment grade credit rating is immediately in breach of its licence, even if it has a plan in place to remedy and recover that rating. The licence then sets out the cash lock-up provisions to be undertaken should the

Appointee lose its investment grade credit rating. An Appointee in this position would already be in breach of its licence, placing the Appointee and the Regulator in a difficult position. How would Ofwat respond should a company be in temporary breach of licence? Would there be a recognition that the circumstances were temporary? Retaining the 'reasonable endeavours' provisions would importantly give Ofwat the discretion to delay enforcement action, provided a recovery plan was in place.

We are also concerned about recent Ofwat actions that Moody's referred to on 22 May 2018 in their water sector report as having "undermined the stability and predictability" of the sector, as a result of which four companies were placed on negative watch (Thames, Anglian, Affinity and Wessex). Continuation of such Ofwat actions could further destabilise company credit ratings and potentially even trigger such dividend lock-up provisions that Ofwat is now proposing without any company specific action being responsible for such an outcome. We believe the current licence provisions of using all 'reasonable endeavours' to maintain an investment grade credit rating provides sufficient protection to customers, and that no additional dividend lock-up provisions should be proposed.

All Appointees and company Boards fully recognise the importance of maintaining an investment grade credit rating, and as such we do not believe there is a requirement to move away from the 'reasonable endeavours' provisions to an obligation to strengthen the ring fencing conditions.

Similarly the NWL Board take the other matters noted above very seriously and ensure appropriate governance arrangements are operated, and as such we again feel it is not necessary to create any additional explicit requirements for these other matters. Also, if any confidential information passed from one company to another then that would give rise to remedies under law.

- 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?**

We have no views on the specific circumstances of the Thames investors. However, we do believe that it would be appropriate for Ofwat to continue to undertake its own well established professional regulatory assessment of any new investors rather than inviting any public assessments.

We would be grateful if Ofwat could consider the above responses also for its recently issued consultation document relating to the Change of Control of Portsmouth Water Limited.

Northumbrian Water Limited
June 2018