

May 2018

Trust in water

# Consultation for proposed modifications to license conditions for Portsmouth Water Limited

## About this document

This document is a consultation on the issues arising out of the recent change of control of Portsmouth Water ('Portsmouth Water'). It sets out:

- Our assessment for Portsmouth Water against our policy approach to changes of ownership and control to a water and wastewater undertaker.
- The proposed modifications to the conditions of the Instrument of Appointment ('licence') of Portsmouth 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<sup>1</sup> 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 Portsmouth Water, this document (including attached Appendix A1) is a Notice under section 13.

On 11 May 2018 we published [Change of control - general policy and its application to Thames Water](#) for consultation ('the Change of Control – general policy consultation'), which sets out for comment:

- Our approach to assessing changes in control of a water (and/or wastewater) company (an "Appointee"),
- 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.

The licence changes we propose in this document for Portsmouth Water and our assessment of the change of control of the Appointee should be viewed in the wider context of the Change of Control – general policy consultation.

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<sup>1</sup> 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

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.

In this document, we set out the specific regulatory considerations arising from the recent change in control of Portsmouth Water following its acquisition by Ancala Partners (“Ancala”).

In the Change of Control – general policy consultation we set out the high level principles that we apply to our assessment of change of control and the information we review as part of this assessment.

Our aim is to take a proportionate approach when there is a change of control of an Appointee. Consistent with the process set out in the Change of Control – general policy consultation, for Portsmouth Water our assessment was based on information the company provided to us. As part of this assessment, we have identified areas of the Appointee’s licence that need updating.

This document also sets out proposed modifications to Portsmouth Water’s licence. We propose updating Portsmouth Water’s licence to the highest current standard for ring fencing provisions. The changes we propose here are consistent with those recently consulted on for Thames Water. Further detail of the reasons for these changes and our wider thinking on strengthening the financial ring fencing framework for the sector can be found in the Change of Control – general policy consultation.

## **2. Portsmouth Water – background and assessment of the incoming owners**

In this section we set out an overview of recent changes to the shareholding structure of Portsmouth Water. We also assess the capacity of its new group of investors to be the owners of a regulated water company.

### **2.1 Overview of changes in Portsmouth Water shareholding structure**

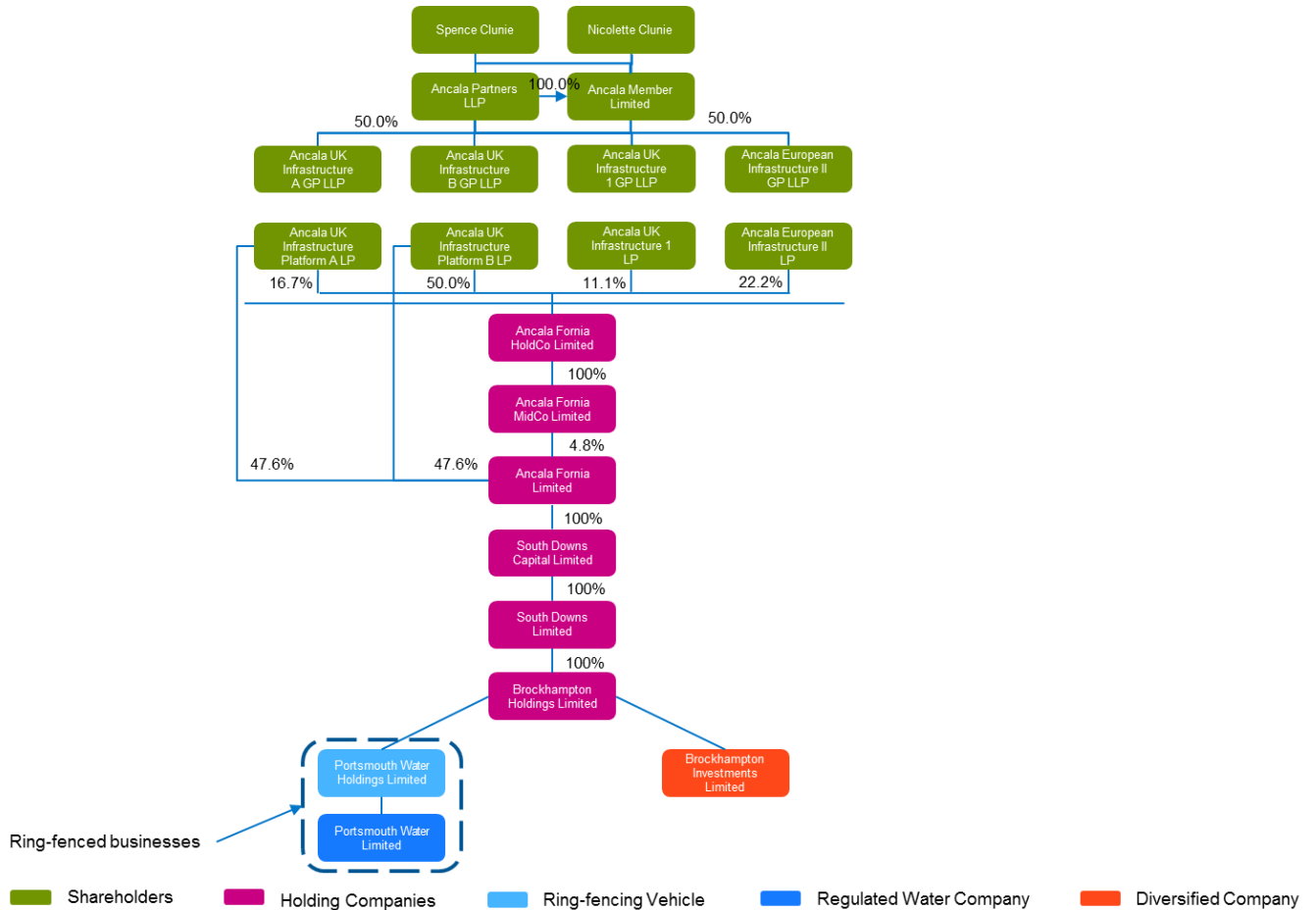
In its response dated 21 December 2017 to our request for information using the questions set out in Appendix A2 in the Change of Control – general policy consultation, Ancala confirmed that a series of four funds, structured as limited partnerships with a variety of third party investors and managed in each case by Ancala Partners LLP as general partner, would (indirectly) acquire 100 per cent of the shares of South Downs Capital Limited ('SDCL'), Portsmouth Water's then UK holding company. The acquisition of Portsmouth Water by Ancala closed on 16 March 2018.

The four funds are:

1. Ancala UK Infrastructure Platform A LP (with Ancala UK Infrastructure A GP LLP as its general partner);
2. Ancala UK Infrastructure Platform B LP (with Ancala UK Infrastructure B GP LLP as its general partner);
3. Ancala UK Infrastructure 1 LP (with Ancala UK Infrastructure 1 GP LLP as its general partner); and
4. Ancala European Infrastructure II LP (with Ancala European Infrastructure II GP LLP as its general partner).

Ancala also noted that the new ownership structure will not alter the corporate structure at the level of the regulated entity.

Portsmouth Water’s latest corporate structure is shown in the Figure 1 below



**Figure 1. Latest shareholding structure of Portsmouth Water**

## 2.2 Assessment of the new owners and capacity to be an owner of a regulated water company

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, in each particular case, that any prospective controller has the integrity and the operational and financial capacity to assume that role. We also want to be satisfied that any change of control does not compromise the effective management of the Appointee.

## **The incoming shareholders**

### **Ancala Partners LLP (“Ancala”)**

Founded in 2010, Ancala is an independent investment manager focussed on mid-market investments in UK and European infrastructure assets.

We note from Ancala’s published materials that it works closely with governments, local authorities and regulators, and considers that the practical knowledge gained through these relationships is enhanced by the involvement of Ancala's individual industry partners who have a track record in regulated sectors including water, energy and utility services. We have considered this in the context of the information provided to us. In its response dated 21 December 2017 to our information request, Ancala stated it has “an embedded and broad appreciation for the regulatory environments in the sectors in which it operates, and, in particular, acknowledges that customers expect such essential public services to operate to high standards of governance and leadership”.

### **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 businesses. As a result, we requested the incoming investor to provide us with the relevant information to facilitate our change of control assessment. In addition to the information provided by Ancala we have separately carried out our own high-level due diligence on the new corporate structure (as illustrated in Figure 1 above) using public sources of information.

### **Experience in the infrastructure sector**

Ancala have publically said that they are committed to a responsible, long-term shareholding and the development of Portsmouth Water. In its information response to us, Ancala note that it is committed to maintaining Portsmouth Water's core mission, being: “...to supply drinking water of the highest quality, providing high levels of customer service and excellent value for money”. Ancala has also said their investment will, by providing access to additional capital, allow the company to pursue potential opportunities to utilise the company’s water resources for the benefit of Portsmouth Water’s customers, and for the south east region in general through the provision of bulk supplies.

Ancala's other significant portfolio companies include:

- International Energy Group (IEG): IEG owns and operates the sole gas distribution network and supply business on the Channel Islands and Isle of Man.
- Scottish Area Gas Evacuation system (SAGE): Ancala acquired a 30.3 per cent interest in SAGE terminal and pipeline and a 60.6 per cent interest in Beryl pipeline from Apache Corporation in November 2017. The investment was made through the Ancala Midstream platform, a business established to complete and manage investments in North Sea midstream infrastructure assets.
- Leep Utilities: a multi-utility 50:50 joint venture with the Peel Group, a leading UK property group, which owns and operates a range of regulated "last mile" electricity, water and district heating utility assets.
- Green Highland Renewables (GHR): a leading owner and operator of hydroelectric power plants in Scotland. Ancala has established GHR as a platform for growth in the UK hydro sector both organically and through acquisitions.
- Ancala Solar: Ancala has built a c.100MW portfolio of 21 ground mounted solar PV plants located across the UK. Ancala has recently retrofitted the portfolio with batteries for the storage of electricity.
- Biogen: a leading owner and operator of biogas plants in the UK with c.25MW installed capacity. Ancala is using the company as a platform for growth in the UK biogas sector and has recently completed the follow-on acquisitions of Millerhill and Tamar Energy.
- Aquatrine Package A: In March 2018 Ancala acquired the Kelda Water Services interests in the Aquatrine private finance initiative contracts which delivers water and wastewater for the UK Ministry of Defence. This business has been rebranded as Ancala Water Services.



## **Corporate governance and management of Portsmouth Water**

The Portsmouth Water board is currently made up of seven board members:

- An independent Chair.
- Two independent non-executive directors.
- Three executive directors – CEO, CFO and engineering director.
- One investor (Ancala)-nominated non-executive director.

Ofwat’s principles of Board Leadership, Transparency and Governance (the “BLTG principles”) state that independent non-executive directors should be the single largest group on the board of the regulated company. The current composition of the Portsmouth Water board does not meet this expectation. This is because there are as many executive directors as independent non-executive directors, meaning that independent directors are only the joint largest group.

Portsmouth Water’s board has therefore approved the recruitment of an additional independent director which will allow it to satisfy the expectation that independent directors are the single largest group. The company has told us that it is aiming to appoint the new director to the board by the end of September 2018.

## **Economic and financial standing**

Based on the responses received to the questions set out in Appendix A2 in the Change of Control – general policy consultation we have reviewed the information received from Ancala about their economic and financial standing. Further, Ancala has stated that it is not subject to any financial investigations or has any legal or financial claims against them which might have a material impact on their financial standing. We have not independently verified these statements.

## **Conflicts of interest**

Ancala’s other water sector related interests include:

1. A 50% joint venture interest in Leep Holdings (Utilities) Ltd (“Leep Group”), a holding company of a multi-utility group which includes:
  - Leep Water, a water and sewerage undertaker, which operates a small water and wastewater network (including provision to Media City Salford); and

- POD53 Limited (“POD53”), a water supply and sewerage licensee, eligible to supply non-household premises (i.e. a commercial retail water and waste water supplier).
2. A 1.5MW Scottish anaerobic digestion (AD) plant acquired from Kelda Water Services through Ancala’s Biogen fund.
  3. A 2.2% indirect interest in Southern Water Services Limited (‘SWSL’) funded by Ancala European Infrastructure III LP’s limited partnership interest in Hermes Infrastructure Spring III LP (the “Hermes Fund”).
  4. An interest in the Aquatrine Package “A” private finance initiative contracts which delivers water and wastewater for the UK Ministry of Defence.

We have considered Ancala’s other water interests with regards to any actual or potential conflict of interest as follows:

1. SWSL: Ancala does not, via its 2.2% indirect minority interest, have control of or material influence over the performance or strategy of SWSL. However, there is a commercial arrangement in place between Portsmouth Water and SWSL (an existing bulk supply agreement).
2. Ancala is likely to be considered to have control of or material influence over the Leep Group (and thereby Leep Water or POD53) by virtue of the 50% joint venture interest of Ancala managed funds. Currently neither Leep Water or POD53 has any commercial arrangements with Portsmouth Water.
3. The AD plant and the Aquatrine Package “A” PFI contract both fall outside of Ofwat’s regulatory purview. Portsmouth Water currently has no commercial arrangements in respect of the AD plant or the Aquatrine Package “A” PFI contract.

Any relationship between Portsmouth Water and other Ancala activities has the potential to create a conflict of interest. In such circumstances, in reaching decisions in relation to Portsmouth Water, Ancala must not take account of matters other than those that are solely in the interests of Portsmouth Water and its customers.

Where Portsmouth Water enter into arrangements with an associated company it would be required to satisfy the ring-fencing conditions included in its licence and meet the transfer pricing requirements set out in the Regulatory Accounting Guidelines (RAGs).

In relation to the only existing relationship, we have concluded that given the nature and size of the indirect interest, this is unlikely to present a current issue by reference to the existing arrangements between Portsmouth Water and SWSL. Any future commercial relationship between the parties could create a similar potential conflict of interest and we will have circumstances like this in mind as we develop our policy work in this area.

## **Conclusion**

Our change of control assessment has not found any issues associated with the new investors that have purchased Portsmouth 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 owners taking over the company.

However, we do consider that some modifications are needed to the ring fencing conditions in Portsmouth Water's licence to represent the most up to date provisions that we seek from all companies and to include the proposed licence notification and information requirements arising from a change of control (see the Change of Control – general policy consultation for further information). We have set our views in relation to this in Section 3 below.

## **Questions:**

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

### **3. Portsmouth Water - regulatory issues arising from change in control and proposed licence modifications**

In Section 2 we discuss, and seek views on, our assessment of the incoming owners of Portsmouth Water. Given the change in control of Portsmouth Water, we are taking this opportunity to enhance their licence, and this section sets out the immediate changes that we propose to make. These are consistent with the enhanced conditions we recently proposed for Thames Water and which we discuss in more detail in the Change of Control – general policy consultation.

We discuss the proposed changes in general terms in Section 3.1 below and provide the indicative, specific drafting changes to the current licence of Portsmouth Water in Appendix A1.

We have also considered the identification of Ultimate Controller(s) of Portsmouth Water under the new shareholding structure in Section 3.2 of this document.

Portsmouth Water has indicated that it generally agrees with the principles of the proposed licence modifications referred to below, but has raised a concern in relation to the change from “reasonable endeavours” to “must ensure” that it has an Investment Grade credit rating.

#### **3.1 Proposed licence modifications**

##### **Structure of the regulatory ring-fence licence conditions**

We want to ensure that all companies have the most up to date ring fencing conditions. Portsmouth Water’s licence does not have a licence condition under which all ring fencing and related provisions are contained. Where the licence does contain some of the ring fencing conditions, these provisions are spread across the licence.

We propose introducing a new Condition P into Portsmouth Water’s licence that will consolidate the ring fencing conditions they have, and will also include the most up to date ring fencing conditions. We also propose to move and introduce related definitions to Condition A of the licence.

## **Board Leadership Transparency and Governance Principles**

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 therefore propose introducing a licence requirement as part of the updated Condition P, to require Portsmouth Water to meet the BLTG principles. We propose the inclusion of the current up to date version of this provision in the licence. We will be reviewing the BLTG principles shortly.

## **Enforcement of Ultimate Controller undertakings**

We propose introducing wording to Portsmouth Water's licence to require it to comply with a direction from Ofwat to enforce the legal undertakings it has procured from its Ultimate Controllers. This is in line with our approach to addressing the issue of the Ultimate Controller undertaking enforceability set out in the Change of Control – general policy consultation.

## **Change of control notification requirements**

As noted in Section 2 of the Change of Control – general policy consultation, we propose introducing a provision as part of the new consolidated Condition P in Portsmouth Water's licence 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.

## **Change of control information requirements**

Section 3.2 of the Change of Control – general policy consultation, explained that we are proposing to introduce a requirement for the management of Portsmouth Water to collect necessary information when a change of control occurs or is likely to occur.

## **Regulatory ring-fence – credit rating requirements**

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 Portsmouth Water's licence to the current highest standard we propose a change to the licence condition to require the Appointee to ensure that it has 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.

Portsmouth Water has acknowledged the importance of maintaining an investment grade credit rating but has concerns about the implication of moving from 'reasonable endeavours' to 'must ensure'. We want all companies to adopt the highest current standard as we consider that regulated entities should maintain at least a minimum investment grade rating. We consider this provides a clear requirement on the Appointee and protects customers by providing a clearer obligation on companies to take all precautions and actively ensure investment grade ratings are maintained.

We also propose introducing the cash lock up provision into Portsmouth Water's licence. This applies where the company has not maintained, or is at risk of not maintaining, an investment grade credit rating. It prevents the company paying dividends or making payments to associated companies in those circumstances.

#### **Questions:**

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

### **3.2 Identification of ultimate controllers**

We have also considered the identification of the Ultimate Controller(s) of Portsmouth Water under the new shareholding structure.

Further to the information submitted by Ancala, dated 21 December 2017, the following four entities were identified and proposed as joint Ultimate Controllers by Ancala:

1. Ancala UK Infrastructure A GP LLP (in its capacity as general partner of, and on behalf of, Ancala UK Infrastructure Platform A LP);
2. Ancala UK Infrastructure B GP LLP (in its capacity as general partner of, and on behalf of, Ancala UK Infrastructure Platform B LP);
3. Ancala UK Infrastructure 1 GP LLP (in its capacity as general partner of, and on behalf of, Ancala UK Infrastructure 1 LP); and
4. Ancala European Infrastructure II GP LLP (in its capacity as general partner of, and on behalf of, Ancala European Infrastructure II LP).

The ultimate controller of the four general partners listed above is Ancala Partners LLP.

We carried out our own due diligence on the new ownership structure of Portsmouth Water (please refer to Figure 1 above for details). Based on publicly available information on the entities involved, we identified the following two entities as additional Ultimate Controllers to those proposed by Ancala.

1. Ancala Partners LLP, which is the ultimate owner of the four general partnerships identified above; and,
2. Ancala Fornia Holdco Limited, which following the change of ownership, is Portsmouth Water's new ultimate UK holding company, inserted above SDCL and replacing SDCL in that capacity.

We have discussed the identification of Ultimate Controllers with Portsmouth Water and Ancala, who agree with our assessment and legal undertakings from the parties listed above were provided to Portsmouth Water at close of the transaction on 16 March 2018.

**Questions:**

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

## 4. 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](mailto:FinanceAndGovernance@ofwat.gsi.gov.uk). You can also submit your response by post to:

Change of Control – Portsmouth Water  
Ofwat,  
Centre City Tower  
7 Hill Street  
Birmingham, B5 4UA

The closing date for this consultation is 22 June 2018. We will publish responses to this consultation 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 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.



### **Consultation questions**

We welcome responses to the following questions.

- 1) Do you agree with our assessment of the incoming owners?
- 2) What are your views on the ability of the new owners to run a regulated water utility?
- 3) Do you have any concerns with the new owners that might affect the ability of Portsmouth Water to fulfil its statutory duties and obligations under its licence?
- 4) What are your views on the proposed modifications of Portsmouth Water's licence?
- 5) What are your views on our assessment of the Ultimate Controllers?

## A1 Proposed modifications to Portsmouth Water's licence

We propose to make the following modifications to Portsmouth 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 of 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 that 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 or entity 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 modifying 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 is 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 sub-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 separate 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 calendar 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 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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**OGI**