south east water

CHANGE OF CONTROL – GENERAL POLICY AND ITS APPLICATION TO THAMES WATER

South East Water response

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Contents

1. Introduction

This is South East Water's response to Ofwat's consultation on its general policy relating to change of control and its application to Thames Water.

It is helpful to set out principles for the assessment of ultimate controllers and information requirements in advance. We have highlighted some areas where we believe additional details would help all parties understand Ofwat's expectations and anticipate its information needs. It would also help companies to carry out regular reviews against a common set of criteria.

We generally support the rationalisation and simplification of the licence but there is a need to coordinate the current work streams.

We are concerned with the proposed introduction of a direction to take legal proceedings to enforce a condition P undertaking against an ultimate controller. We highlight practical issues with this proposal in our response below. Ofwat already has sufficient powers to require appointees directly to comply with their statutory and licence obligations and the ability to impose penalties. The decision to enforce an undertaking should remain a prerogative of the boards of appointees taking account of all relevant considerations including legal advice. There is an issue of principle with creating a situation where Ofwat would both set requirements and direct their enforcement.

We welcome this early engagement on potential changes to the licence conditions but a better process would be to complete a consultation process with the industry as a whole before considering applying the changes to a particular company.

2. Responses to questions

QUESTION 1: What are your views on the introduction of notification requirements on change of control into the licence information requirements?

Appointees already have an obligation to obtain a binding undertaking which requires engagement with Ofwat in advance because (i) the undertaking must be in a form specified by Ofwat, (ii) condition P states that whether or not a person exercises control or material influence is determined by reference to "the reasonable opinion of Ofwat", (iii) the undertaking(s) must be produced to Ofwat before the change of control takes effect (on the current wording of condition P).

Appointees, shareholders and prospective ultimate controllers would normally approach Ofwat and provide information before a change of control. Initially, the senior management of appointees will be aware that a change of ultimate controller may occur (e.g. because of a due diligence process) but may not be able to identify a prospective ultimate controller until a later stage of the process.

We consider that a new obligation to notify Ofwat in the licence would be acceptable. To the extent that this change is proposed to ensure that in less obvious cases companies carry out an assessment and inform Ofwat, the consultation on this change should be used as an opportunity to clarify some areas which would also help streamline the process.

We would like to have more clarity on who may be an ultimate controller:

- In more complex cases of share ownership (such as cases of dispersed ownership as mentioned in section 2.2. of the consultation document and illustrated by the assessment of ultimate controllers of Thames Water).
- In cases where Ofwat refers to "another party". It would be useful to understand who in Ofwat's reasonable opinion would also exercise control or influence as this is subject to interpretation.
- A possible approach is to use similar criteria to those developed for the identification of persons with significant control.

We accept that the assessment of who is an ultimate controller needs to be on a case by case basis but we believe that Ofwat would be able to provide additional clarity and transparency about the criteria it may use to assess who may be an ultimate controller without constraining its decision making.

We believe that setting out clear expectations and addressing in advance more complex scenarios is the best way of streamlining the process and ensuring that prospective ultimate controllers and appointees can anticipate Ofwat's information needs.

Another area that would benefit from clarification by Ofwat and examples is the reference to the way governance arrangements and directors' affiliations may affect who may be considered an ultimate controller (page 9 and 10 of the consultation document). A common vocabulary and set of criteria would help appointees make their own assessment in a way that it consistent with Ofwat's thinking in these areas.

There could also be benefit in having a standard form of undertaking (considering that the current Condition P refers to the undertaking being in a form specified by Ofwat even if that requirement is removed from the proposed revised condition P).

To understand how the assessment of prospective ultimate controllers would work in practice, it would be helpful to give examples of the concrete actions and requirements Ofwat might require companies to take following an assessment and what types of issues they would address.

It is legitimate for Ofwat to assess the integrity and the operational and financial capability of the ultimate controller to the extent it might impact the Appointee itself, but another aspect of the process that it would be useful to clarify is whether the assessment carried out by Ofwat could delay the acceptance of the condition P undertaking provided by a prospective ultimate controller even if that undertaking satisfies the formal requirements of condition P.

QUESTION 2: What are your views on the proposed obligation to provide us with information?

QUESTION 3: What are your views on the information that may be helpful for our assessment of change of control?

In our view the approach adopted by Ofwat should be guided by practical considerations acknowledging that there is a transitional phase where there will not be enforceable rights to obtain information from prospective ultimate controllers and that information should be requested from the person who is best able to provide it.

It should also be recognised that this process takes place during confidential commercial negotiations between existing shareholders and prospective buyers and that the management of the appointee may not be directly involved in the detail of these negotiations. As they progress appointees are able to ensure that an appropriate undertaking under condition P is provided but they would not have all the information needed by Ofwat to make an assessment of the prospective ultimate controller earlier in the process.

A more pragmatic solution would be to publish an information document based on the content of the consultation document and the information checklist (and any further work carried out with companies following this consultation) setting out what Ofwat expects to receive from the relevant parties when dealing with a new condition P undertaking and providing as much clarity as possible on the topics we have mentioned in our response to question 1.

Prospective ultimate controllers have a very strong incentive to establish a good relationship with Ofwat as a regulator of the appointee, and securing the condition P undertaking would also be a condition for the completion of a transfer of shares. These incentives would normally ensure Ofwat's access to the information it needs.

We acknowledge that there may be cases where changes are less obvious, as highlighted in the consultation document in the cases of smaller changes in shareholding, and publication of additional information would help relevant parties meet Ofwat's expectations.

The information checklist for change of control assessments in Appendix A2 seems appropriate but as it relates to the structure, financial affairs and plans of the prospective ultimate controller this reinforces our comment that most of the information is held and should be provided by the prospective ultimate controller especially if it is to be provided early in the process to allow Ofwat to carry out its assessment.

We provide more details on our reasons to suggest that a new obligation of the appointee would not alone be the most practical approach.

The appointee already has an obligation to provide information that Ofwat reasonably requires to carry out its function. This would include its duty under section 2A(1)(b) WIA91 to ensure that the functions of an undertaker are properly carried out. This is set out in condition M (either as currently drafted or as proposed as part of the licence simplification project).

However, relying on an obligation of the appointee to provide information on prospective ultimate controllers may not improve Ofwat's access to information:

- At this stage the appointee has no legal right to obtain information from a prospective ultimate controller.

- Whilst confidential negotiations on a potential change of control are ongoing, shareholders are likely to be in a better position than the appointee itself to provide all the information required by Ofwat and earlier than the appointee.

The appointee only has a right to obtain information from the current ultimate controller(s) under the condition P undertaking. The ultimate controller would not have a right to obtain information from the prospective ultimate controller (unless the latter had accepted to enter into an agreement to that effect). The appointee may not have the information and may not be able to obtain it other than relying on the goodwill of the prospective ultimate controller. Even if there was a chain of rights and obligations between the appointee, the current ultimate controllers and the prospective ultimate controller it would be complicated to enforce if it became necessary.

Imposing an obligation on appointees knowing that the risk of non-compliance is not within their control is not satisfactory. It would be more effective to clearly set out what is expected from prospective ultimate controller in a guidance or information notice.

If an obligation was introduced it should be limited to the information in the possession of the appointee at the relevant time.

QUESTION 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?

The proposed condition would allow Ofwat to force appointees to start legal proceedings against an ultimate controller to enforce a condition P undertaking. In effect this would allow Ofwat to step in, substituting itself to the board of appointees in taking the decision to start legal actions against an ultimate controller.

A decision to start proceedings needs to be based on a careful assessment of the risks, available remedies, prospect of success, alternative courses of action and costs and after taking legal advice. A legal action may or may not be successful.

Is there an issue?

There is no suggestion in the consultation document that there has actually been any case where an appointee should have enforced an undertaking but did not. We are not aware of any such circumstances and believe that they would be extremely rare.

The consultation document does not explain what types of issues this would address and why and how Ofwat would use such a right.

Are the existing powers of Ofwat insufficient? Would the new provision improve the ability of Ofwat to carry out its functions?

A condition P undertaking requires the ultimate controller (and relevant associates of the appointee) to:

- Provide information that may be necessary to enable the appointee to comply with its obligations under the WAI91 or the instrument of appointment.
- Refrain from any action which would or may cause the appointee to breach any of these obligations.

An appointee is therefore in a position to enforce a condition P undertaking when it is, or is likely to be, itself in breach of its own obligations due to an act or omission of the ultimate controller.

Where an appointee is, or is likely to be, in breach of its relevant obligations, Ofwat has power to require compliance by making a final enforcement order or making and confirming a provisional enforcement order against the appointee under section 18 WIA91. Ofwat may also be able to impose a penalty of up to 10% of the appointee's turnover under section 22 WIA91.

If a breach occurred due to an ultimate controller it is likely that it would be sufficient for the appointee to demand that the relevant ultimate controller cease any wrongful behaviour.

If such behaviour continued, the board of the appointee would have to start proceedings to comply with any order made by Ofwat or face a penalty. It would affect the performance of the appointee and the interest of other shareholders. It would also affect their relationship with Ofwat and other stakeholders. A failure by the appointee to comply with an order would also open up liability to third parties who may suffer a loss as a result of the breach by the appointee. There are also existing restrictions on the ability of the appointee to enter into new arrangements with ultimate controllers and relevant associates when there is a breach of an undertaking.

Ofwat already has sufficient powers to require compliance by appointees with their obligations including when non-compliance is caused by an ultimate controller.

If an obligation to enforce a condition P undertaking was introduced in the licence, that obligation would also have to be enforced by Ofwat under section 18. It would be simpler and quicker for Ofwat to require compliance directly from the appointee rather than require the appointee to take action against the ultimate controller.

Finally, although the power of Ofwat to require appointees to comply with their obligations is clearly set out in legislation, there does not seem to be a specific power for issuing a direction requiring an appointee to enforce a condition P undertaking. It would be useful for Ofwat to clarify its understanding of the regulatory regime on this point.

Is it practical to enforce?

There would be practical issues in enforcing such a condition:

- How would Ofwat carry an assessment of the chances of success of any proceedings?

- Would Ofwat issue an enforcement order requiring compliance from the appointee or another order requiring the appointee to enforce the condition P undertaking or both (in which case the latter would be unnecessary)?

- If a company started proceedings following a direction but did not obtain the remedy required what would happen then? How would the appointee recoup the costs incurred and from whom?

- Any direction would need to take account that the ultimate controller may cease the wrongful behaviour or remedy any breach before the proceedings are started or during the proceedings.

Issues of principle

Creating a right to force companies to start legal actions is far reaching and of a different nature than requiring appointees to comply with their existing obligations. It would also create a situation where Ofwat could both impose requirements and direct their enforcement against ultimate controllers. It is therefore open ended in terms of the nature of the obligations that

may be imposed on appointees and indirectly ultimate controllers. Such concentration of powers cannot guarantee the proper separation of duties and the checks and balances necessary to ensure due process. We would be concerned by the introduction of these types of provisions in the licence.

The management of the company lies with its board. The decision to start legal action should remain a prerogative of the boards of appointees making a proper assessment of the circumstances and following legal advice.

Conclusion

We do not support the introduction of a licence condition to enforce a condition P undertaking in appointees' instruments of appointment. We do not believe that imposing such a condition is necessary or proportionate as Ofwat already has relevant powers in the WIA91.

QUESTION 5: What are your views on bringing all the licences up to the same standards, including introducing a requirement to meet the BLTG principles?

We support a rationalisation and simplification of the licence conditions following a process similar to that followed for the licence simplification project.

After matching the conditions set out in the new condition P at Appendix 3 of the consultation document with the current conditions of condition F we have not identified any significant issue of principle with the proposal (other than those highlighted in our response to question 4). However, in order to comment on the proposal fully we would need to have sight of any revised condition F and new BLTG principles as well as the proposed revised condition P. We welcome the opportunity to comments on updated conditions in the near future and the forthcoming revision of the BLTG principles would be an opportunity to provide more clarity.

Considering the number of recent changes to the licence for market opening, Water 2020/PR19, the expected changes from the licence simplification (phase 1) and the other ongoing work for licence simplification or the changes signalled in the consultation document it would be useful to define a road map for the licence changes and a coordinated plan. There is a risk that with several work streams at the same time we could lose visibility of the document as a whole despite the efforts that have been made so far. It would also be useful to work towards updated consolidated versions of the licence at the earliest opportunity for the same reasons.

In respect of the BLTG principles, companies have already adopted these principles and we would be prepared to consider the inclusion of a relevant obligation in licences.

We note that most of the existing condition 6A.5A may be deleted. We would like to understand whether the BLTG principles referred to in paragraph 2 of the proposed condition P may be intended to replace the deleted provisions. We would also like to understand whether the reference to the UK Corporate Governance Code will be maintained through the BLTG principles. We believe that any principles of governance should continue to

complement the UK Corporate Governance Code and other principles and guidance defined by the Financial Reporting Council which is the main body responsible for promoting corporate governance in line with the evolution of company law and listing rules.

The wording of any condition about principles of governance would therefore need to take account of the need for appointees to realise a synthesis of the general principles of governance, company law and as appropriate listing rules and those set out by Ofwat. This is important to define what "meeting" the BLTG principle means if an obligation is introduced in the licence.

QUESTION 6: Are there aspects of the most up to date provisions which you think we need to revisit or amend?

The main issues relating to the most up to date provisions are those we have raised in response to the previous questions. Our main concern is with the introduction of an obligation to enforce a condition P undertaking.

QUESTION 7: 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?**

We believe that in the context of the existing financial and other regulatory reporting requirements a general obligation to inform Ofwat of circumstances that would affect the ability of the appointee to carry out regulated activities is appropriate.

Potential issues with the use of information in case of cross-shareholding or conduct of the appointed business as a sole and separate business may be addressed in the governance principles. The forthcoming review of the BLTG principles would be an opportunity to explore and provide examples of any issues Ofwat may wish to address specifically.

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