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Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

08 June 2018

Dear Sir / Madam

Response to Ofwat consultation on TWUL change of control

Tideway welcomes the chance to respond to Ofwat's consultation, "Change of control - general policy and its application to Thames Water".

We understand, and welcome, Ofwat's intention to address the issues listed in the introduction to the consultation. The thoughts included in this letter and our detailed response are aimed at supporting Ofwat in evolving the regime to meet these challenges and in doing so create a set of proposals that are proportionate, targeted and effective.

The interests of customers and the public interest are best served through companies maintaining high standards of corporate governance. The consultation is helpful in setting out proposals for discussion. To take them further forward will require significant engagement with companies and other stakeholders. In those discussions, it might be helpful to discuss further:

- desirable outcomes;
- the nature of the problem that each proposal is trying to address, its scale, prevalence and cost;
- why existing arrangements are not considered to be effective, whether these are existing licence conditions or other requirements on companies; and
- an analysis of the range of options available for moving forward.

Given the high level nature of some of the proposals it may be difficult, at present, to assess their full implications and hence whether the benefits outweigh the costs or indeed whether alternative approaches may be preferable. It may be helpful to consider the diversity of the sector in terms of determining a proportionate way forward.

We consider the legitimacy of the sector to be critical to its future success. In that regard, we are keen to continue to engage Ofwat and support it in considering how best to address current challenges.

In Annex 1, we have commented on questions 1-7. We have not responded on the specific Thames Water questions 8-12.

Yours faithfully

Matt Parr
Head of Strategy and Regulation

Tel. 020 3744 4010
www.tideway.london

Annex 1: Tideway Response to Specific Consultation Questions

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

We accept that Ofwat wishes to know about the identity of the Ultimate Controllers of water companies, which are key elements of UK infrastructure, and provide vital services to millions of customers. However, we consider that the proposals contained in the consultation may raise practical problems, such as:

- the definition of “control” and “Ultimate Controller” is vague. This could create uncertainty in deciding whether a given change in ownership triggers the notification requirements;
- it is unclear whether Ofwat expects shareholders to self-certify as ultimate controllers, or appointed companies to make this determination in the first instance, or if Ofwat would determine this ex-post;
- the requirement to notify when a change of control “takes place or is likely to take place” is potentially vague;
- it is unclear at what stage the Appointee will become aware that a change in ownership is contemplated. Clearly, the Appointee cannot notify Ofwat of a likely change in control before it is aware of the possibility. However, a licence can only place obligations on the Appointee, not on its future shareholders;
- Ofwat is effectively inserting itself as an insider into many financial transactions, with the legal and other responsibilities involved with such a status; and
- the requirements outlined could cause difficulties with the timescale of a financial transaction, which can move very quickly.

More generally, we would find it helpful if Ofwat were to provide more information on the scale or extent of the current problem. This might inform how best, through consultation and engagement with stakeholders, to take these issues forward. It might also be helpful to test the proposals in different scenarios.

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

Condition M of our licence already requires us to provide such information as Ofwat may require in the discharge of its functions. Any change should be consistent with this requirement. From the consultation, we are unclear exactly what weakness in the licence this change is meant to address. Further, we note that licences are legal agreements between Ofwat and regulated companies and cannot bind shareholders.

Furthermore, it is not clear in which circumstances companies have not voluntarily provided this information to Ofwat. If there is not an existing problem or likely problem then there may not be a strong case for change.

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

The list of information required seems sensible, though we note the provision that it “can vary”. We note that much of the information provided is likely to be commercially sensitive. It will be important for Ofwat to continue to take all reasonable steps to ensure that only those staff with a need to know are privy to the data items notified under this requirement.

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?

It would be helpful in taking these proposals forward if Ofwat were to set out the circumstances where this obligation would have applied in the past or might do so in the future.

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

It seems sensible to discuss the benefits of bringing all licences up the same standard. We might also consider whether there are valid reasons for maintaining differences which reflect the diversity of the companies including business models and position in the value chain.

- Ofwat appears to propose to amend licences to require compliance with the BLTG principles, as opposed to the current provision in Tideway's Licence, which is to comply or explain. If this is Ofwat's intention, we consider that it should rethink, or justify further, this change;
- the change proposed would significantly reduce the discretion of the Board in certain circumstances;
- allowing non-compliance if companies provide an explanation could reflect the diversity of the sector. It allows companies to reflect their own circumstances, under which occasional non-compliance could be appropriate, or even necessary;
- it is inconsistent with the approach in the UK Corporate Governance Code (LR 9.8.6 R(6)), which requires companies to "comply or explain"; and
- the requirements in our licence are consistent with the "comply and explain" requirement, rather than the "comply" requirement. If Ofwat implements this change, therefore, we would expect that it would need to review each individual requirement, to ensure that it remains appropriate.

We note that Ofwat intends to review the BLTG requirements meaning that companies would effectively be being asked to make an open-ended commitment which places decisions on standards of corporate governance with Ofwat without allowing for discretion, variation or potentially innovation in the sector.

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

We refer Ofwat to our responses to other questions, in particular question 5. It might be helpful for Ofwat to set out for interested parties any concerns it has in relation to individual principles.

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?

The proposed requirement could significantly increase Appointees' risk profiles by exposing them to risks outside of their control. Changes in the capital markets could put them in breach of their licences during times of overall financial stress compounding an already difficult situation. This could increase the sector's cost of capital and impact on customer bills.

Further, we consider that a requirement to maintain an investment grade credit rating, as opposed to using all reasonable endeavours to do so, is unnecessary, because:

- strong incentives already exist on companies to maintain an investment grade credit rating, in particular the requirement to preserve access to capital markets at a reasonable cost. The stronger requirement therefore does not add significantly to the strength of protection of Appointees' financial viability. However, it does increase significantly the risk which companies may face, as ratings are subject to factors beyond their control; and
- if, in practice, it is ever triggered, it is likely to be during extreme financial stress, caused by external market or financial industry factors. It is unclear what, if any, effect this provision would have under such circumstances.

b) Whether there needs to be a more explicit requirement to inform us of particular events affecting the Appointee?

Conditions K and M of Tideway's licence contain provisions to provide information under certain circumstances (in particular, if Tideway is in financial distress). We consider that these are appropriate. We are not aware of any recent situation when these provisions have been inadequate, or of any future situation where this is likely to be the case. If Ofwat can provide a reasonable example of such a scenario, however, we would consider supporting such a change.

c) Managing potential conflicts of interest where there are cross-shareholdings?

We consider that a high-level conflict of interest clause is unnecessary. Boards should, as a matter of course, police and address such conflicts. The proposed clause could lead to a significant increase in the scope of regulation.

d) Safeguarding the autonomy of the Appointee

Besides the points raised under c) above, we have no issues with this aim.