

November 2018

Trust in water

Thames Water: Conclusions on Change of Control and Modification of Instrument of Appointment

About this document

On 11 May 2018 we published a consultation on “[Change of control – general policy and its application to Thames Water](#)”. The consultation closed on 8 June 2018.

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 Instrument of Appointment (‘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. The part of the consultation dealing with specific changes to Thames Water’s licence was a notice under section 13.

In this document, ‘Thames Water: Conclusions on Change of Control and Modification of Instrument of Appointment’, we set out in section 1 our response to the issues raised specifically on the changes of control at Thames Water Utilities Limited (‘Thames Water’). This document is also a notice confirming that Ofwat has now modified the licence of Thames Water in accordance with section 13 of the WIA91 and sets out our reasons for doing so as required by section 195A WIA91. These changes will come into effect on 21 November 2018.

The consultation also sought initial views on a number of wider policy questions relating to Ofwat’s policy on changes of control and the introduction of appropriate ring-fencing conditions into companies’ licences. This document sets out in section 2 our responses and further thinking on those questions which related to change of control, as these are germane to understanding the provisions in the licence modification we have issued to Thames Water.

We will set out our responses and our further thinking on the remaining questions from the consultation on “Change of control – general policy and its application to Thames Water” which relate to the regulatory ring-fencing framework in a further consultation to be published shortly.

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1. Responses to the consultation questions about Thames Water

1.1 Our consultation included the following questions specifically about Thames Water's change of control:

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?
- What are your views on the proposed modifications of Thames Water's licence?
- What are your views on our assessment of the Ultimate Controllers under the current arrangements?

1.2 We received 16 responses to the consultation: 11 from existing licensed companies (Appointees), one from a holding company, one from an infrastructure provider, one investor, one independent consultant and the Consumer Council for Water.

1.3 The vast majority of the responses focused on the questions relating to the issues of general policy rather than the issues specific to Thames Water. We are publishing all the responses and a [summary](#)¹ of them alongside this document, although the issues raised in response to our proposals on strengthening the regulatory ring-fencing framework will be picked up in a further consultation to be published shortly. In the sections below we discuss the responses received in relation to each question and our consideration of the issues.

¹ "Change of control – general policy and its application to Thames Water: Summary of responses"

Our assessment of the incoming investors of Thames Water

- 1.4 A few respondents said that they had not formed a view on the specific matters that relate to Thames Water. Yorkshire Water said that it would have liked to see more information to enable it to form a view. However, we set out in the consultation document the type of information and issues that we consider in these circumstances and, in relation to the change of control of Thames Water, we set out the information that we considered relevant to our assessment. In the absence of any responses to suggest that further assessment is required, our initial view remains.

The ability of the new investors of Thames Water to run a regulated water utility

- 1.5 We received no comments on this question. Our change of control assessment did not find adverse evidence about the ability of the new investors to run a regulated water utility, and we therefore conclude that additional protections beyond those proposed are unnecessary.

Any issues 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

- 1.6 We received no comments on this question. Our change of control assessment did not give rise to any concerns associated with the new investors that have purchased shares in Kemble Water Holdings Limited ('Kemble') and thereby Thames Water, based on the information we received. Therefore, we do not see a need to introduce additional protections in the licence as a result of the new ownership structure beyond those proposed in the consultation.

The proposed modifications of Thames Water's licence

- 1.7 We considered that it was appropriate to amend Thames Water's licence to bring the ring-fence provisions up to the industry-leading standard. We also canvassed initial views on bringing all licences up to this standard.
- 1.8 We received two responses to the question about modifications to Thames Water's licence. One was from Thames Water. The other was from the Consumer Council for Water, which supported the proposed licence

modifications for Thames Water because ‘they are in line with the more consistent licence conditions Ofwat is proposing for all company licences’.

- 1.9 Thames Water indicated that it was prepared to accept the licence modifications, whilst seeking clarification (a) on the definition of Issuer Credit Rating proposed for Condition A, and (b) on meeting the Board, Leadership, Transparency and Governance (BLTG) Principles. We held further discussions with Thames Water on these issues, after which it concluded its acceptance of the licence modifications. The paragraphs below expand on the issues concerned.
- 1.10 The first issue is whether we will continue to interpret the definition in Condition A of “Issuer Credit Rating” in Thames Water’s licence in accordance with the approach that was set out between Ofwat and Thames Water in a letter dated 27 June 2007. This letter from Ofwat to Thames Water indicated that we would accept a corporate family rating of Thames Water’s securitised group of companies as an acceptable issuer credit rating for the purposes of the definition set out in the licence. Thames Water sought to bring that understanding explicitly into its licence to reflect how Ofwat interprets the definition in practice.
- 1.11 We consider that an investment grade credit rating signals the ability of the Appointee to access the capital markets and hence to continue to be able to finance its activities into the future. Having an investment grade credit rating should, therefore, also indicate the underlying financial resilience of the Appointee. The proposed licence wording in our consultation document tied the scope of the relevant credit rating to the Appointee, as this is the entity that we regulate and which we expect to be financially resilient.
- 1.12 Some companies, however, have adopted securitised structures in which the Appointee is financed by a separate Associated Company or subsidiary company. In certain circumstances, as approved by Ofwat, it may be more appropriate that an Appointee’s financial resilience is reflected by the rating of a securitised group known as a corporate family rating. This is due to the financial reliance of the Appointee on the financing subsidiary or Associated Company. We accept that we should recognise an appropriate credit rating where the scope of that rating covers the securitised group.
- 1.13 Our intention is to capture a rating that gives a signal about the financial resilience of the Appointee. It follows, however, that we would not wish to accept a rating where, for instance:

- It relates to a corporate family group of companies which does not reflect the financial resilience of the Appointee, or
- It encompasses non-regulated business that may affect the financial resilience of the regulated business.

1.14 We have therefore decided to modify the Condition A definition of Issuer Credit Rating in Thames Water's licence as set out below. The wording clarifies the need to get Ofwat approval of the corporate family rating, while still tying the rating to the financial resilience of the Appointee.

Condition A

"Issuer Credit Rating" means, either;

- (a) an issuer credit rating assigned to an issuer of corporate debt by a Credit Rating Agency; or
- (b) a Corporate Family Rating assigned by a Credit Rating Agency, for so long as the Appointee continues to be a member of a corporate group approved for this purpose by the Water Services Regulation Authority².

"Corporate Family Rating" means a credit rating assigned by a Credit Rating Agency to reflect its opinion of the ability of a corporate group to honour all of its financial obligations, as if there was a single class of debt and a single consolidated legal entity structure, where the corporate group is as determined by the relevant Credit Rating Agency, and the Water Services Regulation Authority has approved in writing to the Appointee that such corporate group can be used for this purpose.

1.15 The second issue that Thames Water raised in its initial letter was to note that Thames Water is meeting our expectations in terms of compliance with the BLTG Principles, as per the Company Monitoring Framework assessment.

1.16 In the 2017 Company Monitoring Framework report of 30 November 2017 our assessment was that Thames Water met our expectations.

² We are currently consulting on licence changes. If our proposed licence simplification goes ahead, all references to The Water Service Regulation Authority will appear as Ofwat for brevity and to reflect common usage. 'Ofwat' will be defined in Condition A as 'the Water Services Regulation Authority

- 1.17 Thames Water submitted its latest governance information as part of its Annual Performance Report on 15 July 2018. We will be assessing that information as part of the 2018 Company Monitoring Framework, the outcome of which we anticipate publishing in January 2019.
- 1.18 In July 2018, we consulted on proposed revisions to the Principles as well as a licence requirement for all water companies to meet Ofwat's [Principles](#). We will publish the consultation responses in due course, along with our consideration of the issues raised. We intend to engage further with Appointees and other stakeholders on future BLTG licence conditions.
- 1.19 Thames Water confirmed that it accepts the amended licence modification on the credit rating definition and all the other proposed licence modifications as consulted upon.

Our assessment of the Ultimate Controllers under the current arrangements

- 1.20 In response to our consultation Thames Water said "We are currently reviewing our internal governance arrangements and we expect this to affect your assessment of Ultimate Controllers". It has not disputed that the current arrangements mean that the following entities are Ultimate Controllers of Thames Water: OMERS, Universities Superannuation Scheme (USS), Infinity Investments, Wren House, BriTel Fund Trustees Ltd, Cicero Investment Corporation (CIC) and bclMC Investment Corporation. Thames Water has sent Ultimate Controller undertakings provided to it by all of these companies.
- 1.21 One respondent to our consultation asked whether Macquarie Group maintains any continuing influence or "control" over Thames Water post-March 2017. We can confirm that it does not.
- 1.22 Since March 2017 Kemble, the UK holding company of Thames Water, has provided undertakings to Thames Water. One respondent suggested that we deemed Kemble to be inadequate as an Ultimate Controller in February 2007, but deemed it acceptable from March 2017 to date. He asked why that assessment had changed and why customers were not informed when this change arose.
- 1.23 It is not the case that the Kemble undertaking was unacceptable. The licence requires an undertaking to be given by any Ultimate Controller, and also by the UK holding company where that UK holding company is not an Ultimate

Controller. We were sent an undertaking provided by Kemble to Thames Water on 14 August 2007 as it was the highest level UK corporate owner at the time. Separately, in 2007 we considered Macquarie was an Ultimate Controller because of the reserved rights attached to its shareholdings. Thames Water consequently sought and obtained an undertaking from Macquarie as an Ultimate Controller, dated 31 July 2007. The Ultimate Controllers of Thames Water changed when Macquarie sold its shareholding and various other changes in shareholding occurred. At that time Macquarie ceased to be an Ultimate Controller, but the Kemble undertaking remained in place as it remained the UK Holding Company. The resulting identity of the Ultimate Controllers after the changes in shareholding occurred was set out in the consultation document.

2. Change of control – general policy issues

- 2.1 In this section, we set out our updated thinking on the questions in our ‘Change of control – general policy and its application to Thames Water’ consultation that relate to general regulatory issues arising from a change in control and the need for related licence modifications. We have reviewed all the responses received and taken those responses into account while formulating our thinking.
- 2.2 Our consultation included the following questions on general policy for change of control and the need for related licence modification:

Questions

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

Notification requirements on change of control

- 2.3 We said in the consultation that 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. Our consultation proposed introducing a new condition in all licences that requires the Appointee to inform us when it becomes aware of a change, or an upcoming likely change, that might be considered to have led to or may lead to a change to the Ultimate Controller of the Appointee.
- 2.4 There was a broad level of support for this proposal but a number of comments were made about the practical application of the proposed notification obligation.

- 2.5 There were numerous queries about the timing of notification, especially in the period before the change of Ultimate Controller(s). In addition, one respondent said that it may not be easy in practice to determine accurately when the obligation might be triggered and two respondents asked that Ofwat set out how to determine this.
- 2.6 We do not intend the Appointee to exercise definitive judgement on whether or not there has been or might be such a change, nor to anticipate the identity of an Ultimate Controller based on what would be Ofwat's 'reasonable determination'. For this reason we have couched the licence text in conditional terms; "may lead to..." and "might be considered to have led to...". Once we have been notified and have gathered any necessary information, we will consider if there has been or might be a change to the Ultimate Controller(s) and consequently whether any action needs to be taken. We recognise that the identification of this change may not be straight-forward, for instance where control is widely distributed or control is exerted through many holding tiers. We would, therefore, encourage Appointees to take a precautionary approach in deciding when to notify us. We would expect to be notified at the point where there is reasonable certainty that a change to the Ultimate Controller(s) may take place. An example would be when a "Heads of Terms" agreement is about to be signed, but it is possible that there are other points in any investment process where an Appointee might consider that a change to the Ultimate Controller(s) might occur and notify us accordingly.
- 2.7 We appreciate early notification so that we can consider any issues arising at an early stage and, if necessary, modify licences in a timely way. This will enable us to maintain appropriate protections for customers and affords any prospective incoming Ultimate Controller the opportunity to discuss our regulatory expectations. We accept that the notification may in some cases make us an insider to a sensitive financial transaction and, as a matter of course, we will comply with the [FCA Listing Rules](#). We are used to dealing with sensitive financial information and have the appropriate processes and safeguards in place.
- 2.8 A few respondents said that this proposal might delay or constrain a financial transaction. This obligation is not a pre-approval vetting process. The two primary outputs of our change of control process are to identify from whom Ultimate Controller undertakings need to be procured, and to identify the need for any modifications to licence conditions in light of our analysis. These should occur promptly, but do not need to work within the same timescale as the financial transaction itself.

- 2.9 One respondent said that the notification to Ofwat should be made by a prospective investor rather than the Appointee. Whilst we welcome contact and information from incoming and current shareholders, the obligation is on the Appointee as the licence holder to tell us where they are aware of a change, or an upcoming likely change.
- 2.10 A respondent said that the notification and other requirements should not apply to a refinancing of an Appointee. The requirement to notify and provide information will apply to refinancing an Appointee to the extent that the refinancing may lead to an actual or potential change to the Ultimate Controller(s) of the Appointee.

Identification of Ultimate Controllers

- 2.11 A number of respondents commented on the identification of Ultimate Controllers, although the consultation did not ask a question on this topic. A few said that more clarity is needed as to who may be an Ultimate Controller. One respondent said that there needs to be a transparent and consistent approach to determining material influence. One respondent said that the proportions of shareholder equity in a company may not necessarily reflect who is in control and that this approach does not reflect the full range of factors which might result in someone being able to exert material influence. An example provided where control may arise is where “shareholders may have assigned their ownership/management rights to a third party, as can arise with Private Equity-structured deals”. We remain of the view that it would not be apposite to attempt to define all the circumstances which might give rise to control or material influence. Control or influence may take several forms, such as voting rights, approval of organisational strategy and business plan, or the right to appoint board members.
- 2.12 A suggestion was made that instead of requiring notification of a potential change in Ultimate Controller, Ofwat might introduce a pre-approval process for potential investors. We are not inclined to pursue this suggestion on the basis that we do not approve investors. Our intention is to ensure that appropriate undertakings are in place from Ultimate Controller(s), and to assess whether licence protections remain appropriate.

An obligation to provide Ofwat with information

- 2.13 We have historically relied on informal requests for information to Appointees and investors to provide information about actual or potential changes to the Ultimate Controller(s) of the Appointee. We consulted about introducing an explicit obligation in Appointees' licences for the Appointee to provide Ofwat with any information that we may reasonably require for the purposes of our assessment of any such actual or potential change.
- 2.14 A few respondents said that they are already required by Condition M of their licence to provide us with information reasonably required for the purpose of Ofwat carrying out our functions under the WIA91. Condition M is framed in general rather than specific terms. We have reconsidered whether there is a need for a specific power beyond the provision set out in Condition M, and have concluded that the requirements of Condition M are sufficiently broad to enable us to require provision of information with as much certainty as the proposed wording set out in the draft Condition P in the consultation.
- 2.15 We are consulting currently on the modernisation and simplification of a number of licence conditions including Condition M. Our proposal for Condition M seeks to consolidate our information-gathering powers in the licence, and to remove exceptions, such as the exclusion of gathering information to support our activity under section 27 of WIA91. **In light of this, we do not intend to insert a specific information-gathering power within Condition P and have deleted the proposed wording from the modifications that we made to Thames Water's licence.**
- 2.16 Some respondents said that the information might not be available to the Appointee at the relevant time and there is potential for an Appointee to be in breach of its licence if it does not possess such information. The definition of information in Condition A makes clear that Ofwat can only request information held or which can reasonably be acquired. There were also concerns about the sensitivity of information covered by professional legal privilege. Condition M specifically excludes information covered by professional legal privilege from its scope.

The information to assist an assessment of change of control

- 2.17 Appendix A2 of our consultation provided a checklist of the information we might seek in respect of incoming investors. We received many responses about the limitations of the information available, particularly in the early stages

of a change of control, and the extent to which it is appropriate to release more sensitive information.

- 2.18 We gather information to enable us to make a determination as to the identity of Ultimate Controllers and to establish if any modifications to licence conditions are necessary. The former gives certainty about who should be providing an Ultimate Controller undertaking to the Appointee, and the latter may result in adjusted protections in the licence. The Appointee's obligation is to provide information which we reasonably require for this purpose. The list in Appendix A2 gave an indication of the information which we will generally seek in order to form a view on the two issues above. However, the precise information we request will depend on the specific circumstances and the scale or depth of the changes involved. We do not intend the list of information we provided at Appendix A2 of the consultation document to be regarded as a checklist to be provided uncritically in each case and we confirm that we will take a proportionate approach as raised by one respondent. We also acknowledge that some of the information may not be available to the Appointee at the earliest stages of any change of control.
- 2.19 One respondent to the consultation said that a potential incoming Ultimate Controller may have no experience of the water sector, and that it is not necessary for a potential investor to have technical proficiency in the water sector. Our primary concern in these circumstances is to see evidence that new investors understand the sector and the nature of the regulatory environment, and especially so where they are looking to appoint a director to an Appointee board. Gathering the information that we request in such circumstances will assist us in making our assessment in the round.
- 2.20 One respondent said that in the event that merger clearance by the Competition and Markets Authority ('CMA') is required, the information requested by Ofwat should be similar so that both regulators can make their decisions based on the same information. Ofwat carries out a separate and stand-alone process from the CMA who have a distinct statutory role in the merger control regime alongside wide ranging information gathering powers. In the event that a transaction falls within the jurisdiction of the CMA, it may be that the Appointee is required to provide some similar information to both the CMA and Ofwat
- 2.21 A few respondents said that the information required may be of a sensitive nature. We have procedures in place for the appropriate handling of information of varying sensitivities, including information which is confidential or price sensitive.

Enforcement of the undertakings from Ultimate Controllers

- 2.22 The licence requires the Appointee to procure legally enforceable undertakings from its Ultimate Controller(s). The Ultimate Controller undertaking is intended to prevent behaviour by Ultimate Controllers which leads to the Appointee breaching its licence. It shields the Appointee from influence exerted by an Ultimate Controller to act in breach of its licence and provides a route for the Appointee to ensure that the actions of its Controller(s) do not themselves lead to a breach (for example by the Controller failing to provide information or by amending group finance arrangements in a way that breaches the regulatory ring-fence). This in turn protects customers' interests by preserving the integrity of the licence obligations.
- 2.23 The licence does not, however, currently provide for an obligation on the Appointee to enforce an undertaking. In our consultation we asked for views on a proposed obligation to require the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller's undertaking.
- 2.24 Some respondents said that Ofwat already has sufficient powers to require compliance in the WIA91 and that we have the power to impose enforcement orders and fines in the event that an Appointee breaches its licence, arguing that these give sufficient protection.
- 2.25 It is correct that Ofwat has powers to require Appointees to act in compliance with the obligations in their licence and to sanction Appointees in the event of a breach. Ofwat has no power to pursue an Ultimate Controller for not complying with the terms of its undertaking to the Appointee, it cannot enforce the terms of the undertaking directly against the Appointee and it cannot force an Ultimate Controller to comply with an undertaking it has given.
- 2.26 Whilst enforcement involving financial penalties might influence an Ultimate Controller to meet the terms of its undertaking, this invites a calculation on the part of the Ultimate Controller to maximise its return rather than to comply with its undertaking. Whilst the Appointee has a duty to inform us of a breach of an undertaking, Ofwat does not have a regulatory tool to require resolution with the Ultimate Controller. Additionally, good governance will also reduce the likelihood of an Ultimate Controller breaching the undertaking without redress, but will not remove that risk, especially if the influence is brought to bear on governance arrangements.
- 2.27 The undertaking is only as good as the Appointee's willingness to enforce it. We appreciate that Appointee Boards will wish not to breach their licences and

will take a robust line with their Ultimate Controllers. Such robust action may include, but need not necessarily include, legal action. In doing so they will be fully responsible for the decisions made. There may be some circumstances where they are influenced by the Ultimate Controller or are under pressure not to enforce the undertaking. These are the circumstances where we see the direction from Ofwat coming into play, because the possibility of Ofwat using this enforcement power may strengthen the Appointee's position. Therefore, just as the undertaking strengthens the ability of the Appointee to comply with its licence, this regulatory direction strengthens the "shield" from Ultimate Controller influence which may prejudice licence compliance.

- 2.28 One respondent said that we do not have a specific power to issue directions. Section 12 (1) (a) of WIA91 provides that conditions included in an appointment may "require the appointed company to comply with any direction given by the Director..." thereby giving Ofwat a power to give an enforceable direction to an Appointee. Should an Appointee fail to comply with our direction then we may take enforcement action against them for that failure, using the processes set out in sections 18-22E of the WIA91.
- 2.29 It is also possible that an Appointee might comply with the direction and enforce the undertaking but not achieve the result which the direction had anticipated. In this circumstance the Appointee would have complied with the direction given by Ofwat to enforce the undertaking and it will have discharged its obligation. At all times the Ultimate Controller undertaking remains an agreement between the Appointee and its Ultimate Controllers, with Ofwat never becoming a party to it.
- 2.30 Thames Water highlighted that there was a risk that enforcement of an undertaking could put directors in conflict with their duties under section 172 of the Companies Act 2006. Section 172 of the Companies Act 2006 imposes on a director the duty to 'act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole', and in so doing, to have regard to a series of listed factors.
- 2.31 We do not consider that the issuance of a direction will affect the ability of a director to comply with their duty under section 172. A regulated company needs to comply with its licence in order to continue operating to ensure company success. Compliance with the regulatory regime should therefore be an important consideration by the Board as it will be in the interests of the company, and consequently its members, to ensure that it continues to have a licence to operate and derive revenue.

3. Next Steps

- 3.1 The changes to the Thames Water licence come into force on 21 November 2018. A copy of the final licence conditions are attached as Appendix A2. The final version includes a revised definition of “Issuer Credit Rating” in Condition A, and the omission of a specific provision for requiring information to be submitted, when compared with the version we consulted upon.
- 3.2 Thames Water’s review of internal governance arrangements is in progress. As and when there are relevant changes in governance or ownership we will revisit the identity of Ultimate Controllers as necessary.
- 3.3 We will set out our responses and our further thinking on the remaining questions from the consultation on “Change of control – general policy and its application to Thames Water” which relate to the regulatory ring-fencing framework in a further consultation to be published shortly.
- 3.4 We are taking forward our work in relation to the proposed changes to the BLTG principles and related licence conditions separately. Our consultation in July 2018 dealt with these matters and we expect to publish the outcomes of that consultation in due course.
- 3.5 Once we have concluded our policy position on these issues, we expect then to proceed to consultation to make relevant modifications to water companies’ licences by notice under section 13 of the WIA91.

A1 List of respondents to the consultation

Water Only and Water and Sewerage Companies

Affinity Water

Anglian Water

Bristol Water

Northumbrian Water

South East Water

Southern Water

South West Water

Sutton and East Surrey Water

Thames Water

United Utilities

Yorkshire Water

Other

Anglian Water Group

Bazalgette Tunnel Limited

Martin Blaiklock

Consumer Council for Water

iCON Infrastructure

A2 Licence conditions for Thames Water after consultation³

We have made the following modifications to the Thames Water licence.

Condition A

We added the following to Condition A:

1. 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

(4) 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.

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

“Corporate Family Rating” means a credit rating assigned by a Credit Rating Agency, to reflect its opinion of the ability of a corporate group to honour all of its financial obligations, as if there was a single class of debt and a single consolidated legal entity structure, where the corporate group is as determined by the relevant Credit Rating Agency, and the Water Services Regulation Authority has approved in writing to the Appointee that such corporate group can be used for this purpose.

^{3 3} We are currently consulting on proposals to simplify various licence conditions of all undertakers licences. If our proposed licence simplification goes ahead, all references to The Water Service Regulation Authority will appear as Ofwat for brevity and to reflect common usage. ‘Ofwat’ will be defined in Condition A as ‘the Water Services Regulation Authority. The numbering of the licence conditions will also change to reflect the modernised numbering proposed in the consultation. <https://www.ofwat.gov.uk/wp-content/uploads/2018/09/Consultation-under-section-13-of-the-Water-Industry-Act-1991-on-proposed-modification-to-simplify-various-conditions-of-all-undertakers-licences.pdf>

“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, either:

- (a) an issuer credit rating assigned to an issuer of corporate debt by a Credit Rating Agency; or

- (b) a Corporate Family Rating assigned by a Credit Rating Agency to the Appointee for so long as the Appointee continues to be a member of a corporate group approved for this purpose by the Water Services Regulation Authority.

“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 have replaced 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 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 removed 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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