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Strategy & Regulation

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Dear Martyn

Consultation on Ofwat's change of control policy and its application to Thames Water

Thank you for the opportunity to comment on your proposed change of control policy. We have responded separately to your section 13 notice to amend our licence and this response, therefore, is focussed on contributing to the development of the wider change of control policy. Overall, we welcome the introduction of a transparent and consistent change of control policy for the industry and we believe the increased clarity around the process will ensure incoming investors understand the regulatory process for changes in ownership. We have set out our comments on the main policy proposals below.

Identification of Ultimate Controllers

As we highlight above, we support the introduction of change of control policy. It will be important to underpin this policy with a transparent and consistent approach to interpreting material influence, and whilst we note your proposal to take a case-by-case approach to identifying Ultimate Controllers, we think it will be important to develop an evidence-based assessment approach that can be applied consistently to the industry. This will increase the level of transparency around the change of control process and will provide confidence to stakeholders.

With regards to the proposed Ultimate Controllers of Thames Water, we are currently reviewing our internal governance arrangements and we expect this to affect your assessment of Ultimate Controllers. In any event, we understand that you will continue to identify OMERS as an Ultimate Controller. OMER has now provided us with a Condition P undertaking which we have sent through to you.

Enforcing an Ultimate Controller's undertaking

We have accepted the proposed amendment to our licence that will require us to enforce an Ultimate Controller undertaking. We do not expect to ever need to enforce an undertaking but if we were, we note that it might be difficult in practice and there is a risk that it could be deemed to put board directors in conflict with their section 172 duty under the Companies Act 2006. Therefore, we would expect that a wider view of companies' legal obligations would be taken before considering whether a company is in breach of the requirement to enforce an Ultimate Controller undertaking.

Notification and information requirements arising from a change of control
We agree with your proposed notification and information requirements arising from a change of control. In terms of the practicalities of complying with the requirements, in many cases the information provided would be market sensitive and it would be important for companies to have certainty as to who it should notify within Ofwat to ensure sensitive information remains within a small group of ring-fenced people.

Reporting of material issues
The current requirement to inform Ofwat of circumstances that may affect the Appointee's ability to carry out regulated activities is sufficiently wide to capture the important issues which Ofwat needs to be notified about and therefore does not need to strengthened.

If there are other events about which you would like to be notified, these do not necessarily need to be included as a licence obligation and could instead be agreed separately with the companies.

Conflicts of interests – minority shareholdings
We understand the concern about the risk of potential conflicts of interests where there are cross shareholdings that fall below the prescribed thresholds for the special water merger regime. These conflicts can be managed through good corporate governance and companies' current arrangements for managing directors' conflicts. We therefore do not think it is necessary to introduce any new licence obligations.

Ring-fencing requirements
We are supportive of the requirement to maintain an investment grade credit rating and our licence has contained similar provisions since 2007. We have therefore accepted the proposal to amend our licence to strengthen the requirement to maintain an investment grade credit rating on the understanding that Ofwat will continue to interpret the definition of issuer credit rating in the way it has since 2007.

We have also proposed the following, minor drafting amendments to the definition of Issuer Credit Rating and Condition P to reflect how Ofwat interprets the condition in practice:

Condition A:

"Issuer Credit Rating" *means, (a) for so long as the Appointee is a member of the corporate group that has been assigned a Corporate Family Rating by a Credit Rating Agency, such Corporate Family Rating; or (b), where the Appointee is not a member of a corporate group that has been assigned such a Corporate Family Rating, the credit rating assigned by a Credit Rating Agency to the debt ranked as senior issued or guaranteed (as the case may be) by the Appointee.*

"Corporate Family Rating" *means a credit rating issued by a Credit Rating Agency to all classes of debt issued by companies that are members and/ or affiliates of the same corporate group where the "corporate group" is as determined by the relevant Credit Rating Agency for such purpose*

We also suggest the following amendment is made to new Condition P, paragraph 7.3(b):

7.3: The "Cash Lock-Up" provisions set out in paragraph 7.4 apply in any circumstance where:…
(b) the Appointee holds an Issuer Credit Rating that is not an Investment Grade Rating.

Board Leadership and Governance
We support the proposal to introduce a requirement to comply with a set of corporate governance principles, and the current Board Leadership, Transparency and Governance (BLTG) principles have worked well to drive a step change in corporate governance across all appointees.

We recognise the need for these principles to evolve and to be updated to reflect the latest best practice in corporate governance. Any changes to the current principles will need to carefully balance Ofwat's principle based regulatory framework with pressure to place more prescriptive requirements on companies. In particular, it will be important that the principles are flexible enough to allow governance arrangements that are in the long term best interests of customers and the environment.

We are interested in supporting your work to develop the BLTG principles, and given the introduction of a requirement to comply with the BLTG principles, we recommend you consider developing:

- a framework for the principles, for example, what is appropriate to be included in a separate document covering the principles versus more specific obligations that might be better included on the face of the licence;

- a clear governance process for proposing and considering changes to the principles, including a clear engagement process with the industry and stakeholders; and

- transition arrangements for implementing new requirements - the introduction of mandatory corporate governance principles and changes to those principles may take time to implement, for example, if new principles required greater independent representation on the regulated company Board. It will, therefore, be important to consult on transition arrangements in conjunction with the introduction of mandatory principles and subsequent changes to them.

As the sector continues to evolve and new markets begin to mature, it will be important to consider how and when an equivalent requirement to comply with the principles should apply to other regulated parties. Ensuring all types of regulated entities operate to the same high standards of board governance will be vital to future proofing the legitimacy of the whole sector.

Yours sincerely

Nick Fincham
Director of Strategy & Regulation