

November 2018

Trust in water

# Consultation on strengthening the regulatory ring-fencing framework

## About this document

This document is a consultation on strengthening the regulatory ring-fencing framework to bring all licences up to the industry leading standard<sup>1</sup>. It sets out why we believe that the regulatory ring-fencing framework should comprise licence conditions which are consistent across the industry. The proposals<sup>2</sup> in this document build on previous consultations and discussions in industry workshops, and specifically relate to:

- maintaining investment grade credit ratings and cash lock-up;
- providing ring-fencing certificates;
- reporting of material issues; and
- change of control.

In parallel and separately, we are taking forward our work in relation to proposed changes to the Board Leadership, Transparency and Governance (BLTG) principles and related licence conditions. We will publish a response to our [consultation](#) on these matters in due course.

The precise wording and coverage of the individual ring-fencing conditions currently varies between licences. To achieve a consistent regulatory ring-fencing framework, we propose to introduce a new Condition P for those companies that don't yet have this condition drawing together all of the ring-fencing provisions, and to ensure that all companies' Conditions A and P are updated where necessary to reflect the specific proposals in this document. To help illustrate these proposals, the Annex sets out what we consider to be the current industry-leading standard licence provisions for the regulatory ring-fencing framework, in relation to the issues covered in this consultation.

The following relevant documents have also been published:

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<sup>1</sup> By "industry-leading standard" we refer to regulatory ring-fencing licence conditions that have been implemented in one or more Instruments of Appointment which we consider currently to reflect the most appropriate robust level of protection of the Appointee and its customers.

<sup>2</sup> The proposals in this document do not apply to New Appointments and Variations. We are not proposing to change our approach towards the licences of these companies at this time but continue to keep our policy towards them under review.

- [Conclusions on Change of Control and Modification of Instrument of Appointment](#) (“Thames Water Conclusions Document”), which sets out specific licence amendments that are now implemented in the licence of Thames Water Utilities Limited (‘Thames Water’), following [consultation](#). It also sets out our considered views in relation to general policy issues relating to change of control, which are not therefore repeated in detail in this document.
- [Thames Water Change of Control – general policy and its application to Thames Water: Summary of Responses](#) (“Thames Water Summary of Responses”), which summarises the responses we received to all of the questions in the Thames Water Consultation. We have taken these responses into account in refining the proposals we are consulting on.

We welcome responses to this consultation by close of business on 8 January 2019. We are particularly keen to hear points relating to the practical implementation of the changes by companies.

We continue to review the desirability of further strengthening of this framework beyond these proposals, for example we are still considering the matter of minority cross-shareholdings, and we expect to engage further in due course on any proposals.

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## 1. Introduction

Water companies deliver vital services that are essential for public health, the environment and economy and a well-functioning society. Our goal is a thriving water sector that holds the trust and confidence of customers and wider society and recognises the importance of focusing on delivering in the interests of customers.

In a [letter to water and wastewater and water only companies](#) on 13 April, we set out some of the steps that Ofwat is taking as part of a wider work package to protect the interests of customers and wider interests, consistent with our statutory responsibilities. A key part of this work was in relation to improving the financial resilience of companies.

We said that we would seek views on how to ensure that all customers have the same level of protection by bringing the regulatory ring-fencing framework of all companies up to an industry leading standard.

### 1.1 Financial Resilience and the Regulatory Ring-fencing Framework

In our PR19 methodology, we define financial resilience as:

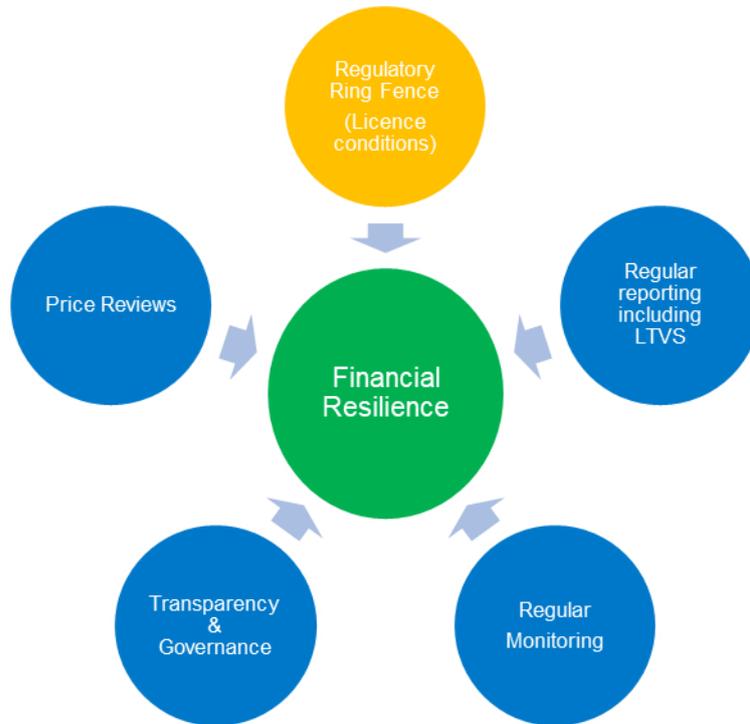
*“the extent to which an organisation’s financial arrangements enable it to avoid, cope with and recover from disruption”*

The regulatory ring-fence<sup>3</sup> provides an important protection for Appointees and their customers. Its purpose is to ensure that the regulated company maintains sufficient financial and management resources which enable it to carry out its functions in a sustainable manner. It protects the regulated company from the activities of other entities such as other group companies. The regulatory ring-fencing framework

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<sup>3</sup> In this document we use the term “regulatory ring-fencing framework” to refer to the ring-fencing licence conditions in all companies’ licences (noting that at present there are differences between licences and that the proposals in this document may not cover all aspects of these ring-fencing provisions). We use the term “regulatory ring-fence” to refer to the ring-fencing licence conditions for a specific company.

complements other measures that contribute to achieving financial resilience. This is illustrated in the figure below.



*Figure 1: Financial resilience and regulatory ring-fence (LTVS - Long term viability statements)*

Each company's regulatory ring-fence consists of licence conditions which place specific obligations on it. There is currently some variation in licence conditions but broadly they include provisions which:

- oblige the Appointee to maintain sufficient financial resources, management resources and systems;
- prevent inappropriate extraction of financial resources by shareholders particularly at times of financial distress;
- require the provision of information to Ofwat about material matters or events affecting the regulated entity; and
- create obligations in relation to other matters such as conduct, preparedness for special administration, and maintaining arms-length relationships with other group companies.

It is important to ensure that the regulatory ring-fencing framework continues to provide an appropriate level of protection. We have highlighted our intention to review its effectiveness and this consultation is an important step.

The proposals we set out in this document for consultation have been informed by the responses to our Thames Water Consultation as set out above. We have also been grateful for input to our thinking by the industry on many of the matters raised, particularly at an industry workshop on 4th September.

The rest of this document is set out as follows:

- Section 2 explains our rationale for bringing the regulatory ring-fencing framework to an industry-leading standard for all Appointees and sets out specific policy proposals in relation to some elements of the regulatory ring-fence
- Section 3 outlines how to respond to this consultation and expected next steps.

## 2. The Regulatory Ring-fencing Framework

In this section, we set out our thinking in relation to the regulatory ring-fencing framework and, where relevant, proposals for change.

As set out in the Thames Water Consultation, we consider there is a strong case for our seeking to ensure that the regulatory ring-fencing framework is consistent across the industry and that all Appointees' licences are brought up to the industry-leading standard.

The industry-leading standard has evolved over time and has generally reflected our evolving view of the standards which appropriately protect the interests of the regulated business and its customers. In the past, we have used the opportunity afforded by consultations on change of control to amend the licence conditions of the affected companies.

The changes we are consulting on here would involve, for some companies, bringing some existing ring-fencing provisions in Condition F<sup>4</sup> and Condition K into a new Condition P. It would also involve changes to the wording of some existing licence provisions, including updating the definitions in Condition A. We have set out in the Annex the licence provisions we would like to see in all companies' licences in respect of the proposals in this consultation.

### Views on our proposal for consistency

Stakeholder feedback received so far suggests agreement in principle from many for the proposal for consistency across the industry, including amongst those responding to the Thames Water Consultation.

However, a number of stakeholders think that there should be scope for variation, with some of these citing that this needs to be objectively justified by the circumstances of an individual company. For example, one response to the Thames Water Consultation observed that there are variations in the nature and complexity of companies' ownership structures and business models and noted that some companies are

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<sup>4</sup> Ofwat's recent consultation on [Licence Simplification](#) closed in October and we are currently considering the responses. The consultation proposes that some provisions currently in Condition F of some Instruments of Appointment would be transferred to a new Condition I. Should these changes be made as proposed, in some cases implementation of the consistency proposal discussed here would involve moving ring-fencing provisions from Condition I and Condition K to Condition P.

privately owned while others are publicly listed. It therefore queried the appropriateness of uniform provisions.

Another respondent questioned the feasibility of bringing licences to a consistent standard within the same timeframe, given companies' different circumstances.

## **Our view**

We recognise the variation in the circumstances of individual companies but we are not convinced by the argument that these differences justify variation in the standard of protection which the ring-fencing provisions provide for the regulated business and its customers. The purpose of the ring-fencing framework is to protect customers and the Appointee from group activities outside the ring-fence and to ensure that the Appointee has adequate resources and facilities to carry out its regulated activities at all times. We do not think that variations between licences that result in a different minimum standard of protection with some regulated businesses having a lower standard serve customers well.

It is therefore our view that the same standard of protection should apply consistently to every Appointee irrespective of business model, ownership structure or listing status. We understand that there are circumstances where the detail of a particular licence provision may need to vary between licences, recognising individual circumstances, but this variation should be consistent with providing the same standard of protection.

We believe that a consistent and equivalent standard is most simply and transparently achieved when each company has identical licence conditions. This provides for clarity and transparency. We therefore seek to make licence conditions the same unless there is a clear rationale to do otherwise.

We do not consider on the basis of the information we presently have that any company will require additional time to meet the requirements of the updated licence conditions. If a company believes that there is a valid reason why additional time may be required, then they should explain this in any response to this consultation.

## **Specific issues for consultation**

The remainder of this section sets out our thinking informed by views expressed by stakeholders in response to previous consultations or at the industry workshop, and asks for further views on issues raised in relation to particular elements of the regulatory ring-fencing framework:

- Maintaining investment grade credit ratings and cash lock-up (Section 2.1)
- Providing ring-fencing certificates (Section 2.2)
- Reporting of material issues (Section 2.3)
- Change of control (Section 2.4)

## **2.1 Maintaining investment grade credit ratings and cash lock-up**

### **Maintaining investment grade credit ratings**

Maintaining an investment grade credit rating is important because it signals the ability of the Appointee to access the capital markets and hence to continue to be able to finance its activities. Having an investment grade credit rating should provide some assurance that the Appointee can access the necessary resources that it may require to finance itself in the future and it should also be an important indicator of the underlying financial resilience and creditworthiness of the Appointee.

The current licence provisions vary across Appointees with respect to maintaining an investment grade credit rating. While the licences of some companies require them to use “reasonable endeavours” or “best endeavours” to maintain an investment grade credit rating, in recent years a number of licences have been updated to include the requirement that the company “must ensure” that an investment grade credit rating is “maintained at all times”. This form of words has been included in the licences where the regulatory ring-fence is contained in Condition P. The companies with an updated “must ensure” wording are Severn Trent Water, Hafren Dyfrdwy, South West Water, Portsmouth Water and Thames Water.

It should be noted that the form of licence condition included in Condition P requires that companies maintain at least one investment grade credit rating, but does not require that every one of its ratings should be investment grade.

Two companies<sup>5</sup> are exempted from the requirement to maintain an investment grade credit rating. These Appointees’ licences contain additional provisions which have the effect of replacing the obligation to maintain an investment grade credit rating with alternative requirements which aim to provide a similar level of protection: the Appointee’s Board is required to certify its opinion that it would be able to obtain such a rating, together with relevant information supporting its opinion, including financial

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<sup>5</sup> South West Water and Hafren Dyfrdwy

metrics. We consider these arrangements to be exceptional but we believe that it is in the interests of customers, in certain circumstances, to accept an alternative test and these arrangements will continue to apply.

## **Stakeholders' views**

Stakeholders have expressed a range of views in relation to maintaining investment grade credit ratings, both in responding to our Thames Water Consultation and in the stakeholder workshop.

Companies were generally supportive of the principle of maintaining an investment grade credit rating as an important protection. One respondent to the Thames Water Consultation emphasised that it should not be the only tool for evaluating the financial health of companies.

Some stakeholders support our proposal that companies “must maintain” an investment grade credit rating, with some noting that some companies already have such a condition in their licence. Others asserted that a “reasonable endeavours” approach should be maintained because it provides sufficient protection to customers. Stakeholders noted that there are already strong incentives to maintain ratings at investment grade and that the Boards of appointees recognise the importance of this.

Respondents to the Thames Water Consultation and attendees at the workshop were concerned about the consequences if matters outside their control meant that they would be unable to maintain their ratings. In particular, companies were concerned about the consequences of financial distress caused by factors impacting capital markets generally or of unanticipated changes in rating agency methodology or their view of the wider regulatory framework.

It was observed that if such factors led to rating downgrades then this would result in an immediate breach of the licence. Stakeholders asked how we might respond to such a breach, suggesting that our response and the timing and nature of any enforcement action should take account of the circumstances. One stakeholder was concerned that the existence of a breach may hinder affected Appointees in taking action to rectify the issue. Others suggested that the actions companies may take when in a situation of financial distress may not be affected by the change and highlighted the protections already in place. The potential for uncertainty arising about how Ofwat might enforce the conditions was also raised.

A few stakeholders commented on the consistency of treatment across Appointees, with one respondent to the Thames Water Consultation calling for all companies to be

required to maintain an investment grade credit rating irrespective of their circumstances.

Responding to the Thames Water Consultation, Thames Water asked for confirmation that it could continue to rely on its corporate family rating as previously agreed. We decided that it would be clearer to bring provisions dealing with this arrangement into the licence. We have therefore made amendments to Thames Water's licence to the definition of "Issuer Credit Rating" and included a new definition of "Corporate Family Rating".

## **Our views and proposals**

We have carefully considered what we have heard from stakeholders in response to the Thames Water Consultation, and at the company workshop.

We continue to believe that there are good reasons for all companies to have a licence condition which requires them to ensure that they maintain an investment grade credit rating.

We consider that a "must ensure" licence condition is consistent with the importance of the investment grade credit rating as a potential indicator of a company's financial resilience. It makes it clear that companies must do all they can to manage their finances to maintain an investment grade credit rating, in particular by considering how they might protect themselves against events outside of their control. We have heard arguments from some companies that a reasonable or best endeavours standard achieves this, but we are not convinced that this is the case and believe that our proposal provides stronger protection for Appointees and customers. It supports our expectation that companies should take a precautionary approach to potential future events affecting their financial resilience, in particular that they should properly stress test their financial arrangements, consider what action is required to address resulting issues and ensure that they have appropriate capacity and flexibility within their finances.

Moreover, this wording provides greater clarity for all parties as to whether or not a breach has occurred. With a "must ensure" condition, breach is immediately consequent on an observable fact. As a consequence, Appointees can be very clear about the standard which they must attain and this should ensure that their focus is on maintaining the investment grade credit rating.

By signalling more clearly if and when a breach occurs, this form of wording also enables us to take action more directly to address the substance of the resilience issue. One advantage of the change to 'must maintain' is that our first focus and that

of the company in light of any breach will be on protecting the financial position of the Appointee and preventing detriment to customers, rather than scrutinising the actions of the company and deciding whether or not they have done enough to maintain their credit ratings.

For these reasons, we are strongly of the view that it is appropriate to bring all companies' licences to the same standard by including the "must ensure" wording in relation to maintaining an investment grade credit rating.

We understand that events may happen which reflect factors in the wider economy or which appear to be outside the control of an Appointee and which can impact the sector as a whole rather than individual companies. We consider that such circumstances can properly be taken into account in our consideration of the appropriate, proportionate action to take under our enforcement procedures, for example, in terms of our consideration of any action the company is taking to address a failure to comply with their obligation.

We are also consulting on whether the changes to the definition of issuer credit ratings in Thames Water's licence to allow for the use of a corporate family rating should also be included in the licences of all Appointees.

A number of other Appointees use group companies to raise finance. The revised definition (as set out in the Annex) would clarify our acceptance of a corporate family rating in appropriate circumstances. The licence provision provides that Ofwat will still need to confirm that any corporate group on which the corporate family rating is based is acceptable and provides an appropriate reflection of the financial position of the Appointee.

We believe it is appropriate to reflect this in all licences so that all Appointees have an equivalent opportunity to take this approach. We therefore propose to reflect the amendments to the definition of issuer credit ratings in the licences of all Appointees.

### **The cash lock-up requirement**

For most companies, there is a licence provision which triggers a cash lock up in certain circumstances, for example either where an Appointee does not hold an issuer credit rating which is investment grade, one or more issuer credit ratings held by an appointee is not investment grade, or where the rating outlook as specified by the credit rating agency which has assigned the lowest investment grade rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation or has been changed from stable or positive to negative.

The purpose of the cash lock up provision is to protect the Appointee and to ensure that there is no further deterioration in its available resources when there is an increased level of risk to its overall financial resilience. Once the cash lock up is triggered<sup>6</sup>, the Appointee cannot release any funds to its holding company or other associated businesses, including paying dividends, without our consent.

Three companies, namely Wessex Water, Bristol Water and Welsh Water currently do not have a cash lock-up provision in their licence so these Appointees and their customers are not afforded the equivalent level of protection, compared to other companies.

## **Our view and proposals**

The cash lock-up provisions represent important protections for Appointees and their customers by ensuring that in adverse financial circumstances, funds are retained by the Appointee to enable it to carry on its business. We do not believe that it is in the interests of the relevant Appointees (where this protection does not exist) or their customers to face the risk of funds being extracted from the Appointee in circumstances when it is under financial distress. Nor does it seem equitable that dissimilar levels of protection apply for different Appointees. We therefore intend to make this provision consistent across all companies' licences by adding the most up-to-date wording into licences (as set out in the Annex) where it is currently not present.

## **Questions:**

- In light of the summary of views expressed and our initial consideration of the points made to date, do you agree with, or have any further comments to make with respect to, the proposal that all Appointees' licences require that they "must ensure" they maintain an appropriate investment grade credit rating at all times? (See Annex: Condition P7) Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.
- Do you agree with the proposal to adjust the definition of issuer credit rating to explicitly allow for the use of a corporate family rating? (See Annex: Condition P7)

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<sup>6</sup> For South West Water and Hafren Dyfrdwy, the cash lock up is triggered when specific requirements for annual certification are not met, rather than by reference to credit ratings.

- Do you agree with, or have any further comments to make with respect to, the proposal to include the most up-to-date cash lock-up provisions for companies where they are currently not included? (See Annex: Condition P7)

## **2.2 Providing ring-fencing certificates**

Most Appointees are obliged by their licences to submit a ring-fencing certificate to Ofwat annually, at the time the company publishes its Annual Performance Report. The ring-fencing certificate is required to state that in the opinion of the Board of the Appointee:

- 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;
- 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
- 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.

The purpose of providing an annual ring-fencing certificate is to provide additional assurance to Ofwat and other stakeholders that the Appointee is and will be able to carry out its functions in the short term and hence this enhances the protection for customers provided by the regulatory ring-fencing framework. It places an obligation upon the Board of the Appointee to acknowledge and comply with the ring-fence conditions, transparently reinforcing their accountability to stakeholders and thus enhances the confidence that stakeholders have about the Appointee's ability to carry out its functions in the coming year.

Licence provisions also require Appointees to state the main factors which the Board has considered in coming to its opinion and requires the Board to sign or approve the ring-fencing certificate.

Notification to Ofwat and re-certification is required if the Board 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 carry on its regulated activities. It requires the Appointee to notify Ofwat if it becomes aware of circumstances which would cause it to change the opinion on which its most

recent certification was based. A report by the Appointee's external auditors to Ofwat is also required to be submitted covering the consistency of the ring-fencing certificate with its regulatory accounts or information gathered during the audit.

### **Proposed licence changes to bring licences to industry-leading standard**

Currently there are minor variations between companies' licence requirements on ring-fencing certificates and, in line with the general intent of the proposals in this consultation, we are proposing changes to make the requirements consistent with the current industry-leading standard. For those companies that do not yet have a new Condition P, we intend to bring all the requirements on ring-fencing certificates into a new Condition P.

There is a requirement for separate ring-fencing certificates for retail and residual businesses which is currently included in Condition F for some companies. For those companies that have chosen to exit the non-household retail market under the Retail Exit Code, we propose that these provisions should not be brought into Condition P as the requirement is not relevant to their situation. This is consistent with the approach already adopted for companies who already have a Condition P. We propose to retain the requirement for companies that have not chosen to exit.

Our proposals for the ring-fencing certificate provision in the updated Condition P do not have a requirement for a Reporter's report on the ring-fencing certificate which is currently included in Condition F for some companies. We do think it is important that there is an adequate level of external assurance in relation to the ring-fencing certificate to help address the risk that insufficient attention is placed upon the process. At present, as a basic obligation, we believe that the requirement for a report on the ring-fencing certificate by a company's external auditor adequately serves the need for a level of external assurance. Related to this we propose that the requirement to provide an audit report is included in the licences of all companies.<sup>7</sup>

We acknowledge that there are other minor wording changes represented by our proposal for the ring-fencing certificate provision in the updated Condition P when compared with the current ring-fencing certificate provisions of some existing licences, but these are not changes of substance and we are aiming to deliver uniformity of wording across all licences.

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<sup>7</sup> Currently South West Water's Instrument of Appointment does not include this obligation.

It is clearly an important protection for the Appointee and its customers that Boards give proper attention to the annual ring-fencing certification. It is for companies to decide how they fulfil the licence conditions relating to ring-fencing certification. We note that companies take a variety of approaches in practice: the form, substance and level of detail provided varies.

We are considering whether there is a need to improve the form and consistency of ring-fencing certificates submitted. It remains our expectation that companies should:

- clearly set out where in their Annual Performance Reports, the ring-fencing certificate is presented and ensure that it is sufficiently prominent to the reader;
- clearly state the various factors and approach that the company's board has taken into account in giving its opinion for the ring-fencing certificate and provide a sufficient level of detail in relation to each element covered by the reporting requirements: i.e. financial resources and facilities, management resources and systems of planning and internal control and inter-company contracts; and
- include and clearly sign-post the report prepared by the Appointee's external auditors.

At our September company workshop we outlined proposals to make licences consistent across the industry. Discussions about the potential for guidance on certification indicated a range of views among companies about whether useful guidance could be developed. We are not convinced that separate guidance is required, but have restated our expectations in relation to ring-fencing certificates above.

### **Questions:**

- What are your views on the licence changes we have set out to bring the provisions relating to ring-fencing certificates for all companies into line with industry-leading standards? (See Annex: Condition P9)
- Do you have any views about the form and consistency of information provided with ring-fencing certificates or our expectations in relation to these matters?

## **2.3 Reporting material issues**

Currently, some companies' licences include a requirement for the Board of the Appointee to inform Ofwat as soon as possible when they become aware of any circumstance that may materially affect the Appointee's ability to carry out its regulated activities. We are proposing to introduce this condition into the licence of all companies

which do not currently have it. The proposed wording is set out in the Annex: Condition P10.

The proposed licence provision does not specify the types of matters that might be considered material. We have not to date considered it necessary to issue any specific guidance about this or about the timing of such a notification requirement or the information that should be provided.

We expect companies to use their own judgement to assess which issues are likely to be considered to have a 'material' impact on the financial, operational and corporate resilience of the company to the detriment of customers and wider stakeholders. Potential examples include:

- material issues impacting financial resilience – these could include cases of financial distress, actual or potential credit rating downgrade, breach of borrowing covenants, or indications of withdrawal of financial support by creditors;
- material issues impacting operational resilience – these could include major operational incidents, uninsured or underinsured catastrophes, enforcement actions by other regulators or loss of key supplier or sub-contractor contracts which impact on service delivery for customers; and
- material issues impacting corporate resilience – these could include loss of key management personnel, change in board of directors, any actual or threatened enforcement actions being taken by other regulators, material legal claims/fines, or issues related to wider group activities.

## **Stakeholders' views**

We sought stakeholder views on reporting of material issues in the Thames Water Consultation and at our September 2018 company workshop. We asked for views on whether there needs to be a more explicit requirement for all companies to inform us of particular events affecting the Appointee. Many of the stakeholders who expressed views on this issue consider that their current requirement is appropriate and sufficient. At the workshop there was a range of views on whether guidance might be useful for companies and if so what it might cover, but there was no strong consensus on guidance.

## **Our views and proposals**

We have carefully considered stakeholder feedback so far.

We have not heard anything from stakeholders in relation to reporting of material issues which suggests that we should change our proposed approach to this licence condition. Therefore we are proposing to bring all companies licences to the same standard.

We have considered whether guidance might better enable companies to comply with their licence obligations by providing further clarity about our expectations of the content and timing of information provided. However, we do not believe that there is a strong case for such guidance. We think that it is important that the lines of communication between companies and Ofwat about material issues continue to be open at all levels but do not believe that the development of guidance on this would offer any substantial additional benefit to companies making decisions about what to report and when, given the range of potential circumstances that they may face. It could even be counter-productive if it leads to a box-ticking approach.

### **Questions:**

- Do you agree with, or have any further comments to make with respect to, the proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance? (See Annex: Condition P10)

## **2.4 Change of control and other matters**

In our Thames Water Conclusions document we have set out our views on our general policy on change of control and the need for related licence modification. We do not repeat the summary of views expressed on that issue and our conclusions.

We have inserted the following provisions into Thames Water's licence:

- A requirement for 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;
- A requirement for the Appointee to inform us when 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;
- An obligation for the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller undertaking.

We now propose to implement these provisions in all Appointees' licences. See Annex: Condition P3 for the detailed provisions.

In addition we note that implementing a consolidated Condition P in all licences will result in minor wording changes to some of the other provisions in Condition P which are not specifically discussed in this document. The precise changes required for each company will vary depending on its current licence and we intend to discuss these changes with individual companies.

## **Questions**

- Do you have any other comments on the issues discussed above or elsewhere in this consultation that you would like us to consider?

### **3. Responding to this consultation and next steps**

We would welcome any comments on this document. Please send your responses to [FinanceAndGovernance@ofwat.gsi.gov.uk](mailto:FinanceAndGovernance@ofwat.gsi.gov.uk). You can also submit your response by post to:

Regulatory Ring-fencing  
Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

The closing date for this consultation is 8 January 2019. We will publish responses to this consultation on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 2018 and the Environmental Information Regulations 2004.

If you would like the information that you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons that the contents of those written responses remain confidential.

As next steps, following the careful consideration of stakeholders’ responses, we currently expect to publish our decision on this consultation, and engage with individual companies on how their licences should be updated in light of this. Subject to the outcomes of this consultation, and further engagement with companies, we would then expect to publish proposals under s13 WIA for specific licence modifications reflecting our conclusions on the policy issues in this document.

### **Consultation questions:**

We welcome responses to the following questions:

- 1) In light of the summary of views expressed and our initial consideration of the points made to date, do you agree with, or have any further comments to make with respect to, the proposal that all Appointees' licences require that they "must ensure" they maintain an appropriate investment grade credit rating at all times? (See Annex: Condition P7) Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.
- 2) Do you agree with the proposal to adjust the definition of issuer credit rating to explicitly allow for the use of a corporate family rating? (See Annex: Condition P7)
- 3) Do you agree with, or have any further comments to make with respect to, the proposal to include the most up-to-date cash lock-up provisions for companies where they are currently not included? (See Annex: Condition P7)
- 4) What are your views on the changes we have set out to bring the provisions relating to ring-fencing certificates into line with industry-leading standards? (See Annex: Condition P9)
- 5) Do you have any views about the form and consistency of information provided with ring-fencing certificates or our expectations in relation to these matters?
- 6) Do you agree with our proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance? (See Annex: Condition P10)
- 7) Do you have any other comments on the issues discussed above or elsewhere in this consultation that you would like us to consider?

## **Annex: Provisions to bring all licences up to the industry-leading standard for the regulatory ring-fence<sup>8</sup>**

This Annex contains text that we consider to be the current industry-leading standard for the regulatory ring-fence, reflecting the proposals laid out in this consultation. It consists of relevant definitions in Condition A, and the relevant provisions for each of the specific areas of the regulatory ring-fence discussed in this consultation.

Subject to considering the responses to this consultation, we anticipate that these proposals will be taken forward by introducing a new Condition P for those companies that do not yet have it, and updating the existing Condition P of some of those companies who currently have a version of Condition P. We also anticipate updating Condition A for some companies. The specific changes for each company will be discussed further with individual companies before moving to issue a consultation under s13 of the Water Industry Act.

### **Condition A**

We propose adding 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

(a) references to a loan shall be taken to include the transfer or lending, by any means, of any sum of money or rights in respect of such sum.

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<sup>8</sup> Our recent consultation on [Licence Simplification](#) proposed 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.

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.

**“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 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;

...

**“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 Regulatory 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;

## **Provisions for all licences relating to the regulatory ring-fence**

Here we set out the provisions that we expect all licences will have as a result of the proposals set out in this consultation. For ease of reference, these are numbered as though they are part of an updated Condition P. In relation to condition P3, we have included surrounding text (greyed out) to aid understanding, although only provisions 3.6 and 3.7 are the subject of this consultation.

### **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 by the Water Services Regulation Authority.

- 3.4 The Appointee must provide to Ofwat 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.

## 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, licences 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.

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.

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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