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# **Statement of reasons: The granting of consents to Severn Trent Water Limited pursuant to conditions A and P of its licence**

## **1. Background**

Ofwat decided on 29 June 2018 to modify the conditions of the Instrument of Appointment ('licence') of Severn Trent Water Limited ('Severn Trent') with effect from 1 July 2018. Severn Trent's acceptance of these modifications was a condition of us granting variations to its and Dee Valley Water Limited's<sup>1</sup> ('Dee Valley') areas of appointment and Dee Valley a new sewerage licence<sup>2</sup>. The applications from both companies to vary their areas of appointment followed Severn Trent's purchase of Dee Valley in February 2017. Dee Valley has been, since that date, wholly owned by Severn Trent.

Until these modifications, Severn Trent's licence did not contain many of the ring fencing conditions found in licences of other regulated water companies. We considered it important to address this gap in Severn Trent's licence so that its customers enjoyed the same level of protection in this area as enjoyed by customers of other companies. In addition, given that Severn Trent and Dee Valley continue to operate as two separate companies, each holding a licence and therefore regulated separately, it is important that the two businesses are appropriately ring fenced from each other. The ring fencing conditions aim to 'ring fence' the regulated company from the activities of other entities such as other group companies. The purpose of the ring fence is to ensure that the regulated company retains sufficient rights and assets and has in place adequate management resources and systems of planning and internal controls and that any transfers or transactions entered into by the regulated

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<sup>1</sup> Dee Valley Water Limited was renamed Hafren Dyfrdwy Limited on 30 June 2018 and, subsequently, Hafren Dyfrdwy Cyfyngedig on 7 November 2018.

<sup>2</sup> See: [Variation of Severn Trent Water Limited's \(Severn Trent Water\) appointment to include the Chester Site and variation of Dee Valley Water Limited's \(Dee Valley Water\) appointment to include the Powys site](#).

company do not adversely affect the company's ability to carry out the regulated activities. This constitutes an important protection for customers.

The ring fencing conditions which have been inserted into Severn Trent's licence contain provisions which, amongst other things, restrict Severn Trent's ability to enter into transactions with associated companies and restrict its ability to maintain agreements which include cross default obligations without the prior approval or agreement of Ofwat.

In the absence of the relevant ring fencing conditions, Severn Trent did not require consent for relevant provisions in its financing arrangements. Once it had the relevant conditions in its licence the company would, for the first time, require Ofwat's consent for these provisions. In a letter dated 24 May 2017 (the **Consent Request Letter**, see appendix 1), in anticipation of these ring fencing conditions being introduced into its licence, Severn Trent sought Ofwat's consent in relation to certain provisions in its existing financing arrangements (including intra-group financing arrangements). It also sought consent, in the event of any refinancing, for future arrangements, which Severn Trent considered required Ofwat's consent, approval or agreement pursuant to provisions in its licence<sup>3</sup>.

This document sets out the consents we have granted and approvals or agreements we have given<sup>4</sup>, the licence conditions under which they have been given, the conditions which we have placed on those consents and the reasons for granting those consents. It should be read in conjunction with our letter to the company dated 28 June 2018 (the **Consent Letter**, see appendix 2). The relevant licence conditions under which consent has been granted in the Consent Letter can be found in appendix 3.

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<sup>3</sup> The relevant conditions under which Severn Trent sought consent, approval or agreement are set out in appendix 3.

<sup>4</sup> Consents, approvals and agreements are collectively referred to as 'consents' hereafter.

## **2. Our approach**

The consents which we have granted are specific to the circumstances of this particular case, in particular the fact that Severn Trent is being required by its licence to comply with new licence conditions having already secured long term financing. In some cases the consents which we have granted are valid for a transitional period only. Given these two factors and save where expressly stated to apply to future arrangements, they should not be relied on by any company, including Severn Trent, as necessarily indicative of our approach in the future.

In assessing Severn Trent's requests we have considered the particular circumstances in light of our statutory duties (see summary in appendix 5). In particular, in assessing the requests from Severn Trent, we have considered the extent to which customers would be protected in the event of a default by associated companies in relation to loans made or cross default obligations or guarantees given. We have also considered risks to the financial resilience of the company and our duty to ensure that regulated companies can finance the proper carrying out of their functions. We did not grant all the consents which Severn Trent originally requested where we assessed the potential risk to customers or the financial resilience of the company to be greater than we considered acceptable.

In some cases where we have granted consents, we have time limited those consents to allow the company to put in place replacement arrangements thereby avoiding significant disruption to its financing arrangements with the knock on effects this could have, including on customers. In other cases we have attached conditions to the consents which we have granted to help mitigate any risks to customers or the financial resilience of the company.

## List of consents granted and reasons

Consent sought	Nature of consent / licence conditions (full detail set out in consent letter)	Conditions on consent (full detail set out in consent letter)	Reasons for granting consent and supporting factors
<p><b>Intra-group Financing Consent</b></p> <p>Consent sought for making and maintaining loans and maintaining cross default obligations and giving guarantees in relation to financial arrangements with Dee Valley</p> <p>The particular financing arrangements were described in paragraph 3.2.1 of the Consent Request Letter</p>	<p>Approval for Severn Trent to make and maintain loans and maintain cross default obligations and give guarantees</p> <p>Consent pursuant to Condition P, paragraphs 6.3(a), 6.3(b) and 6.4 of Severn Trent's licence</p>	<p>The actual or potential liability of Severn Trent pursuant to all intra-group financing arrangements described in paragraph 3.2.1 of the Consent Request Letter taken together shall not at any time exceed 1.5% of Severn Trent's regulatory capital value as most recently published by Ofwat. See paragraph 3.1.2(a) of the Consent Letter.</p> <p>There shall be no material changes, without Severn Trent first obtaining Ofwat's further consent, to the terms of the: i) loan arrangements, ii) existing debt facilities held within Dee Valley and its</p>	<p>Severn Trent states that these arrangements allow Dee Valley to access finance at a lower cost than it otherwise would be likely to be able to if it did so outside the group. These arrangements were put in place before Severn Trent had the relevant ring fencing conditions in its licence. Granting this consent therefore helped to ensure that Severn Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.</p> <p>The limitations on the total actual or potential liability of Severn Trent minimise the risk to Severn Trent's customers in the event of default by Dee Valley on any of the financial arrangements covered by this consent. This is because the maximum amount which can be lent to Dee Valley is small relative to the size of Severn Trent's regulatory capital value.</p> <p>The funds being provided by Severn Trent to Dee Valley are to allow Dee Valley to finance its regulated business. Given the nature of this business, Dee Valley has predictable cash inflows which will allow it to service this debt. This means that the risk of default by Dee Valley is low.</p> <p>Dee Valley could obtain alternative finance to that provided by Severn Trent by borrowing against its regulatory capital</p>

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		subsidiaries for which Severn Trent has provided or proposes to provide guarantees or iii) the arrangement between Severn Trent and Artesian lenders in respect of a loan previously held by Dee Valley. See paragraph 3.1.2(b) of the Consent Letter.	value which would allow it to repay the amounts lent by Severn Trent if required. There can be no material changes to the arrangements without Severn Trent seeking further consent which would allow us to withhold consent if our assessment shows that it is not appropriate to consent to an amended arrangement.
<b>Existing Financing Arrangements Consent – miscellaneous arrangements</b>  Consent sought for guarantees and cross default obligations within certain of Severn Trent's existing financing arrangements  These arrangements were described in paragraph 3.3.1, sub-paragraphs 1(1) to (12) (inclusive), and the associated parts of Annex 1	Approval for cross default obligations and guarantees  Consent pursuant to Condition P, paragraphs 6.3(a), 6.3(c) and 6.4 of Severn Trent's licence	The financial arrangements, which incorporate the cross default obligations and guarantees, can only be used and maintained for: i) existing borrowings and drawing down further on those arrangements and, ii) repaying the debt of Severn Trent, Dee Valley and/or their Financing Subsidiaries. See paragraph 3.2.1 of the Consent Letter.  There shall be no material change (including if such a change would constitute a renewal, extension or	We granted this consent to provide Severn Trent with certainty that it would be able to continue with existing arrangements, put in place before it had the relevant ring fencing conditions in its licence. This was to help ensure that Severn Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.  Severn Trent stated in the Consent Request letter that the maintenance and continued use of its existing financing arrangements (containing the guarantees and cross default obligations with other group companies for which it was seeking consent) is efficient and minimises costs. If the company was required to put in place replacement arrangements it would face significant disruption to its financing arrangements with the knock on effects this could have on the running of its business in the short term while it did this.  The limitation on what the arrangements can be used and maintained for (that is existing borrowings and drawing

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and Annex 2, of the Consent Request Letter		replacement) to the terms of these arrangements without Severn Trent first obtaining Ofwat's further consent. See paragraph 3.2.2 of the Consent Letter.	<p>down on those arrangements and repaying the debt of Severn Trent, Dee Valley and/or their Financing Subsidiaries) reduces the risk to customers and to the financial resilience of the company as a whole. This is because the arrangements cannot be used for risky activities which would increase the likelihood of Severn Trent being negatively impacted by the guarantees which it has given or the cross default obligations which are in place.</p> <p>The consents are for specific named arrangements only which means that if any further arrangements were put in place which may pose an increased risk to Severn Trent, these would not be covered by these consents and new consents would need to be sought. There can be no material changes to the arrangements without Severn Trent seeking further consent which means that we can withhold consent if our assessment shows that it is not appropriate to consent to an amended arrangement.</p>
<b>Existing Financing Arrangements Consent – cash management facility</b> <p>Consent sought for loans made pursuant to a cash management facility with</p>	<p>Approval for loans made by Severn Trent</p> <p>Consent pursuant to Condition P, paragraph 6.3(b) of Severn Trent's licence</p>	<p>Consent expires on 30 June 2023.</p> <p>In the event that the circumstances set out in paragraph 7.3 of Condition P apply then Severn Trent must not lend any further sums under the facility. The company must also seek repayment of all debt due under this facility when these circumstance apply.</p>	<p>We granted this consent to provide Severn Trent with certainty that it would be able to continue with the existing arrangement, put in place before it had the relevant ring fencing conditions in its licence, for a transitional period before putting a replacement arrangement in place. This was to help ensure that Severn Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.</p> <p>Severn Trent told us that the facility is the most efficient form of cash management available to it and Severn Trent plc and is cheaper than an equivalent overdraft facility with a financial institution.</p> <p>While there may be a benefit to Severn Trent of this arrangement, this arrangement also allows Severn Trent to</p>

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Severn Trent plc <sup>5</sup> described in paragraph 3.3.1, subparagraph (13) of the Consent Request Letter		<p>See sub-paragraph 3.2.3(a) of the Consent Letter.</p> <p>Paragraph 7.3 of Condition P sets out the circumstances when the 'Cash Lock-Up' provisions set out in the company's licence apply. See appendix 4 for the 'Cash Lock-Up' provisions in Severn Trent's licence.</p> <p>Outstanding loans made by Severn Trent pursuant to the cash management facility must not exceed £250m at any time. See sub-paragraph 3.2.2(b) of the Consent Letter.</p>	<p>loan money to Severn Trent plc. To minimise the risk to customers the ring fence normally prohibits loans being made to associated companies, including the parent, without consent.</p> <p>However it could be disruptive to Severn Trent if it were required to cease this arrangement at short notice without having an appropriate replacement framework in place. We have therefore allowed this arrangement to continue for a temporary period with appropriate constraints to reduce risk.</p> <p>The limitation on the total outstanding loans made by Severn Trent under this arrangement minimises the risk to Severn Trent's customers in the event of default by Severn Trent plc.</p> <p>In addition, the limitation of the time for which this arrangement can remain in place under this consent time limits any risk which may arise as a result of this arrangement while giving the company time to seek to put in place a new financing framework.</p> <p>In the event that Severn Trent finds itself in an adverse financial situation where the 'Cash Lock-Up' provisions of its licence apply then it must seek repayment of any debt due. This will help protect the financial resilience of the company.</p>

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<sup>5</sup> Severn Trent's ultimate holding company.

Consent sought	Nature of consent / licence conditions (full detail set out in consent letter)	Conditions on consent (full detail set out in consent letter)	Reasons for granting consent and supporting factors
<p><b>Existing Financing Arrangements Consent – overdraft and cash pooling arrangement</b></p> <p>Consent sought for guarantees and cross default obligations and loans in connection with a group wide overdraft and cash pooling arrangement. Further detail is provided in 3.3.1, sub-paragraph 1(14) of the Consent Request Letter</p>	<p>Approval for guarantees and cross default obligations and loans</p> <p>Consent pursuant to Condition P, paragraphs 6.3(a), 6.3(b), 6.3(c) and 6.4 of Severn Trent's licence</p>	<p>Consent expires on 30 June 2021.</p> <p>Severn Trent will use all reasonable endeavours as soon as reasonably practicable to split out the arrangement into separate arrangements including one for Severn Trent and its Financing Subsidiaries (these are listed in paragraph 3.2.5 of the Consent Letter) only. It will also provide Ofwat with an annual update on the progress it is making in doing this. See paragraph 3.2.4 of the Consent Letter.</p>	<p>We granted this consent to provide Severn Trent with certainty that it would be able to continue with the existing arrangement, put in place before it had the relevant ring fencing conditions in its licence, for a transitional period while putting a replacement arrangement in place. This was to help ensure that Severn Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.</p> <p>While there may be a benefit to this arrangement in that it can help to minimise costs for Severn Trent if, for example, it finds itself temporarily overdrawn as this can be offset by credit balances held by other companies within the group. However this is a reciprocal arrangement which means that Severn Trent could be exposed to risk from other companies within the group over which it has no control.</p> <p>The arrangement itself contains controls over the amounts that can be loaned between companies and this limits the exposure of Severn Trent to any problems which may arise with other group companies taking part in this arrangement.</p> <p>We consider that the conditions which we have put in place for this consent and the limits which the arrangement contains help mitigate the risks while still allowing Severn Trent certainty over this financing arrangement for the near future.</p>
<p><b>Existing Financing Arrangements Consent – Financing Subsidiaries</b></p> <p>Consent for certain associated companies of Severn Trent to be</p>	<p>Consent for four associated companies of Severn Trent to be considered Financing Subsidiaries</p>	<p>Consent expires on 30 June 2023 or the date on which the relevant company ceases to be a subsidiary of Severn Trent, if earlier.</p>	<p>We granted this consent to provide Severn Trent with certainty that it would be able to continue with existing arrangements, put in place before it had the relevant ring fencing conditions in its licence, for a transitional period while using all reasonable endeavours to make the necessary changes at the companies covered by this consent. Our consent was to help ensure that Severn</p>

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considered as Financing Subsidiaries for the purposes of Severn Trent's licence. See paragraph 3.2.5 of the Consent Letter for details of the companies	Sub-paragraph (2) of definition of "Financing Subsidiary" in condition A of Severn Trent's licence	<p>Severn Trent will use all reasonable endeavours as soon as reasonably practicable to take steps in relation to these companies such that Ofwat consent is no longer required.</p> <p>See paragraph 3.2.5 of the Consent Letter.</p>	<p>Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.</p> <p>The standard definition of a Financing Subsidiary, used across water companies' licences, is that to be considered a Financing Subsidiary a company must a) be a wholly owned subsidiary of the regulated company and b) have raising finance on behalf of the regulated company for the purposes of the regulated activities as its sole purpose.</p> <p>Severn Trent confirmed that while the purpose of the companies covered by this consent is to raise finance for the regulated company, they do not fall into the standard licence definition of Financing Subsidiaries which is used across companies. This is because these companies are not wholly owned by Severn Trent nor do they have the requisite provisions in their articles of association.</p> <p>In the event of a 'Cash Lock-Up' Severn Trent is not able to repay loans early to any company which is not defined as a Financing Subsidiary. If the consent which was being sought was not granted, Severn Trent considered that this would have had an impact on the credit worthiness of the companies which it sought consent to be considered Financing Subsidiaries. It stated that it would have a significant negative impact on the credit worthiness of existing loans as well the company's ability to raise finance in the future.</p> <p>The risk associated with consenting to these companies being considered Financing Subsidiaries is principally that without Severn Trent having full control of these companies and without the articles of association appropriately limiting their activities, these companies could be used for purposes other than raising finance for</p>

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			<p>Severn Trent. This would mean that in the event of a 'Cash Lock-Up' money could flow from the regulated business to activities which are not in the interests of Severn Trent or its customers.</p> <p>However we consider this risk to be small given the stated purpose of these companies and the activities they currently carry out. We have sought to reduce the risk further by time limiting the consent. In order for these companies to continue to be considered Financing Subsidiaries once this consent expires, Severn Trent will need to have changed the articles of association and ownership structure of the relevant companies such that they fall within the standard definition of a Financing Subsidiary.</p>
<b>Existing Financing Arrangements Consent – working capital facility</b> <p>Consent sought for loans by Severn Trent to Water Plus<sup>6</sup> pursuant to a working capital facility described in</p>	<p>Approval for provision of loans by Severn Trent</p> <p>Consent pursuant to Condition P, paragraph 6.3(b) of Severn Trent's licence</p>	<p>Consent expires on 19 April 2019.</p> <p>The loans made by Severn Trent to Water Plus shall not exceed a prescribed limit.</p>	<p>We granted United Utilities Water consent to provide loans to Water Plus in April 2016. Although Severn Trent did not have the relevant ring fencing conditions at this time, it provided equivalent assurances to those provided by United Utilities Water in relation to customer protection, competition, licence compliance, financing and resilience (see <a href="#">Statement of Reasons: The granting of consent for</a></p>

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<sup>6</sup> Water Plus is a 50:50 joint venture between Severn Trent plc and United Utilities plc (a holding company of United Utilities Water Limited, another regulated water and sewerage company). It is a water supply and sewerage licensee providing retail services to businesses, charity and public sector organisation customers.

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paragraph 3.3.1, subparagraph 4 of the Consent Request Letter			<p>United Utilities Water Limited to make loans to an associated company).</p> <p>On this basis we have granted Severn Trent an identical consent for the same reasons as we granted the consent to United Utilities Water which are set out in <a href="#">Statement of Reasons: The granting of consent for United Utilities Water Limited to make loans to an associated company</a>. We explained in this document that 'we would have been prepared to grant such consent had it been formally required'. Severn Trent did not need to seek consent at the time which we granted the consent to United Utilities because it did not have the relevant requirements in its licence.</p> <p>Given this arrangement was put in place before Severn Trent had the relevant ring fencing conditions in its licence, granting this consent therefore helped to ensure that Severn Trent felt that it was able to consent to the licence changes we were proposing with the benefits that these have for customers.</p> <p>The limitation on the total loans which can be made to Water Plus minimises the risk to Severn Trent's customers in the event of default by Water Plus. This is because the maximum amount which can be lent to Water Plus is small relative to the size of Severn Trent's regulatory capital value.</p>
<b>New Financing Arrangements Consent – miscellaneous arrangements</b>	Approval for giving guarantees pursuant to and incorporating cross default obligations into future financing arrangements	Any new financing arrangements must be used exclusively for the benefit of Severn Trent and its Financing Subsidiaries. See sub-	We have granted this consent because Severn Trent anticipates the need to provide guarantees and cross default obligations to allow its Financing Subsidiaries to carry out their function of providing financing to Severn Trent. Financing Subsidiaries do not trade or generate any revenue in their own right and therefore are likely to need cross defaults and guarantees from Severn Trent to be

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Consent sought for giving guarantees pursuant to and incorporating cross default obligations into financing arrangements entered into after 28 June 2018	Consent pursuant to Condition P, paragraphs 6.3(a), 6.3(c) and 6.4 of Severn Trent's licence	<p>paragraph 3.5.1(a) of the Consent Letter.</p> <p>Guarantees given may be in relation to the liabilities of Severn Trent's Financing Subsidiaries only. See sub-paragraph 3.5.1(b) of the Consent Letter.</p> <p>Severn Trent's liability under the relevant cross default obligations would arise only on a default of a Financing Subsidiary. See sub-paragraph 3.5.1(c) of the Consent Letter.</p> <p>On the date on which the new arrangement is entered into, Ofwat has not notified Severn Trent that the grant of a new consent may be no longer be consistent with Ofwat's policy. See sub-paragraph 3.5.1(d) of the Consent Letter.</p>	<p>able to access financing on Severn Trent's behalf. The consent therefore allows Severn Trent to enter into new financing arrangements with some certainty which contributes to the continued, smooth running of its business.</p> <p>The restriction on new financing arrangements being used exclusively for the benefit of Severn Trent and its Financing Subsidiaries reduces the risk of arrangements being used for activities unrelated to the regulated business. These activities may not be in the interests of Severn Trent's customers and may be riskier than regulated activities raising the chance of a default in relation to these arrangements</p> <p>The limitation on cross default obligations and giving guarantees in relation to Financing Subsidiaries only considerably reduces the risk to Severn Trent as, given the purpose of those companies, the risk of any default which could impact the company is low. Severn Trent also has control over these companies and therefore the activities they undertake and transactions which they enter into, which further reduces risk.</p> <p>While we are satisfied that the granting of this consent balances our duties appropriately at the current time, Ofwat's future position regarding Financing Subsidiaries and financial ring-fencing more broadly may change. While any such change would occur in accordance with our statutory and general administrative law duties, we considered it prudent to note in our consent that, if Ofwat's policy changes, we will notify Severn Trent of the impact on the consent granted so that Severn Trent does not assume that the consent applies to future arrangements entered into following a change in our policy.</p>

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<p><b>New Financing Arrangements Consent – overdraft and cash pooling arrangements</b></p> <p>Consent sought for guarantees and cross default obligations and making loans pursuant to new overdraft and cash pooling arrangements</p>	<p>Approval for guarantees and cross default obligations and making loans</p> <p>Consent pursuant to Condition P, paragraphs 6.3(a), 6.3(b), 6.3(c) and 6.4 of Severn Trent's licence</p>	<p>Arrangements should be on terms materially similar to those of the existing overdraft and cash pooling arrangement and relate to Severn Trent and its Financing Subsidiaries only. See sub-paragraph 3.5.2(a) of the Consent Letter.</p> <p>On the date on which the arrangement is entered into Ofwat has not notified Severn Trent that the grant of a new consent may no longer be consistent with Ofwat's policy. See sub-paragraph 3.5.2(b) of the Consent Letter.</p>	<p>This overdraft and cash pooling arrangement can only comprise Severn Trent and its Financing Subsidiaries. This means that Severn Trent is not exposed to the risk of any default by companies in the wider group, and there may be a benefit to this arrangement as it can help to minimise costs for Severn Trent if, for example, it is in a position where it may find itself temporarily overdrawn as this can be offset by credit balances held by its Financing Subsidiaries.</p> <p>Any risks are limited because the arrangement is with Financing Subsidiaries over which Severn Trent has control. These companies are also limited in the activities which they undertake.</p> <p>While we are satisfied that the granting of this consent balances our duties appropriately at the current time, Ofwat's future position regarding Financing Subsidiaries and financial ring-fencing more broadly may change. While any such change would occur in accordance with our statutory and general administrative law duties, we considered it prudent to note in our consent that, if Ofwat's policy changes, we will notify Severn Trent of the impact on the consent granted so that Severn Trent does not assume that the consent applies to future arrangements entered into following a change in our policy.</p>

## Appendix 1: Consent Request Letter



Severn Trent Water

24 May 2017

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Dear Aileen

### PROJECT PENGUIN - LICENCE MODIFICATIONS AND CONSENTS

Severn Trent Water Limited ("STW") has been in discussions with Ofwat about a modification to the conditions of its instrument of appointment ("licence") in order to introduce new financial ring fencing conditions into its to bring it in line with the rest of the industry and in the context of STW's acquisition of Dee Valley Group plc, the holding company of Dee Valley Water plc ("DVW") and plans to restructure the DVW and STW businesses into separate English and Welsh licensees (together, the "Transaction"). This letter contains our request for the granting of consents set out in the Comfort Letter of 5 October 2016.

Ofwat has requested that STW and DVW adopt the most recent set of financial ring fencing conditions as part of the Transaction, using Condition P of the recently modified South West Water licence as a starting template. STW has agreed in principle on behalf of itself and DVW to accept this version of Condition P and its associated definitions (subject to the modifications described in paragraph 3.3.1.3 of this letter) (the "New Conditions") but has noted that a number of consents and approvals would be required from Ofwat. We set out the text of the New Conditions in Annex 3.

STW understands that as regards both the STW and DVW licences, acceptance of the New Conditions will be accompanied by the consequential removal of provisions currently contained in the licences which would otherwise be duplicative and potentially contradictory, including the financial ring fencing conditions contained in Condition F of each licence.

(Save where otherwise specified, a reference to Condition P in this letter should be read as a reference to Condition P of the New Conditions.)

This letter sets out the licence consents that STW and DVW would require from Ofwat in order to adopt the New Conditions and explains why granting the consents would be in line with Ofwat's statutory duties.

## 1 Overview of the Transaction

The devolution of powers from Westminster to Wales is creating a growing need for the Severn Trent group to establish a stronger presence in Wales. This presence is of strategic importance to the Severn Trent group because:

- [REDACTED]
- a significant population of STW's customers reside in Wales.

This importance is illustrated by the significant investments (in excess of £300m) STW is undertaking to improve the resilience of supplies from and in Wales. The most prominent investment is the Elan Valley Aqueduct (EVA) project which will provide STW with the ability to robustly maintain the EVA. This will ensure that the population of Birmingham can continue to be supplied with high quality water; and mitigates the impact of the EVA failing at certain points on Welsh communities.

Of STW's appointed area, 11% of the water service area is located within Wales. This area includes c.35,000 Welsh customers (1% of our total base) which along with the assets are regulated under English Government policy.

The distinction between English and Welsh customers (and differences in policy) is expected to continue to grow in light of the Commission on Devolution in Wales (the "**Silk Commission**"). The Silk Commission proposed the following 4 key recommendations for the water sector:

- powers over sewerage should be devolved to the National Assembly for Wales;
- the boundary for legislative competence for water should be aligned with the national border. We recognise the need for further consideration of the practical implications of alignment, with particular regard for the interests of consumers, and involving the regulator, consumer representatives, water companies and both Governments;
- a formal intergovernmental protocol should be established in relation to cross-border issues; (necessary to make point 2 work) and
- the Secretary of State's existing legislative and executive powers of intervention in relation to water should be removed in favour of mechanisms under the intergovernmental protocol.

The growing policy gap between England and Wales raises some concern because STW is the only major water undertaker to have a service area in Wales but not have a Welsh licence. Therefore STW has no "seat at the table" on Welsh policy issues. Implementation of the Silk Commission recommendations through the Wales Act 2017 will create complications for companies spanning the English/Welsh border.

The Transaction aims to eliminate some of that complexity and provide a company-led solution to a political challenge. We believe this approach will deliver benefits to customers; the environment and to the political-regulatory landscape.

## 2 Benefits of the Transaction

The Transaction will benefit customers of both companies and potentially broader through the positive impact on comparators. We discuss these benefits under three headings- customer; wider stakeholder and regulatory benefits.

### 2.1 Customer benefits

- The Transaction will generate cost and operating synergies that will be shared with customers by wholesale totex cost sharing and the normal efficiency assessment carried out at price control reviews.
- It allows for better management of DVW and future benefits from improved service levels.

- It allows for better management and will help move DVW out of "prescribed assurance" by improving the quality of data and assurance. This will ensure customers have access to data that they can better rely upon.
- It creates a Welsh entity that will have a stronger, local affinity with its Welsh customers as it is a water provider aligned to the national border and the requirements of its Welsh customers.
- It will promote more effective retail competition consistent with respective English and Welsh political decisions. Post-restructuring, Chester (English) business customers will be able to benefit from the NHH retail market opening. In the absence of the Transaction this issue will be exposed given that certain customers' sewerage service (provided by UU) can be switched, but their water service (provided by DVW) cannot (unless they use at least 50 million litres of water a year).
- It removes future financing risks that may arise given DVW's financing arrangements.
- It will promote a more resilient financial structure through the adoption of the New Conditions which are not presently in STW's licence.
- It commits STW/DVW to not seek the small company premium (limiting impact on customer bills) and which provides Ofwat with a useful reference point in abolishing the small company premium.
- Customers will be protected by our approach to price protection and ODIs.

## 2.2 Wider stakeholder benefits

- It increases focus on the separation of Welsh and English policy issues at a licenced company level and allows greater input into the policy debate from a company with a long term strategic focus on Wales.
- It helps to resolve some of the Silk recommendations without needing to legislate or enact legislation on a complex issue.
- It removes a "democratic deficit" in policy decision making for both English and Welsh customers.
- Depending on government policy, potential in the future for Chester customers to benefit from HH retail.
- It allows for better working relationships to be built with Natural Resources Wales (NRW) on Welsh abstraction reform and implementation of Water Framework Directive in Wales.
- It becomes easier for the Welsh government to set, implement and monitor Welsh environmental policy direction.

## 2.3 Regulatory benefits

- It retains additional comparator information along the Welsh/English border which is not available today-supported where appropriate by enhanced reporting arrangements (reflecting both the structure of the price controls and the design of the wholesale econometric cost models).
- It creates the potential for a new, albeit small, sewerage comparator (if licensing and regulatory changes permit).
- Unlike Pennon-Bournemouth, there is no loss of a meaningful comparator (given proposed dual licence structure and DVW being a less important comparator).
- The CMA's completed review of STW's acquisition of DVW confirmed that any remaining loss of comparative information does not jeopardise the interests of customers and cleared the transaction in Phase 1.
- It allows Ofwat greater ability to implement Welsh government policy for Welsh companies and which could potentially simplify PR19 (depending on progress of the Silk recommendations).

- It creates a useful decision precedent in separating RCVs across the value chain in a way consistent with Water 2020 principles.
- (Environmental Regulation) It removes complex cross-border licensing, permitting and monitoring issues arising from companies straddling the English-Welsh national border.

### **3 Licence modifications and consents**

Ofwat has requested that STW adopt the most recent set of financial ring fencing conditions as part of the Transaction. STW is willing to adopt the New Conditions subject to the grant of the approvals and confirmations requested in this letter.

#### **3.1 Purpose of the consents requested**

In this section 3, we describe the approvals and confirmations ("consents") required for both STW and DVW to adopt the New Conditions, together with the rationale for requesting such consents. We explain why the grant of such consents is consistent with the intent, and preserves the operation, of the financial ring-fence.

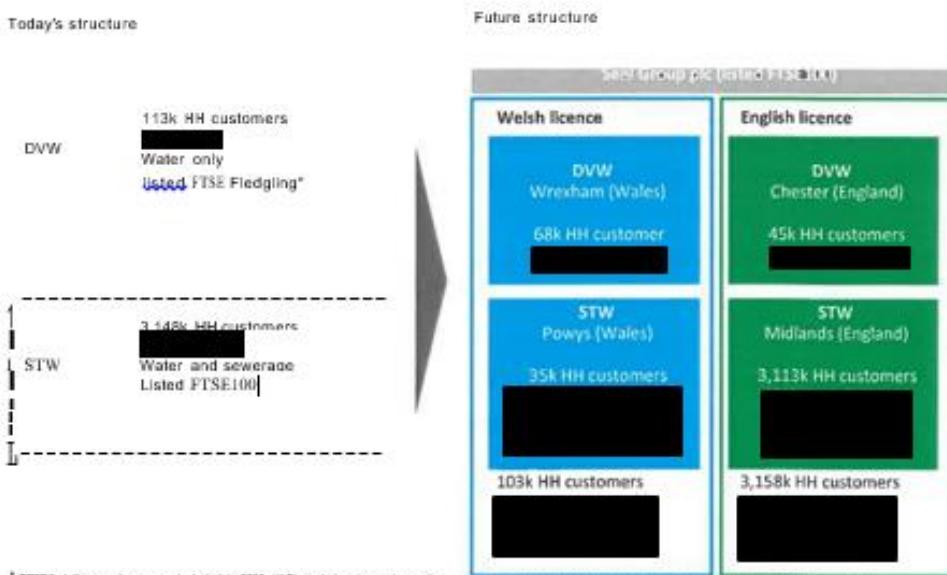
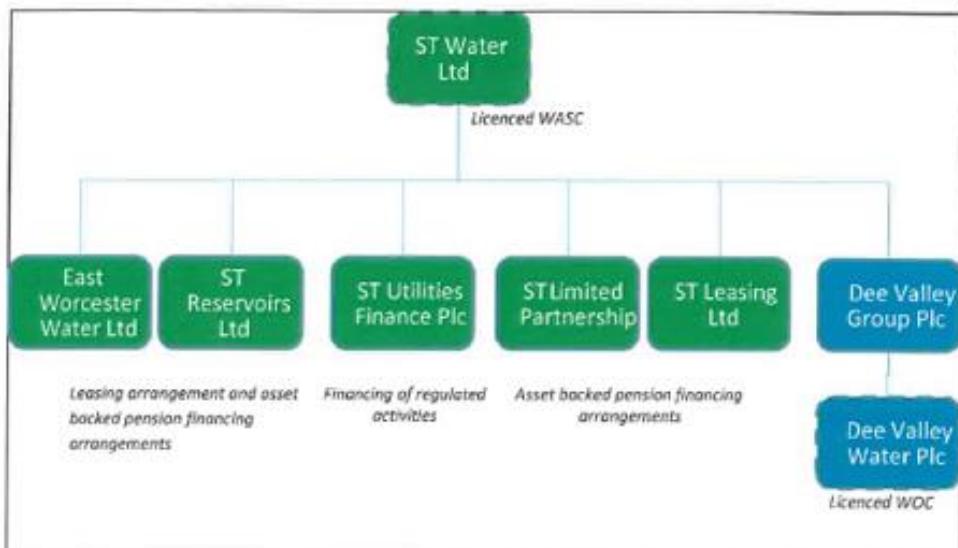
As described in detail below, the financial arrangements for which we are requesting consents are for the benefit of the regulated business, promote efficiency and/or involve de minimis sums. In particular, certain consents are required to preserve the financial position of the licensees in light of cross-default obligations and guarantees contained in their existing financing arrangements and to permit similar provisions arising on the refinancing of, or further use of, these arrangements. The cross-default obligations and guarantees are typical for the type of debt products described below, meaning that any restriction on providing these in any refinancing or further use of these financing arrangements would lead to STW incurring higher than necessary debt costs. We are also seeking consent to certain intra-group loan arrangements.

The consents requested comprise:

- (i) As described in section 3.2.1, consents under certain paragraphs and conditions of both the STW and DVW licences, required in order to take steps which the parties consider necessary to effect the Transaction;
- (ii) As described in section 3.3.1.1, consents required under certain paragraphs of Condition P in STW and DVW's licences to permit STW and DVW to maintain and continue to make use of STW's existing debt arrangements and facilities, its cash management facility, and its overdraft and cash pooling arrangements;
- (iii) As described in section 3.3.1.3, consents for textual modifications so that the New Conditions accommodate certain subsidiaries of STW being considered Financing Subsidiaries for the purposes of Condition P pending STW being able to take the necessary action to ensure that those companies fall within the original definition of Financing Subsidiary; and
- (iv) As described in section 3.3.1.4, consents consistent with Ofwat's established regulatory precedent in relation to the Severn Trent/United Utilities non-household retail Joint Venture.

#### **3.2 Structure of the Transaction**

The Severn Trent group has acquired DVW through a Scheme of Arrangement. The holding company of DVW, Dee Valley Group plc (listed entity), is now a subsidiary of STW. The intention is to retain both the STW and DVW licences and, in due course, realign the areas of appointment in line with the Welsh/English national border and move customers, assets and RCV as part of a licence variation process (see diagrams below).



Note this diagram sets out the indicative movements between licences and that more accurate customer numbers and refined RCV calculations will be separately submitted as part of the NAV and territory realignment process for which we are separately liaising with Ofwat.

### 3.2.1 Required consents relating to the Transaction

Section 3.2.2 explains that customer benefits associated with the Transaction are dependent on avoiding costly disruption to existing financing arrangements, allowing STW and DVW to share the benefits of a single investment grade credit rating and both licensees having access to Severn Trent's financing arrangements.

There are a number of consents that would be required (a) if we were to adopt the New Conditions for both the STW and DVW licences, and (b) under the existing STW and DVW licences in order to effect the Transaction based on the structure set out in the diagrams above. We consider that these consents retain the intent<sup>1</sup> and preserve the operation of the ring fence and given the current mix of debt within DVW, would actually seek to strengthen the financial position of DVW - further detail is set out in Section 3.2.2. The text below is representative of the areas of concern that would arise were the New Conditions to be adopted (and in some instances, arising under existing licence conditions).

1. Consent for STW to provide new and existing loans on arm's length terms to DVW and its subsidiaries for the purposes of the DVW regulated activities, to refinance existing DVW debt and to put in place arrangements in lieu of DVW holding an investment grade credit rating (Condition P, paragraph 6.3(b)).
2. Consent for Severn Trent Water Ltd to provide new and existing guarantees of the existing debt facilities held within DVW Water pic and its subsidiaries for the purposes of the DVW regulated activities (Condition P, paragraph 6.3(a)). Such consent would extend to any de facto guarantee or assumption of liability implicit in the arrangements described in paragraph 3.2.1.5 below.
3. Agreement for DVW (licensed entity) and its financing subsidiaries to not directly hold an investment grade credit rating (Condition P, paragraph 7.1 and 7.3) and clarification from Ofwat that the provision of the certificate pursuant to paragraph 7.3 of Condition P may be based on the Severn Trent Water Ltd investment grade credit rating whilst DVW Water pic remains a wholly owned subsidiary of Severn Trent Water Ltd. This consent would allow DVW Water pic to use the credit rating of its parent, Severn Trent Water Ltd, to fulfil its obligation to hold a credit rating. This would work in practice through a loan agreement which has been established on arm's length terms between STW (as lender) and DVW (as borrower) in lieu of a keep well agreement. The structure and terms of this loan are outlined below. STW requires consent for this loan under paragraph 6.3(b) of Condition P.
  - a. Nature: Committed revolving credit facility;
  - b. Economics: Arms' length terms as to pricing/economics of loan. No up-front fees were payable;
  - c. Term: 5 year facility automatically extended for a further year on each anniversary unless notice to the contrary is served by the lender or such other term as the parties may agree;
  - d. Purpose: General corporate and working capital purposes of the appointed company;
  - e. Conditions Precedent: None were required;
  - f. Interest Periods for Loans: 1/2/3/6 months or as agreed between the parties;
  - g. Guarantees/Security: None;
  - h. Mandatory prepayment by borrower: Illegality only;
  - i. Voluntary prepayment by borrower: At any time on 3 business days' notice subject to payment of break costs;
4. Consent for an existing STW agreement the purpose of which was to refinance and replace the loan made to DVW in the Artesian structure. It was necessary to replace the Artesian loan as its terms precluded the reorganisation of the DVW business post acquisition and hence would have prevented synergies from being delivered. The economics of the new STW loan replicate the economic terms (e.g. interest rate, maturity and inflation linkage) of the Artesian loan that was refinanced. As the original Artesian loan was originally taken out in 2002, it represents a higher funding cost than STW could otherwise have expected to pay in the current market environment. [REDACTED]

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<sup>1</sup> Our understanding of the intent of the financial ring fencing conditions is set out in Section 3.3.1.

The image consists of a series of horizontal bars arranged in a grid. There are ten rows of bars. Each row contains five bars. The bars are thin and have equal widths. They are positioned such that they overlap slightly. The bars alternate in color between black and white. The first bar in each row is black, followed by four white bars, and then another black bar. This pattern repeats across all ten rows.

Consent for these arrangements will be required under Condition P, paragraphs 6.3 and 6.4 of the STW licence.

**STW requests Ofwat to provide the approvals and confirmations described above pursuant to the stated provisions of Condition P.**

### **3.2.2 Why granting these consents are in line with Ofwat's various duties**

The consents we have requested are in line with Ofwat's various duties which we have summarised below:

- a) To further the consumer objective (to protect the interests of consumers, wherever appropriate by promoting competition)

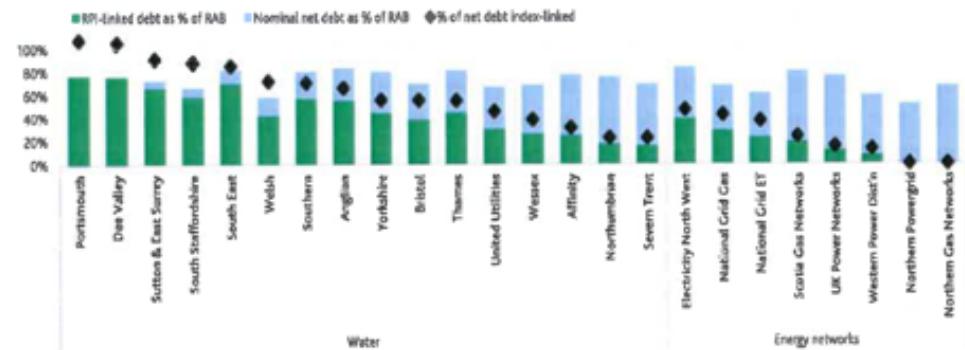
An important part of the synergy case for the Transaction is for STW to raise more cost effective financing going forward and to avoid unnecessary costs in the corporate structure. In order for customers to benefit from lower financing costs, we need a funding mechanism to be able to raise financing at either the level of STW and/or its financing subsidiary, Severn Trent Utilities Finance ("STUF") plc, and pass that on to DVW. Granting the use of such a facility allows us to commit to customers that we will not seek a small company premium going forward, which customers will benefit from. Customers benefit further as new financing would be raised at lower rates than DVW could achieve today, meaning lower embedded debt costs feed into the allowances at future price reviews.

- b) To secure that the relevant companies properly carry out their functions  
n/a

c) To secure that the relevant companies can finance the proper carrying out of their functions

DVW's existing financing structure is highly exposed to RPI and will need to adapt to the move towards a blended RPI/CPI indexation of the RCV from 2020. In Moody's recent sectoral report<sup>2</sup>, DVW had the second highest RPI exposure in the water and electricity sector whereas STW has the lowest in the water industry.

**Exhibit 9**  
**RPI-Linked and nominal debt at March 2015**



Ofwat's Water 2020 framework seeks to make a transition towards CPI indexation over time and makes it clear than companies will need to resolve any issues arising from their chosen capital structures. Granting the consents will secure the long term financing of DVW by ensuring that existing debt structures remain intact and that over time STW can make cost effective loans to DVW that will reduce exposure to RPI in the debt mix. This will improve the financial resilience of the licensee and avoid customer bills having to support any transition.

d) To further the resilience objective (to secure long-term resilience)

Ofwat's new primary duty to further the resilience objective shines a spotlight on the need to secure the long-term resilience of statutory undertakers' water supply and sewerage systems and to secure that such undertakers take steps for the purposes of enabling them to meet, in the long term, the need for the supply of water and the provision of sewerage services to consumers. This implies the need for undertakers, including STW, to undertake substantial investment in their water supply and sewerage systems. There is of course a trade-off between the resilience of a system and the expenditure which consumers are prepared to incur in pursuance of that objective. Raising debt efficiently is key to delivering on the resilience objective because it maximises the investment that can be delivered for a given cost to consumers. It follows that Ofwat would be acting in a manner consistent with both its consumer objective (to protect the interests of consumers, etc.) and its resilience objective by permitting STW to raise debt for investment in the most cost effective way possible. STW believes that it can raise debt most cost effectively by making use of the form of its existing financing arrangements, which are well-established and known to the markets.

e) To ensure that consumers are in particular protected by ensuring that transactions with associated companies are carried out at arm's length

The cost of any loan arrangements and guarantees between STW and DVW would be set in line with requirements under Condition F and Condition P.

<sup>2</sup> Moody's, (Jan 2016) Transition to CPI creates risks for water and energy networks

### 3.3 Severn Trent financing arrangements

STW, its subsidiaries and parent have a number of existing arrangements in place under which it raises finance [REDACTED]. These arrangements include programmes (such as the Euro medium-term note programme described below) as well as loan and note purchase agreements and other arrangements under which financing is raised. This gives rise to questions of compliance with the requirements of paragraphs 6.3 and 6.4 of Condition P.

STW is concerned to ensure that it is able to maintain and to continue to use its existing financing arrangements for existing borrowings and to raise new debt under existing financing arrangements or by refinancing its existing financing arrangements (a) in accordance with its financing plan, and (b) in a manner consistent with maintaining an investment grade credit rating. In particular, continued access to financing arrangements on existing or similar terms (whether under existing programmes or under new standalone arrangements) is required for STW to deliver on its objective of sustainably financing its business, as set out in the Severn Trent Water Business Plan 2015-20.

[REDACTED]  
Adopting the New Conditions would require various consents from Ofwat to ensure these arrangements remain unaffected and that future debt requirements are able to be issued through existing and new arrangements.

As noted in the Severn Trent Water Business Plan, around a quarter of a customer's bill is allocated to providing a return to providers of finance, and STW needs to refinance over a third of STW's existing debt during AMP63. STW needs to ensure this is financed at a low cost to ensure customers benefit over the long term. Ensuring the proposed licence modifications do not affect these financing arrangements and do not limit STW's ability to manage or raise financings under these arrangements is therefore essential, we believe, to the success of the Transaction.

Net debt and gearing tables from the 2014-15 Severn Trent Water Ltd regulatory accounts:

	Fixed interest rate Gm	Floating rate Gm	Index Linked Gm	Total Gm
Bank Loans	150.0	984.3	106.4	1,240.7
Loans due from parent and fellow subsidiary undertakings <sup>3</sup>	-	(108.3)	-	(108.3)
Loans due to parent and fellow subsidiary undertakings	2,447.3	162.4	1,075.3	3,685.0
Finance lease receivables	(100.8)	-	-	(100.8)
Finance lease payables	368.1	95.0	-	463.1
<b>Total net borrowings</b>	<b>2,884.6</b>	<b>1,133.4</b>	<b>1,181.7</b>	<b>5,199.7</b>
Impact of interest rate swaps entered into by the company	318.1	(318.1)	-	-
<b>Total borrowings</b>	<b>3,202.7</b>	<b>815.3</b>	<b>1,181.7</b>	<b>5,199.7</b>
<b>Net debt is comprised as follows:</b>				
Total borrowings	-	-	-	5,199.7
Cash	-	-	-	(4.1)
Short term deposits	-	-	-	(118.0)
<b>Net Debt</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5,080.6</b>
Severn Trent Water Limited net debt as at 31 March 2016			5,080.6	
Intra group loans and leases			(378.5)	
Cash held in Severn Trent Water Limited subsidiaries			(0.9)	
<b>Severn Trent Water Limited net debt as at 31 March 2016-consolidated basis</b>	<b>4,701.8</b>			
<b>Year end RCV</b>			<b>7,736.6</b>	
<b>Gearing based on net debt on a consolidated basis</b>			<b>60.7%</b>	

Further details on these arrangements are included in Annex

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<sup>3</sup> Severn Trent Water Business Plan 2015-2020, p. 40 and 54.

### 3.3.1 Required consents relating to existing financing facilities

As noted in section 3.2.2 above and section 3.3.2 below, in order to deliver the customer benefits associated with the Transaction it will be necessary to avoid costly disruption to existing financing arrangements by obtaining consents from Ofwat.

We consider that these consents retain the intent and preserve the operation of the ring fence (described below) and are in line with Ofwat's duties (further explanation is included in Section 3.3.2).

We understand that the intent of the New Conditions comprises:

- a) limiting the extent to which the licensee is exposed to the risks of unregulated activities carried out by any Associated Company
- b) ensuring that the licensee has the resources to continue to carry out its regulated activities, including accessing debt markets on reasonable terms
- c) protecting the licensee from financial distress elsewhere in the group
- d) prohibiting the appointed business from cross-subsidising unregulated activities
- e) prohibiting the transfer of assets that could limit or harm the ability of the licensee (or a Special Administrator if one were to be appointed) to carry out its regulated activities, and
- f) as last resort protection for the interests of customers provide for the appointment of a Special Administrator in the circumstances of financial distress.

#### 1. Consents for existing financing arrangements

Maintaining and continuing to use existing financing arrangements is efficient and minimises costs. By contrast, there would be substantial wasted costs associated with negotiating alternative arrangements. If STW had to refinance large amounts of debt in the market simultaneously, the concentration of risk for debt suppliers would increase, which would lead to STW achieving less favourable interest rates, thus increasing the cost of embedded debt. Whilst impacts at a facility level could only be estimated in discussion with finance providers, assuming a modest 10bps rise in the cost of new debt across [REDACTED] would increase interest costs [REDACTED] the equivalent of [REDACTED] of DVW's net profits last year.

The existing financing arrangements to which this request for consent relates are:

1. a US note purchase agreement dated 20 November 2015 ("USPP") entered into by STW and the Purchasers (as defined therein) for the purposes of STW's issuance of notes, the latest of which matures in 2031, and which funds STW's regulated business activities;
2. [REDACTED] multi-currency revolving credit facility agreement dated 18 October 2011 (as amended, amended and restated or supplemented from time to time) between STW and the Finance Parties (as defined therein) for STW's regulated business activities, which matures in 2021;
3. [REDACTED] term loan agreement dated 18 August 2016 entered into by STW and [REDACTED] for the general corporate purposes of the group including, without limitation, capital expenditure, which matures in 2023 (and which is on substantially the same terms as the revolving credit facility agreement described in subparagraph 2. above);
4. STW's finance contracts entered into in 2007, 2009 and 2015, each with the European Investment Bank ("EIB") under which EIB provides term loans for the purposes of funding certain projects relating to STW's regulated business activities which are described in Schedule A to each relevant contract, the latest of which matures in 2024;
5. [REDACTED] term loan agreement dated 27 March 2012, maturing in 2022, entered into between STW and [REDACTED] for Severn Trent's regulated business activities;

6. [REDACTED] Euro medium term note ("EMTN") programme whereby Severn Trent Utilities Finance plc is the issuer of notes and STW is a guarantor and which funds the group's regulated business activities; the latest maturity date of the notes issued is in 2067;
7. [REDACTED]
8. [REDACTED]
9. [REDACTED]
10. [REDACTED]
11. [REDACTED]
12. [REDACTED]

13. a cash management facility in place between STW and Severn Trent plc which permits either party to extend an intra-group loan to the other as and when required; and
14. an overdraft and cash pooling arrangements with [REDACTED], which operate across the entire Severn Trent group with a gross limit of [REDACTED] and a net limit of [REDACTED]. STW will use all reasonable endeavours as soon as is reasonably practicable (and in any event within three years of completion of the Transaction) to split these arrangements, with one arrangement for STW and its subsidiaries, including DVW, for which an ongoing consent will be required and a separate arrangement for Severn Trent plc and the remaining group companies.

Further information about the amounts outstanding under these arrangements and their maturity are contained in Annex 1, which sets out the position as at 31 March 2016 (other than in respect of those arrangements that were entered into after 31 March 2016).

Certain of these financing arrangements incorporate (a) Cross-Default Obligations<sup>4</sup> and (b) guarantees provided by STW in relation to liabilities of Associated Companies. The categories of Cross-Default Obligations and guarantees contained in the financing arrangements, and examples of these, are provided at Annex 2.

STW and its advisers have used reasonable endeavours to identify and review the Cross-Default Obligations and guarantees in the Severn Trent Water group's financing arrangements. We believe as a result of this review, that the commercial likelihood of the guarantees being called or the cross-default provisions being triggered is relatively low.

In relation to the splitting of the overdraft and cash pooling arrangements, STW will provide an annual update to Ofwat on steps taken and progress towards effecting the split, until the

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<sup>4</sup> Defined to mean a legal obligation contained in an agreement or arrangement where STW'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 STW.

arrangements have been separated (or terminated). Following the split, any Cross-Default Obligations and guarantees from STW will be limited to its subsidiaries (including DVW).

STW requests Ofwat to provide its approval pursuant to paragraphs 6.3 and 6.4 of Condition P to the Cross-Default Obligations and guarantees contained in the financing arrangements listed above and the categories of which are set out in Annex 2 to enable STW and DVW to maintain and continue to make use of these financing arrangements, both for existing borrowings and to raise new debt under those arrangements, including following the split in the overdraft and cash pooling arrangements described in paragraph (14) above<sup>5</sup>.

STW further requests Ofwat to provide its approval pursuant to paragraphs 6.3 and 6.4 of Condition P to enable the Severn Trent group to:

(a) re-finance its existing debt arrangements [REDACTED] [REDACTED] on similar terms to those contained in the financing arrangements listed above, and

(b) raise new debt pursuant to debt arrangements which are equivalent to those listed above, provided the Cross-Default Obligations and guarantees contained in those debt arrangements are substantially similar to or less onerous for STW than the Cross-Default Obligations and guarantees contained in those financing arrangements listed above and which fall within one or more of the categories described in Annex 2.

We acknowledge that certain of the financing arrangements described in paragraphs (9), (10), (11) and (12) above [REDACTED] may give rise to concerns that a special administrator, if appointed, would not have available to it sufficient rights and assets (other than financial resources) to manage the affairs, business and property of STW so that the purposes of the special administration order could be achieved, contrary to the requirements of paragraph 3 of Condition K of STW's licence. [REDACTED]

[REDACTED]. For the avoidance of doubt, the consent requested above is not intended to derogate from the obligation on STW to ensure that, in relation [REDACTED] described in paragraphs (9), (10), (11) or (12) above:

- The arrangement complies fully with the requirements of paragraph 3 of Condition K;
- STW has obtained Ofwat's consent to any disposal of protected land comprised in the arrangement.

To illustrate how we would expect to satisfy that obligation, in the event that a consent were required pursuant to Condition K, we attach a letter dated 9 December 2011 in which we sought Ofwat's consent to the [REDACTED]. That letter set out in detail how [REDACTED] complies with the requirements of paragraph 3 of Condition K. It also requested Ofwat's consent to the disposals of protected land [REDACTED]. We also attach Ofwat's consent letter dated 22 December 2011. A similar exchange of correspondence took place between STW and Ofwat in [REDACTED] 2.

For the avoidance of doubt, we do not consider that the other Cross-Default Obligations and guarantees for which consents are sought above would give rise to concerns pursuant to Condition K. If any such concerns were to arise, we would separately seek Ofwat's consent pursuant to the process described above.

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<sup>5</sup> The provision described at paragraph 14 above (p.13) is that the existing cash pooling arrangement will be split within three years to two separate cash pools, one for STW and its subsidiaries including DVW, and one for the rest of the Severn Trent Group. These cash pools will continue in existence in their separate forms after they have been divided.

As regards the [REDACTED] described in paragraph (13) above, in accordance with STW's existing obligation not to confer a cross-subsidy, this is an [REDACTED]  
[REDACTED] at market tested rates, [REDACTED] vice versa. [REDACTED]

[REDACTED] Maintaining an equivalent [REDACTED]  
[REDACTED] would be more costly, to the detriment of consumers and STW alike. For example, if Severn Trent Water Ltd were [REDACTED]

The [REDACTED]

[REDACTED]. Upon the commencement of insolvency proceedings in relation to any participant in the arrangements [REDACTED] allow the affected Severn Trent group company to draw down further amounts [REDACTED]

[REDACTED] These arrangements also incorporate Cross-Default Obligations and guarantees provided by STW in relation to liabilities of Associated Companies.

STW requests Ofwat to give its approval pursuant to paragraph 6.3(b) of Condition P to maintain and continue to use the cash management facility described in paragraph (13) above up to a total sum [REDACTED]

[REDACTED] STW further requests Ofwat to give its approval pursuant to paragraph 6.3(b) of Condition P to maintain and continue to [REDACTED]

[REDACTED] described in paragraph (14) above (including once DVW is a party thereto).

STW further requests Ofwat to provide its approval pursuant to paragraph 6.3(b) of Condition P to STW [REDACTED], the primary activities of which are regulated activities or which support the regulated activities of STW, similar to those described in paragraph (14) of section 3.3.1.1 above but with other financial counterparties and from time to time, together [REDACTED]

## 2. Severn Trent's position with regard to non-defaults

There are a number of provisions in STW's financing arrangements and elsewhere under which the occurrence of a particular event may trigger repayment of the loan. Examples of these events include:

- a change of control of STW or Severn Trent plc (whether described as mandatory prepayment or payment events, termination events, events of default, or similar);
- a change of law affecting the lawfulness of a creditor's commitment to lend or maintain a loan or other debt thereby leading to mandatory prepayment; and

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<sup>6</sup> See market announcement on 17 March 2015 of £190m investment programme for renewables. "This investment will take place over the next 5 years principally in two technologies - anaerobic digestion and solar. This will take self generation of renewable energy from 28% of Severn Trent Water's gross energy consumption to around 50% by 2020. This will provide efficient green energy and a long-term hedge against volatile market prices."

- a failure by STW to provide an insurance certificate because the insurance broker or insurer fails to provide STW with such a certificate.

STW takes the view that these types of events do not comprise third party "defaults" (in the ordinary sense of that word) and that the provisions concerned do not therefore comprise Cross-Default Obligations for the purposes of paragraphs 6.3 or 6.4 of Condition P. These events are not triggered by financial distress elsewhere within the group and fall outside the intent of the ring fencing conditions described in Section 3.3.1. As mentioned above, STW and its advisers have used reasonable endeavours to identify and review the Cross-Default Obligations and guarantees in the Severn Trent group's financing arrangements. We believe as a result of this review, that the commercial likelihood of the guarantees being called or the Cross-Default Obligations being triggered is relatively low. STW also considers that these arrangements are consistent with paragraphs 4.1 and 4.2 of Condition P.

**To the extent that Ofwat disagrees with STW's position in this regard, we would ask Ofwat to make its position known to enable STW to seek the necessary approvals from Ofwat under paragraphs 6.3 and 6.4 of Condition P.**

### **3. Defining STW subsidiaries as Financing Subsidiaries**

The cash lock-up provisions of paragraphs 7.4 and 7.5 of Condition P have the effect of restricting the ability of STW to repay loans made to it by STUF plc and STW's other financing subsidiaries (East Worcester Water Limited, Severn Trent Reservoirs Limited, Severn Trent Leasing Limited, and Severn Trent Limited Partnership) in the event that STW does not hold or is at risk of losing its Investment Grade Rating.

There is an exception to this restriction for Financing Subsidiaries, which are defined in Condition P of the South West Water licence as "a subsidiary company of the Appointee: (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."

STUF plc and STW's other financing subsidiaries may not be considered Financing Subsidiaries (as defined in the South West Water licence) as they are not wholly owned by STW (for example Severn Trent plc holds a share in STUF plc for historical reasons), and their articles do not meet the requirement that the sole purpose of each of these companies is to raise finance on behalf of STW for the purposes of the Regulated Activities. For the avoidance of doubt, the purpose of these companies is to raise finance for the Appointee.

While paragraph 7.5(c)(ii) of Condition P permits the repayment of loans entered into in advance of the downgrade event and made in accordance with STW's licence, it does not permit early repayment of those loans. STW considers that this would lead to a reduction in the creditworthiness of STUF plc and the other financing subsidiaries, which would have a significant negative impact on the credit worthiness of existing loans as well as Severn Trent Water's ability to raise finance in future.

The consequence of STW agreeing to include the definition of Financing Subsidiary from the South West Water licence in its licence would therefore be that in the event of an actual or threatened loss of STW's Investment Grade Rating, STW would be prevented from repaying at will its loans from STUF plc and the other financing subsidiaries.

In order to address these issues, STW will use reasonable endeavours as soon as is reasonably practicable to restructure the minority shareholdings of its financing subsidiaries and amend their articles of association such that they fall within the definition of Financing Subsidiaries (as defined in

the South West Water licence) and will provide evidence of this to Ofwat promptly on request.

[REDACTED]

[REDACTED]

In order to address the risks arising before STW is able to complete the required restructuring and constitutional amendments, STW requests Ofwat to:

(i) modify the definition of Financing Subsidiary that will be added to STW's licence for the purposes of Condition P so that it provides as follows:

"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 Regulatory Authority has agreed in writing will be considered to be a Financing Subsidiary.

(ii) confirm that it will consider STUF pic, East Worcester Water Limited, Severn Trent Reservoirs Limited, Severn Trent Leasing Limited, and Severn Trent Limited Partnership as Financing Subsidiaries for the purposes of STW's Condition P until such time as these entities become wholly owned subsidiaries of the Appointee, 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.

#### 4. Working capital facility for Severn Trent / United Utilities non-household retail Joint Venture

We note that Ofwat has stated<sup>7</sup> in its decision for the working capital facility of the Severn Trent / United Utilities non-household retail Joint Venture that it would have been prepared to grant such consent to STW had it been formally required given the assurances that STW made at the time (the letter from STW to Ofwat dated 15 April 2016 in relation to this working capital facility is at Annex 4). At that time, STW did not require such a consent because it did not have Condition F6.11 in its licence. However, once Condition P is included in its licence, it will require such a consent.

STW re-states the assurances it provided at the time of the United Utilities request for consent for the purposes of Ofwat's consideration of STW's request (as to which, see the letter provided at Annex 4) and requests that Ofwat provides its formal consent pursuant to para 6.3(b) of the Condition P to the working capital facility for the Severn Trent / United Utilities non-household retail Joint Venture.

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<sup>7</sup> Ofwat (April 2016), Statement of Reasons: The granting of consent for United Utilities Water Limited to make loans to an associated company

### 3.3.2 Why granting these consents are in line with Ofwat's various duties

The consents we have requested are in line with Ofwat's various duties which we have summarised below:

- a) To further the consumer objective (to protect the interests of consumers, wherever appropriate by promoting competition)

The Severn Trent group's existing balance of debt has been raised efficiently and the Severn Trent group has benefitted from access to markets over time. Customers benefit from our ability to achieve low costs of debt through the resetting mechanism that Ofwat apply at each price review. Were we not able to get the required consents, we would need to either renegotiate existing arrangements, which may have a cost associated with it or at worst, require significant refinancing in the markets. This would be costly and incur transaction costs which would further reduce total outperformance that customers share in. If we had to refinance large amounts of debt in the market simultaneously, the concentration of risk for debt suppliers increases and we would achieve worse interest rates. This would increase the cost of embedded debt, thereby impacting customers through higher embedded debt allowances than would otherwise be the case. Granting the consents protects customers from higher debt costs than would otherwise be the case.

Similarly, it is likely to be more cost-effective for STW to raise new debt through the form of its existing financing arrangements or to re-finance on similar terms in the manner described in section 3.3.1.1, which are well-established and known to the markets. For the reasons set out above, higher debt costs would ultimately feed through to customers as higher charges.

Ofwat would therefore be exercising its powers and duties in a manner consistent with protecting the interests of customers if it were to approve the use of the Severn Trent group's existing financing arrangements in the manner described in section 3.3.1.1.

- b) To secure that the relevant companies properly carry out their functions

The [REDACTED] described in paragraphs (11) and (12) respectively of section 3.3.1.1 were structured so as to satisfy Ofwat that it complied with the existing requirement of STW's licence relating to ensuring that a special administrator, if appointed, would have available to it sufficient rights and assets to manage the affairs, business and property of STW so that the purposes of the special administration order could be achieved (paragraph 3 of Condition K). The consents requested in this letter are not intended to derogate from the need for STW to ensure that any future extension of the [REDACTED] continues to comply with the requirements of paragraph 3 of Condition K of STW's licence.

Similarly, the finance leases described in paragraphs (9) and (10) of section 3.3.1.1 were structured so as to satisfy Ofwat that they complied with the requirements of paragraph 3 of Condition K. In the case of the [REDACTED] described in paragraph (7), each contained provisions designed to ensure that a special administrator, if appointed, would have available to it the equipment that formed the subject matter of the lease, so as to enable the special administrator to manage the affairs, business and property of STW so that the purposes of the special administration order could be achieved. In the case of the [REDACTED] described in paragraph (8), STW provided to Ofwat certain confirmations and undertakings aimed at ensuring compliance with the requirements of paragraph 3 of Condition K. It was on the basis of these confirmations and undertakings that Ofwat gave its consent pursuant to paragraph 4.6 of Condition K [REDACTED], in a letter dated 5 May 2000. The consents requested in this letter are not intended to derogate from the need for STW to ensure that any future [REDACTED] with the requirements of paragraph 3 of Condition K of STW's licence.

c) To secure that the relevant companies can finance the proper carrying out of their functions

Allowing continued access to the use of STW's existing financial arrangements or similar terms in the manner described in section 3.3.1.1 will help secure the proper financing of STW's business (see section (a) above).

In addition, allowing the continuance of existing debt facilities such as the EMTN programme will give the market confidence that modifications to the licence do not result in material adverse changes for companies, an important signal for investor confidence.

Similarly, as regards the request for certain subsidiaries to be considered financing subsidiaries, whilst there are definitional differences between the licence text and for example the articles of association, each of the companies we are seeking consent for exists to provide financing to the Appointee. Granting the consent allows the proper financing of the Appointee if the cash lock-up clause were to be triggered.

d) To further the resilience objective (to secure long-term resilience)

Ofwat's new primary duty to further the resilience objective shines a spotlight on the need to secure the long-term resilience of statutory undertakers' water supply and sewerage systems and to secure that such undertakers take steps for the purposes of enabling them to meet, in the long term, the need for the supply of water and the provision of sewerage services to consumers. This implies the need for undertakers, including STW, to undertake substantial investment in their water supply and sewerage systems. There is of course a trade-off between the resilience of a system and the expenditure which consumers are prepared to incur in pursuance of that objective. Raising debt efficiently is key to delivering on the resilience objective because it maximises the investment that can be delivered for a given cost to consumers. It follows that Ofwat would be acting in a manner consistent with both its consumer objective (to protect the interests of consumers, etc.) and its resilience objective by permitting STW to raise debt for investment in the most cost effective way possible. STW believes that it can raise debt most cost effectively by making use of the form of its existing financing arrangements, which are well-established and known to the markets.

e) To promote economy and efficiency on the part of statutory undertakers

For the reasons set out in section (a) above, STW would incur both higher debt costs and transaction costs if it were required to renegotiate its existing financing arrangements. Similarly, it is likely to be more cost-effective for STW to raise new debt through the form of its existing financing arrangements, which are well-established and known to the markets. Ofwat would therefore be acting in a manner consistent with its duty to promote economy and efficiency on the part of statutory undertakers if it were to approve the use by STW of the form of its existing financing arrangements for both new and existing debt.

- f) To ensure that consumers are in particular protected by ensuring that transactions with associated companies are carried out at arm's length.

Any intercompany loans, such as the cash management facility and the Severn Trent/United Utilities non-household retail Joint Venture working capital facility, will have market tested rates applied to them to ensure there is no cross-subsidy.

Yours sincerely

Dr Tony Ballance  
Director, Strategy & Regulation

**ANNEX 1**

**REDACTED FULLY – ALL TABLES TO BE REMOVED**

**Annex2**

Category of Cross Default Obligation ("COO") or Guarantee	Example
COO caused by failure of a subsidiary of STW to comply with the terms in the relevant financing arrangement	<ol style="list-style-type: none"><li data-bbox="1163 409 1956 520">1. A prepayment by a subsidiary of STW of financings funded by lenders other than EIB such that the EIB financings constitute more [REDACTED] of the aggregate outstanding principal amount of financial indebtedness of the STW group.</li><li data-bbox="1163 536 1956 743">2. Failure for subsidiary of STW to comply with law (or orders or regulations of government or regulatory bodies (eg Secretary of State and the Director General of Water Services)), maintain appropriate authorisations and insurances, maintain in all material respects proper books of record and account in conformity with GAAP, maintain properties in good repair, file all tax returns and pay all taxes, carry on business etc.</li><li data-bbox="1163 759 1956 901">3. Subsidiaries of STW breaching restrictions on entering into material transactions, creating security, disposing of assets, incurring financial indebtedness, breaching the terms of leases, winding itself up or ceasing to exist, repudiating or seeking to terminate guarantees which it has given or becoming a sanctioned person.</li><li data-bbox="1163 917 1956 1060">4. Failure of a subsidiary of STW to repay any financial indebtedness when it becomes due or to comply with the terms of any of its financial indebtedness (whether or not it is accelerated, placed on demand or any commitments cancelled as a result) where the financial indebtedness concerned exceeds a stated amount.</li><li data-bbox="1163 1076 1956 1124">5. An over-drawing or failure to perform payment obligations by a subsidiary of [REDACTED]</li><li data-bbox="1163 1140 1956 1187">6. A subsidiary of STW not complying with pension related obligations, incurring pension liabilities or penalties, having a</li></ol>

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<sup>8</sup> This table does not set out those types of provisions to which paragraph 3.3.1.2 of the OFWAT letter applies nor does it set out in full the [REDACTED] cash pooling arrangements as those are already detailed in paragraph 3.3.3.1.

	<p>unfunded pension positions or failing to maintain (or withdrawing from) pension plans or pension plans being terminated in each case which has a material adverse effect.</p> <ul style="list-style-type: none"><li>7. An event of default is subsisting in relation to any outstanding note issued by a subsidiary of STW under the EMTN programme, or in relation to the Long-dated Bonds.</li><li>8. A subsidiary of STW is subject to sanctions or in breach of anti-bribery law or money laundering laws.</li><li>9. A subsidiary of STW (in its capacity as issuer of notes under the EMTN programme) fails to maintain the listing of notes.</li><li>10. If a subsidiary of STW (in its capacity as issuer of notes under the EMTN programme) fails to pay the agents' fees, or fails to indemnify the agent, STW must pay the fees and provide the indemnity.</li><li>11. The liabilities of STW associated with the provision of a letter of credit that may be at STW's request in respect of the obligations of [REDACTED] under the [REDACTED]</li></ul>
COO caused by a deterioration in the financial condition of a subsidiary of STW	<ul style="list-style-type: none"><li>1. Failure to comply with financial covenants tested on a consolidated STW group basis.</li><li>2. An insolvency event or other event associated with financial distress occurring in respect of, or the commencement of insolvency (or analogous) proceedings against, a subsidiary of STW.</li></ul>
COO in connection with the provision of information relating to a subsidiary of STW requiring cooperation from such subsidiary	<ul style="list-style-type: none"><li>1. Failure by a subsidiary of STW to provide business and financial information to STW as required to be provided by STW to its creditors or in order for STW to prepare consolidated financial statements.</li></ul>
COO in connection with a change of status of STW's sole shareholder	<ul style="list-style-type: none"><li>1. The shareholder of STW becoming a sanctioned person.</li></ul>

	<p>unfunded pension positions or failing to maintain (or withdrawing from) pension plans or pension plans being terminated in each case which has a material adverse effect.</p> <ul style="list-style-type: none"> <li>7. An event of default is subsisting in relation to any outstanding note issued by a subsidiary of STW under the EMTN programme, or in relation to the Long-dated Bonds.</li> <li>8. A subsidiary of STW is subject to sanctions or in breach of anti-bribery law or money laundering laws.</li> <li>9. A subsidiary of STW (in its capacity as issuer of notes under the EMTN programme) fails to maintain the listing of notes.</li> <li>10. If a subsidiary of STW (in its capacity as issuer of notes under the EMTN programme) fails to pay the agents' fees, or fails to indemnify the agent, STW must pay the fees and provide the indemnity.</li> <li>11. The liabilities of STW associated with the provision of a letter of credit that may be at STW's request in respect of the obligations of [REDACTED] under the [REDACTED]</li> </ul>
COO caused by a deterioration in the financial condition of a subsidiary of STW	<ul style="list-style-type: none"> <li>1. Failure to comply with financial covenants tested on a consolidated STW group basis.</li> <li>2. An insolvency event or other event associated with financial distress occurring in respect of, or the commencement of insolvency (or analogous) proceedings against, a subsidiary of STW.</li> </ul>
COO in connection with the provision of information relating to a subsidiary of STW requiring cooperation from such subsidiary	<ul style="list-style-type: none"> <li>1. Failure by a subsidiary of STW to provide business and financial information to STW as required to be provided by STW to its creditors or in order for STW to prepare consolidated financial statements.</li> </ul>
COO in connection with a change of status of STW's sole shareholder	<ul style="list-style-type: none"> <li>1. The shareholder of STW becoming a sanctioned person.</li> </ul>

Guarantees provided by STW for the due and punctual performance of its subsidiaries under debt arrangements	[REDACTED]
Indemnities provided by STW the liabilities of which may arise due to the actions or omissions of its subsidiaries or third parties	<ol style="list-style-type: none"><li>1. A breach by a subsidiary of STW of the relevant terms of the debt arrangement.</li><li>2. A failure to borrow amounts proposed to be utilised (eg, for failure by a subsidiary of STW to satisfy conditions precedent).</li><li>3. A failure to prepay amounts proposed to be prepaid on an irrevocable basis.</li><li>4. Default-related costs incurred under the relevant debt arrangements in respect of a default related to the acts or omissions of a subsidiary of STW.</li><li>5. Currency exposures (eg, payments made in one currency but expressly payable in another currency).</li><li>6. Break costs (eg, prepayments made prior to a relevant interest payment date causing the creditor to suffer break costs).</li></ol> <p>*Note that the examples given here are not-exhaustive but are customary in the debt finance arrangements described in the OFWAT letter.</p> [REDACTED]

**Annex 3**

**New Conditions**

"the Appointed Business" means the business consisting of the carrying out by the Appointee of the Regulated Activities;

"the Area" means the area for which for the time being the Appointee holds the appointment as water undertaker or, as the case may be, sewerage undertaker;

"Associated Company" means any Group Company or Related Company;

"Credit Rating Agency" means:

- (a) Standard and Poor's Ratings Group (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 Regulatory Authority has agreed in writing will be considered to be a Financing Subsidiary.

"Group Company" means any subsidiary or Holding Company of the Appointee and any subsidiary of any Holding Company of the Appointee (other than the Appointee);

"Holding Company" has the meaning set out in section 1159 of the Companies Act 2006;

"Information" means information which is in the possession of the person required to furnish it or which it can reasonably obtain or which it can reasonably prepare from information which is in its possession or which it can reasonably obtain, and information which is required to be furnished under any of these Conditions shall be furnished, subject to the provisions of the Condition under which that information is required to be furnished, in such form and manner as the Water Services Regulation Authority may reasonably require;

"Investment Grade Rating" means an Issuer Credit Rating recognised as investment grade by a Credit Rating Agency;

"Issuer Credit Rating" means a credit rating assigned to an issuer of corporate debt by a Credit Rating Agency;

"Lowest Investment Grade Rating" means:

(a) an Issuer Credit Rating of BBB- by Standard & Poor's Ratings Group 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;

"the Regulated Activities" means the functions of a water undertaker or, as the case may be, a sewerage undertaker and, for the avoidance of doubt, references to the functions of a water undertaker or, as the case may be, a sewerage undertaker shall include references to the duties imposed on a water undertaker or, as the case may be, a sewerage undertaker;

"Related Company" means any company in relation to which the Appointee or any Group Company has a participating interest within the meaning of paragraph 11 of Schedule 10 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 or which has such a participating interest in relation to the Appointee or any Group Company;

"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 on 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 on 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 on 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: 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 that the Water Services Regulation Authority may, from time to time, specify as appropriate for the Appointee.
- 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.

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.
- 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 is 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 requests.
- 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.

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 other than where the Water Service Regulation Authority agrees that the Appointee does not need to comply with paragraph 7.2, whereupon it must comply with paragraph 7.3.
- 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 Where the Water Services Regulation Authority has agreed that the Appointee is not required to comply with paragraph 7.2, the Appointee must 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 submit to the Water Services Regulation Authority a certificate which states that:
- (a) in the opinion of the Board of the Appointee, the Appointee would be able to maintain an Issuer Credit Rating which is an Investment Grade Rating; and
  - (b) includes a statement of the main factors, including financial ratios and other information, which the Board has taken into account in giving its opinion for the certificate.
- 7.4 The "Cash Lock-Up" provisions set out in paragraph 7.5 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.
- 7.5 Where this paragraph 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 7.4 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 7.4 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.
- 7.6 Where the Water Services Regulation Authority has agreed that the Appointee is not required to comply with paragraph 7.2, the "Cash Lock-Up" provisions set out in paragraph 7.5 apply in any circumstances where the Appointee has not complied with paragraph 7.3 (and in those circumstances the references in paragraph 7.5 to paragraph 7.4 have effect as if they were references to this paragraph) and do not apply in any other circumstances.
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 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 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 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.

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 Where the Authority gives notice to the Appointee that a revision is to be made to the guidelines referred to in paragraph 2.2 the Appointee may, by notice given to the Authority within one month of such a notice, require the Authority to make a reference to the Competition and Markets Authority for it to determine whether the revision is reasonable and appropriate for the purposes of this Condition.

- 11.2 Where the Authority has made a reference to the Competition and Markets Authority pursuant to paragraph 11.1, the revision which is the subject of the reference shall not take effect unless the Competition and Markets Authority determines that the revision is to take effect, in which case the revision shall take effect on such a date as the Competition and Markets Authority may determine.

## Appendix 2: Consent Letter



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Centre City Tower, 7 Hill Street, Birmingham B5 4UA  
21 Bloomsbury Street, London WC1B 3HF  
[www.ofwat.gov.uk](http://www.ofwat.gov.uk)

Ms Liv Garfield  
Chief Executive Officer  
Severn Trent Water Ltd  
Severn Trent Centre  
2 St John's Street  
Coventry  
CV1 2LZ

28 June 2018

OFFICIAL

Dear Liv,

### **Consent to certain financing arrangements pursuant to Condition P**

#### **1 Introduction**

- 1.1 Severn Trent Water Limited ("Severn Trent Water") is the holder of an instrument of appointment granted under sections 11 and 14 of the Water Act 1989 (the "Appointment"). Words and expressions defined in the Appointment shall have the same meaning in this letter unless the context otherwise requires.
- 1.2 On or around the date of this letter a new Condition P will become effective in the Appointment. Condition P contains provisions which, among other things, restrict Severn Trent Water's ability to enter into transactions with Associated Companies and to maintain agreements which include cross default obligations, without Ofwat's consent.
- 1.3 In a letter dated 24 May 2017 (the "Consent Request Letter", included as an Appendix to this letter), in anticipation of Condition P being introduced into the Appointment, Severn Trent Water sought Ofwat's approval or agreement (each referred to as a "Consent") in relation to certain provisions in its financing arrangements which Severn Trent Water considered required Ofwat's consent, approval or agreement pursuant to certain provisions of Condition P.
- 1.4 In March 2018, Severn Trent Water provided copies of relevant financing arrangements in order to assist Ofwat's consideration of the Consent Request

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Letter. Further verbal and written explanations were provided in response to questions from Ofwat.

- 1.5 The Consents provided in paragraph 3 of this letter are the only consents granted to Severn Trent Water in respect of the requests made in the Consent Request Letter. Appending the Consent Request Letter to this letter shall not be interpreted as Ofwat consenting or approving other matters detailed in the Consent Request Letter or Ofwat granting consents on the terms requested therein.
- 1.6 The Consents provided in paragraph 3 of this letter are granted on the basis of the information provided by Severn Trent Water to Ofwat in the Consent Request Letter and supplementary explanations and Ofwat's assessment of the specific circumstances of Severn Trent Water at the time. Accordingly, they should not be taken to be a statement of Ofwat's policy in relation to the availability of consents to other appointees.
- 1.7 A copy of this letter, including the Appendix, will be published by Ofwat.
- 1.8 Words and expressions defined in the Appointment shall have the same meaning in this letter unless the context otherwise requires.

## 2 Nature of Consents Sought

- 2.1 Severn Trent Water's request was made in the context of its acquisition of Dee Valley Water Limited (formerly known as Dee Valley Water plc and to be re-named Hafren Dyfrdwy Limited) ("Dee Valley") on 15 February 2017 (the "Acquisition") and the proposed modification of the area covered by the Appointment following the completion of the Acquisition.
- 2.2 Severn Trent Water's requests fall into three broad categories:
  - 2.2.1 Request for Ofwat's Consent pursuant to paragraph 6.3 and/or 6.4 of Condition P to Severn Trent Water maintaining certain financing arrangements which were put in place between Severn Trent Water and Dee Valley, and between Severn Trent Water and Artesian lenders (as described out in the Consent Request Letter), following the completion of the Acquisition (the "Intra-group Financing Consent");
  - 2.2.2 Request for Ofwat's Consent pursuant to:
    - (a) paragraph 6.3 and/or 6.4 of Condition P to Severn Trent Water maintaining the financing arrangements it has in place at the date of this letter and listed in the Consent Request Letter on their current terms; and

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- (b) the definition of "Financing Subsidiary" in Condition A to certain subsidiaries of Severn Trent Water being considered to fall within that definition,
  - (together the "Existing Financing Arrangements Consent"); and
- 2.2.3 Request for Ofwat's Consent pursuant to paragraph 6.3 and/or 6.4 of Condition P to Severn Trent Water entering into new financing arrangements which incorporate loans, guarantees and/or cross default obligations on terms substantially similar to those contained in the existing financing arrangements described in the Consent Request Letter (the "**New Financing Arrangements Consent**").
- 2.3 Severn Trent Water considers that the Intra-group Financing Consent is required because:
  - 2.3.1 it has put in place loans to Dee Valley for the purposes of Dee Valley's regulated activities, to re-finance debt that Dee Valley had in place prior to the completion of the Acquisition and, given that Dee Valley is an Associated Company of Severn Trent Water, such loans (and further loans made pursuant to those financing arrangements) would be prohibited by Condition P, paragraph 6.3(b) unless Ofwat granted Consent;
  - 2.3.2 it has put in place guarantees (including de facto guarantees, indemnities and/or assumptions of liability) of Dee Valley's debt facilities: given that Dee Valley is an Associated Company of Severn Trent Water, such guarantees would be prohibited by Condition P, paragraph 6.3(a) unless Ofwat granted Consent; and
  - 2.3.3 one of the arrangements it put in place with third party creditors in order to re-finance Dee Valley's debt contains cross default obligations: such obligations would be prohibited by Condition P, paragraph 6.4 unless Ofwat granted Consent.
- 2.4 Severn Trent Water considers that the Existing Financing Arrangements Consent is required because:
  - 2.4.1 several of its existing financing arrangements, many of which are long term, contain cross default obligations and/or guarantees in relation to the liabilities of Associated Companies. Details of the relevant financing arrangements, the cross default obligations and guarantees were provided in the Consent Request Letter. Such cross default obligations and guarantees would be prohibited by Condition P, paragraphs 6.4 and 6.3(a) respectively unless Ofwat granted Consent;

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- 2.4.2 it maintains a cash management facility with Severn Trent plc and an overdraft and cash pooling arrangement with a third party lender pursuant to which loans between Severn Trent Water and Associated Companies may arise from time to time: such loans would be prohibited by Condition P, paragraph 6.3(b) unless Ofwat granted Consent;
  - 2.4.3 it maintains arrangements with Severn Trent Utilities Finance plc ("STUF plc"), East Worcester Water Limited, Severn Trent Reservoirs Limited and Severn Trent Leasing Limited the purpose of which is for these companies to raise finance for Severn Trent Water: however, due to the current shareholding structure and/or constitution of these companies, they would not be treated as "Financing Subsidiaries" pursuant to Condition A unless Ofwat granted Consent; and
  - 2.4.4 it provides a working capital facility to Water Plus Group Limited (formerly known as Water Plus Limited, company number 10012579) ("Water Plus"), a joint venture between Severn Trent plc and United Utilities plc: given that Water Plus is an Associated Company of Severn Trent Water, such a loan would be prohibited by Condition P, paragraph 6.3(b) unless Ofwat granted Consent.
- 2.5 Severn Trent Water considers that the New Financing Arrangements Consent is required because it may enter into new arrangements from time to time which contain guarantees and/or cross default obligations on terms substantially similar to its existing arrangements and it considers it more efficient to seek Ofwat's consent now rather than on each occasion on which it enters into new arrangements.

### 3 Ofwat's consent

#### 3.1 Intra-group Financing Consent

- 3.1.1 In accordance with, and for the purposes of Condition P, paragraphs 6.3(a), 6.3(b) and 6.4 and subject to the conditions set out in paragraph 3.1.2 below, Ofwat approves Severn Trent Water making and maintaining the loans, maintaining the cross default obligations and giving the guarantees which are described in paragraph 3.2.1 of the Consent Request Letter.

- 3.1.2 This Consent is subject to the conditions that:

- (a) the actual or potential liability of Severn Trent Water pursuant to all intra-group financing arrangements described in paragraph 3.2.1 of the Consent Request Letter taken together shall not at any time exceed 1.5% of Severn Trent Water's regulatory capital value as most recently published by Ofwat; and

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- (b) there shall be no material changes, as defined in paragraph 3.3.1 (including if such changes would constitute a renewal, extension or replacement) to the terms of:
- (i) the loan arrangements between Severn Trent Water, Dee Valley and Dee Valley's subsidiaries (as described in paragraph 3.2.1(1), (3) and (4) of the Consent Request Letter);
  - (ii) the existing debt facilities held within Dee Valley and its subsidiaries for which Severn Trent Water has provided or proposes to provide guarantees (as described in paragraph 3.2.1(2) of the Consent Request Letter); or
  - (iii) the arrangement between Severn Trent Water and Artesian lenders in respect of a loan previously held by Dee Valley (as described in paragraph 3.2.1(4) of the Consent Request Letter), without Severn Trent Water first obtaining Ofwat's further consent (such consent not to be unreasonably withheld or delayed).

### **3.2 Existing Financing Arrangements Consent**

- 3.2.1 For the purposes of Condition P, paragraphs 6.3(a), 6.3(c) and 6.4 and subject to the conditions set out in this paragraph 3.2.1 and paragraph 3.2.2 below, Ofwat approves the guarantees and cross default obligations described in paragraph 3.3.1, sub-paragaphs 1(1) to (12) (inclusive), and the associated parts of Annex 1 and Annex 2, of the Consent Request Letter insofar as those financing arrangements which incorporate them are used and maintained for:
- (a) existing borrowings and utilisations of commitments pursuant to those arrangements;
  - (b) raising new debt pursuant to those arrangements (within the financial limits of the arrangements set out in the Consent Request Letter); and
  - (c) repaying the debt of Severn Trent Water, Dee Valley and/or their Financing Subsidiaries (as that term is construed as amended pursuant to paragraph 3.2.5 below).
- 3.2.2 This Consent is subject to the condition that there shall be no material changes, as defined in paragraph 3.3.1, (including if such changes would constitute a renewal, extension or replacement) to the terms of the arrangements described in paragraph 3.3.1, sub-paragaphs 1 (1) to (12) inclusive of the Consent Request Letter without Severn Trent Water first

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obtaining Ofwat's further consent (such consent not to be unreasonably withheld or delayed).

- 3.2.3 For the purposes of Condition P, paragraph 6.3(b) and subject to the duration and other conditions set out in this paragraph 3.2.3, Ofwat approves loans made by Severn Trent Water which occur pursuant to the [REDACTED] cash management facility described in paragraph 3.3.1, sub-paragraph 1(13) of the Consent Request Letter (the "Cash Management Facility"). This Consent shall expire on 30 June 2023 and is subject to the following conditions:
- (a) if the circumstances set out in Condition P, paragraph 7.3 apply:
    - (i) Severn Trent Water must not, without the specific consent of Ofwat, lend any further sums to any Associated Company other than a Financing Subsidiary (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5) pursuant to the Cash Management Facility; and
    - (ii) Severn Trent Water shall seek repayment of debt due to it pursuant to the Cash Management Facility; and,
  - (b) the outstanding loans made by Severn Trent Water pursuant to the Cash Management Facility shall not exceed £250million at any time during the period of this Consent.
- 3.2.4 For the purposes of Condition P, paragraphs 6.3(a), 6.3(c) and 6.4 and subject to the conditions set out in this paragraph 3.2.4, Ofwat approves the guarantees and cross default obligations, and for the purposes of Condition P, paragraph 6.3(b) and subject to the conditions set out in this paragraph 3.2.4, Ofwat approves the loans which occur, in each case, pursuant to the overdraft and cash pooling arrangement with [REDACTED], which operates across the Severn Trent group with a gross limit of [REDACTED] and a net limit of [REDACTED] as further described in the Consent Request Letter, paragraph 3.3.1, sub-paragraph 1(14). This Consent shall expire on 30 June 2021 and is subject to the following conditions:
- (a) Severn Trent Water will use all reasonable endeavours as soon as reasonably practicable to split these arrangements into one arrangement for Severn Trent Water and its Financing Subsidiaries (as that term is construed as amended pursuant to paragraph 3.2.5 below) only, one arrangement for Dee Valley and its Financing Subsidiaries only and a separate arrangement for Severn Trent plc and its subsidiaries (excluding Severn Trent Water and any of its Financing Subsidiaries or Dee Valley and its Financing Subsidiaries); and

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- (b) Severn Trent Water will provide an annual update to Ofwat on the progress of the process described in paragraph (a) above.
- 3.2.5 In accordance with, and for the purposes of the definition of "Financing Subsidiary" in Condition A and subject to the duration and other conditions set out in this paragraph 3.2.5, Ofwat agrees to the following companies being considered as Financing Subsidiaries for the purposes of the Appointment and the Consents provided in this letter:

- (a) STUF plc (company number 02914860);
- (b) East Worcester Water Limited (company number 02757948);
- (c) Severn Trent Reservoirs Limited (company number 03115315); and
- (d) Severn Trent Leasing Limited (company number 06810163).

This Consent in respect of each of the companies listed above shall expire on the earlier of 30 June 2023 and the date on which the relevant company ceases to be a subsidiary of Severn Trent Water, and is subject to the condition that Severn Trent Water will use reasonable endeavours as soon as is reasonably practicable to restructure the minority shareholdings of these companies and amend their articles of association such that Ofwat's Consent is no longer required.

- 3.2.6 In accordance with, and for the purposes of Condition P, paragraph 6.3(b) and subject to the duration and other conditions set out in this paragraph 3.2.6, Ofwat approves the continued provision of loans by Severn Trent Water to Water Plus pursuant to a working capital facility described in the Consent Request Letter at paragraph 3.3.1, sub-paragraph 4. This Consent shall expire on 19 April 2021 and is subject to the conditions that:

- (a) the assurances provided by Severn Trent Water on 15 April 2016 and re-stated in the Consent Request Letter are adhered to; and
- (b) the loans made by Severn Trent Water to Water Plus shall not exceed [REDACTED] at any time during the period of this Consent.

### 3.3 Material change

- 3.3.1 For the purposes of paragraphs 3.1.2(b) and 3.2.2, a change shall be considered "material" if such change (by itself or together with other changes to the relevant financial arrangements made after the date of this letter), would or could reasonably be expected to:

- (a) materially extend the period for which the cross default obligation and/or guarantee and/or loans are in effect;

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- (b) materially increase Severn Trent Water's liability under the cross default obligation and/or guarantee and/or loans; or
- (c) materially and adversely modify the circumstances in which liability under the cross default obligation and/or guarantee and/or loans may arise.

### 3.4 Notification of changes

Severn Trent Water shall, as soon as reasonably practicable following a change (and in any event within 30 days of the change becoming effective), notify Ofwat in writing of the details of any changes it makes to the arrangements described in paragraphs 3.1.2(b)(i), (ii) and (iii) above and/or the arrangements described in paragraph 3.3.1, sub-paragraphs 1 (1) to (12) inclusive of the Consent Request Letter.

### 3.5 New Financing Arrangements Consent

- 3.5.1 In accordance with, and for the purposes of Condition P, paragraphs 6.3(a), 6.3(c) and 6.4 and subject to the conditions set out in this paragraph 3.5.1, Ofwat approves Severn Trent Water giving guarantees pursuant to and incorporating cross default arrangements into financing arrangements entered into after the date of this letter ("**New Financing Arrangements**") provided that:
- (a) any New Financing Arrangements are used exclusively for the benefit of Severn Trent Water and its Financing Subsidiaries (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5);
  - (b) the guarantees otherwise prohibited pursuant to Condition P incorporated in those arrangements are in relation to liabilities of Severn Trent Water's Financing Subsidiaries (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5) only;
  - (c) Severn Trent Water's liability under the relevant cross-default obligation would arise only on a default of a Financing Subsidiary (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5); and
  - (d) on the date on which the New Financing Arrangement is entered into Ofwat has not, pursuant to paragraph 3.6.2, notified Severn Trent Water that the grant of a new consent on equivalent terms to that granted in this paragraph 3.5.1 may be no longer be consistent with Ofwat's policy.

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For the avoidance of doubt:

- (i) where a financing arrangement incorporating guarantees and cross-default obligations satisfies each of the provisos to this paragraph 3.5.1, that financing arrangement benefits from the approval granted by this paragraph 3.5.1 notwithstanding that the financing arrangement is one described in paragraph 3.3.1, sub-paragraphs 1(1) to (12) (inclusive) of the Consent Request Letter to which a material change (as defined in paragraph 3.3.1) has been made; and
  - (ii) if any New Financing Arrangements contain guarantees and/or cross-default obligations in relation to Associated Companies other than Severn Trent Water's Financing Subsidiaries (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5), Severn Trent Water will require Ofwat's approval to such guarantees and/or cross default obligations.
- 3.5.2 In accordance with, and subject to the conditions set out in this paragraph 3.5.2: (A) for the purposes of Condition P, paragraphs 6.3(a), 6.3(c) and 6.4, Ofwat approves the guarantees and cross default obligations and (B) for the purposes of Condition P, paragraph 6.3(b), Ofwat approves Severn Trent Water making loans, in each case, pursuant to new overdraft and cash pooling arrangements provided that:
- (a) such arrangements are entered into on terms materially similar to those of the existing overdraft and cash pooling arrangement described in the Consent Request Letter, paragraph 3.3.1, sub-paragraph 1(14) and supplementary information provided by Severn Trent Water, and relate to Severn Trent Water and its Financing Subsidiaries (as that term is to be interpreted consistently with the Consent provided in paragraph 3.2.5) only and are for their benefit only; and
  - (b) on the date on which the overdraft and cash pooling arrangement is entered into Ofwat has not, pursuant to paragraph 3.6.2, notified Severn Trent Water that the grant of a new consent on equivalent terms to that granted in this paragraph 3.5.2 would be no longer be consistent with Ofwat's policy.

### 3.6 General Provisions relating to Ofwat's Consents

- 3.6.1 The Consents described in paragraphs 3.1, 3.2 and 3.5 shall take effect on and from the date and time that the Appointment is modified to include Condition P.

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- 3.6.2 Following a general change in policy with regards to the granting of Consents pursuant to Condition P, sub-paragraph 6.3(a), 6.3(b) or 6.3(c) or paragraph 6.4 and the equivalent provisions in the appointments of other Appointees only, Ofwat may give notice to Severn Trent Water in writing that the grant of a new consent on equivalent terms to that granted in either paragraph 3.5.1 or paragraph 3.5.2 of this letter may not be consistent with Ofwat's policy going forward and any financing arrangements entered into by Severn Trent Water after the date specified in Ofwat's notice will be expected to comply fully with Condition P unless Ofwat provides a new approval, consistent with its new policy.
- 3.6.3 The Consents provided in this letter are without prejudice to Severn Trent Water's other obligations pursuant to its Appointment which are imposed other than pursuant to Condition P.

#### **4 Reasons for Consents**

Ofwat considers that the Consents provided in paragraph 3 above should be granted because, in the current circumstances and from the information provided, Ofwat is satisfied that the granting of consent is consistent with its statutory duties. A statement of Ofwat's reasons for granting the Consents in this letter will be published separately.

Yours sincerely

**Aileen Armstrong**  
**Senior Director Finance and Governance**

Enc (or Encs)

Liv Garfield  
28 June 2018

## **Appendix**

### ***Copy of Consent Request Letter***

## **Appendix 3: Licence conditions under which consent was sought**

Consent was requested by Severn Trent in relation to the following licence conditions.

### **Condition A**

"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.

### **Condition P**

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.

## **Appendix 4: 'Cash Lock-Up' licence provisions**

### **Condition P**

#### **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.

## **Appendix 5: Ofwat's statutory duties**

In summary, our main statutory duties in relation to water and sewerage companies are to:

- further the consumer objective (to protect the interests of consumers, wherever appropriate by promoting competition);
- secure that the relevant companies properly carry out their functions;
- secure that the relevant companies can finance the proper carrying out of their functions; and
- further the resilience objective (to secure long-term resilience)

Subject to those duties, we also have duties to (among other things) ensure that consumers are in particular protected by ensuring that transactions with associated companies are carried out at arm's length.