

Regulatory Ring-fencing (FinanceAndGovernance@ofwat.gsi.gov.uk)
Ofwat, Centre City Tower
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11 January 2019

Dear Sirs

Consultation on strengthening the regulatory ring-fencing framework

Thank you for providing us with the opportunity to comment on the proposals set out in the consultation on strengthening the regulatory ring-fencing framework. We have split our response into two parts. Firstly, we provide our general comments in respect of the issues raised and secondly set out our response to each of the questions included in the consultation paper.

General comments and observations

We fully support Ofwat's goal of a thriving water sector that holds the trust and confidence of customers and wider society and recognises the importance of delivering in the interests of customers. We can also see the merit in ensuring all customers have the same level of protection, where appropriate by bringing the regulatory ring-fencing framework of all companies in line. We do not think this appropriate in respect of the "must ensure" proposal for maintaining investment grade rating and we have also identified aspects where the proposals could be improved by providing additional information and clarity, particularly where the proposed licence amendment is drafted broadly.

If the proposals are implemented as proposed, with each company having identical licence conditions, we would be keen to understand if this then means that the past approach of evolving standards over time through consultations on change of control will cease. We assume this would be the case to remove the potential for inconsistency to be reintroduced at some point in the future but it would be helpful for this point to be addressed.

Consultation questions

- 1. In light of the summary of views expressed and our initial consideration of the points made to date, do you agree with, or have any further comments to make with respect to, the proposal that all Appointees' licences require that they "must ensure" they maintain an appropriate investment grade credit rating at all times? Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.*

We do not agree with the proposal for all Appointees' licences to provide that they "must ensure" they maintain an appropriate investment grade rating at all times. We believe the case has not been made

out as to how the change from “use all reasonable endeavours” would enhance the protection of customers.

While we accept the point made in the consultation that “must ensure” provides greater clarity for all parties as to whether or not a breach has occurred, as a breach is immediately consequent on an observable fact, it still requires Ofwat to consider how it will operate its enforcement provisions. The consultation suggests that Ofwat does have in mind taking enforcement action in the event of investment grade rating not being maintained, yet does not identify what Appointee actions over and above the cash lock-up are envisaged by Ofwat to protect customers.

Practically however, by having “must ensure” in the licence Ofwat will have a duty under Section 18 of the Water Industry Act 1991 to make an enforcement order to secure compliance. The only exceptions to the duty are triviality or where the Appointee has already given an undertaking for the purpose of securing or facilitating compliance. The proposed condition does not allow for a cure period to restore investment grade rating and we would invite Ofwat to consider whether the inclusion of a cure period which, if not met would lead to breach of the condition and engagement of its enforcement duty might be more proportionate whilst still protecting customers.

Further, having “must ensure” in the licence extends the obligation to maintain investment grade rating to include matters outside the control of the Appointee (including the view taken by rating agencies of regulatory risk). This would seem to place potentially significant additional obligations on Ofwat without providing any obvious customer protection given that the existing “all reasonable endeavours” formulation in the licence already gives companies the obligation to do all they can to manage their finances to maintain an investment grade credit rating.

Ofwat acknowledges in the consultation that it will consider circumstances that appear to be outside of Appointee control in its consideration of appropriate and proportionate action to take under its enforcement procedures. However, the consultation does not provide any indication how Ofwat might operate its enforcement duty in practice or whether the protection of customers would necessitate the same actions to be taken by Appointees whether or not the breach was within their control. This could result, for example, in companies make suboptimal decisions on their capital structure to ensure that a credit rating is maintained.

We think it is important that Ofwat should provide additional information and clarity around how it might operate its enforcement duty and enforcement power in the event of a breach, particularly where the breach may be regarded as sector wide or outside control of the Appointee. We believe the proposed amended licence condition should seek to address this point within the licence or Ofwat should reconsider what within the current formulation of the licence condition, over and above cash lockup, prevents Ofwat from being able to protect customers.

2. Do you agree with the proposal to adjust the definition of issuer credit rating to explicitly allow for the use of a corporate family rating?

We agree with this proposal. We consider the definition of lowest investment grade rating should be restricted to Class A debt.

3. *Do you agree with, or have any further comments to make with respect to, the proposal to include the most up-to-date cash lock-up provisions for companies where they are currently not included?*

Subject to the caveats in our response to questions 2 and 3, we agree with this proposal and have no further comments.

4. *What are your views on the changes we have set out to bring the provisions relating to ring-fencing certificates into line with industry-leading standards?*

We support the proposals to bring the provisions in line. We have no further comments.

5. *Do you have any views about the form and consistency of information provided with ring-fencing certificates or our expectations in relation to these matters?*

We do not think that guidance needs to be developed to address the form and consistency of ring-fencing certificates given that Ofwat expectations are already clear around:

- Setting out where in the APR the ring-fencing certificate is presented and that it is sufficiently prominent;
- clearly stating the various factors and approach the Company's Board has taken into account in giving its opinion for the ring fencing certificate and provide sufficient level of detail in relation to each element covered by reporting requirements; and
- include and clearly sign-post the report prepared by the Appointee's external auditors.

6. *Do you agree with our proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance?*

We agree with the proposal to bring all licences in line in relation to the reporting of material issues but we do believe that it would benefit both Ofwat and companies to develop guidance around the question of materiality.

The guidance should not be prescriptive and would need to recognise that individual companies and circumstances are often very different. Nevertheless, there is risk that without guidance the potential for enforcement action for failing to notify will encourage companies to adopt an over-precautionary approach increasing regulatory costs and bureaucracy with no real benefit. We believe that the condition should be limited to material issues occurring after the date the licence is amended.

The formalisation of this reporting obligations would certainly remove any uncertainty around an Appointee reporting matters to Ofwat around maintaining investment grade credit ratings. We would argue that introducing this licence provision would alleviate the need to introduce the requirement that Appointees' "must ensure" they maintain an appropriate investment grade credit rating at all times.

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

We are concerned about the practical implementation of the proposed provisions around changes of control. The current draft is very broad and in particular the specific drafting of 3.6 (a) “arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the Appointee” is much wider than implied within the consultation document which talks about awareness of a change or an upcoming likely change. We would encourage Ofwat to revise and tighten the drafting. It is possible, as with the proposal around reporting material issues, that companies may adopt a precautionary approach increasing regulatory costs and bureaucracy with no real benefit. Finally, an additional concern is there is no recognition that this information may be “inside information” for the purposes of the Market Abuse Regulation. It would therefore be helpful for Ofwat to publish how it would propose to comply with its obligations under MAR with respect to the provision of this information, where it is inside information.

Your sincerely

A handwritten signature in blue ink, appearing to read "C. Offer".

Christopher Offer
Director of Regulation & Strategy