Bristol Water plc
Tel: (0117) 966 5881
www.bristolwater.co.uk

Registered Office
Bridgwater Road,
Bristol BS13 7AT

By email

3 September 2019

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

Dear Ofwat

CONSULTATION ON GUIDANCE ON REGULATORY RING FENCING DEROGATIONS

We support the principles that relate to this consultation – of greater licence standardisation, more transparency in company financial arrangements, and improving the governance over any arrangements that can be demonstrated to be in customers' interests that are outside of the standards expected in the Licence. Ring-fencing derogations should be seen within this context.

However, we found this a difficult consultation to respond to categorically, mainly because of the interaction with the change in wording in the decision document on strengthening the regulatory ring fencing framework. This decision document raised the distinction between an issue and issuer credit rating, and whether derogations were required for existing ratings, as a result of this potential licence change. We are left with uncertainty as to the impact, and how it may affect the need for derogations for other consequential impacts from licence changes.

For this reason, we believe Ofwat need to be clearer that derogations that have been provided in the past, or existing arrangements that did not require derogations under the licence in place at the time, will continue to remain in place. We accept however Ofwat will need to assess this on a case-by-case basis, until licence changes are completed. We do not think a blanket "derogation from derogations" is necessary, or appropriate. Instead, Ofwat should capture this point in the guidance, as this is not clear. Our key point is that we were not clear the status in existing consents – we assume that if no time limit was put on them originally they continue to apply for the length of the specific arrangements they related to. Otherwise, given Ofwat's comments about the length of time lack of guarantee of any timescale or approval for consent, there risks being inadvertent and process drive breaches of Licences by appointees, which is not the intention of the guidance. Ofwat could also, with the guidance as written, introduce new bespoke conditions that were beyond the original intention of the licence to assume that companies had financial flexibility unless there was a material weakening of the regulatory ring-fence as a result.

The consultation is not clear on a number of areas where company existing licence varies. There is support for standardisation, and we have supported changing to the standardised licence terms referred to in this consultation, but the lack of clarity in this consultation could mean that our views change in this regard. We do not think this should be the case, but we set out below our concerns with this specific guidance. We need to understand the impact where ring-fencing provisions were not previously in the licence and consents were given for arrangements based on the Licence at the time. The consultation assumes a form of standardised licence, when those without this version have a different expression of consent compared to the interpretation Ofwat now put forward in this consultation for all conditions, as to the criteria on which consent should be given, if at all. We explain this further from the perspective of the current Bristol Water Licence to illustrate the issue.

Ofwat state in the consultation: *"It is the responsibility of the Appointee to ensure that it possesses all the necessary consents before entering into any arrangement. Companies should alert us whenever they intend to enter into an arrangement that may need consent. In addition, changes to existing arrangements to which Ofwat has previously granted consent may require new consents from Ofwat, for example, where there is a change to the parties to an arrangement. Such changes will be considered according to the framework set out in this document."* This implies on the one hand this only applies to new consents, but also suggests that a change in parties to the consent may require new consent. It does not answer the specific questions we have on consents when ring-fencing licence changes are introduced. It also suggests that changes to consents would always need to go through this framework. This latter point could prove problematic with other licence condition requirements. We assume there is no transition allowed for introducing new licence conditions, something we support as long as there is a reasonable process for considering the implications. This guidance would not necessarily reflect a reasonable process in these circumstances.

As another example of this, a change in ultimate controller / ownership has a separate process that the new ultimate controller or new/existing owner would need to go through with Ofwat, which would include considering the impact on existing ring-fencing arrangements, and other aspects that would have had consent. Are Ofwat saying with this guidance, as is implied, that the Appointee would need to go through reviewing the ring-fencing related consents separately to this process? This is separate to condition P3.3, the ultimate controller may have changed and the existing arrangements transferred. For new agreements this is clearly appropriate, but the guidance also could apply in ways that an undertaker cannot comply with. We are not convinced that this is the appropriate process, and it is not clear this has been considered from the consultation.

Elsewhere in the Licence, but ultimately the main point for ring-fencing consents, is that the Ulitmate Controller provisions require Appointees to secure an undertaking that the Ultimate Controller(s) will refrain from any action which would cause the Appointee to breach any of its obligations under the conditions of Appointment, which we believe includes any derogation

consents. The consultation looks narrowly at ring-fencing but the potential wider interaction and protections within the Licence are not fully considered. We find it difficult to assess this based on the consultation, as in this circumstance, the Appointee hasn't entered such arrangements, and as the Ultimate Controller Licence change consultation recognised, it is not always practical for the Appointee to be aware of the change before it has occurred (the requirement is to inform Ofwat as soon as it becomes aware).

The other challenge we face in this consultation is with the context of PR19, and the assumption about what is, or is not, in customers' interests and the purpose of the licence conditions relating to financial resilience, which to an extent includes ring-fencing. For any regulatory determination, and particularly at a time of a lower draft determination cost of capital with an indication by Ofwat this could be even lower for the final determination, there may well be a mismatch for many companies, between the embedded cost of debt and company actual financing costs. For some companies, the solution can include temporary equity injections, or debt raised at an associate company, which for a period of time results in more complex financing arrangements. These arrangements provide time for spot rates for notional financing to adjust to company actual financing arrangements, which Ofwat have always maintained are for companies to resolve. With the derogation ring-fencing guidance proposed, there is a potential disconnect between how the notional assumptions made when setting the cost of capital assumed companies could manage this mismatch, and the tools that may now available to companies to manage their actual financing against these notional assumptions. These tools allow companies to accept the notional assumptions at price reviews – otherwise there is a significantly increased risk that financing decisions are retrospectively held to be inefficient with no tools available to adapt to this. If this proves to be the case, it ultimately increases the industry cost of capital, as headroom needs to be provided up front, rather than through financing flexibility. Additional steps to use these tools may have a significant time delay based on the uncertainty of process inherent in the guidance.

In theory and hopefully in practice, nothing specifically changes from the consultation guidance – it is helpful to have guidance and process that is clear and the intention of the guidance to achieve this is welcomed. It is the tone within the guidance document, and the lack of certainty as to how this will apply that matters. We explain this point in more detail below. For instance, the consultation assumes that the same process will apply to consents that are within definitions as to express licence provision prohibitions, although we struggled to understand what distinction Ofwat were making here. This is expressed in the consultation as relating to ring-fencing provisions, but other consents in the licence that are prohibitions, and included in some of the ring-fencing consents listed in the Annex for most companies currently, were balanced with an onus on application of Ofwat to agree to them unless there is some reason not to (i.e. "such consent not to be unreasonably withheld or delayed"). This appears to us to apply to some of those elements that link to regulatory ring fencing (e.g. cross-default in condition I9/P6.4). The guidance therefore should consider alongside the requirements on companies, the criteria Ofwat use to not unreasonably withhold or delay consent, and which provisions this applies to. That is different to requiring this nuance within the standardised licence, but unless the guidance is

proportionate and makes a distinction the nuance that is currently within many company licences has a clear case for retention. The simplification in removing this term wasn't necessarily designed to increase the burden on companies in making such a case.

Ofwat set out in the consultation that *"such arrangements must be in customers' interests, both short and long term*". However, this presumption is, with some of the licence conditions that such arrangements are fine as long as they do not clearly work against customers' interests (such as the cross-default). We find it difficult to judge from the consultation as to what is reasonable, as we do not think the consultation on the guidance was clear enough on these issues to allow a full considering of what the proposals mean, as we cannot be sure of the extent of their application. On the one-hand, the consultation is specific that this applies to regulatory ring-fencing. On the other hand, it talks in generic terms about consents in the licence.

"As explained in the draft guidance, there are other licence conditions that allow for the grant of consent as well as consenting provisions in the definitions of certain terms in the regulatory ring-fence. While this guidance is not directly applicable to those other conditions or definitions, generally we expect companies to engage with us in a timely manner when considering the need for a consent although the exact assessment will need to reflect the nature of each particular circumstance and the type of consent sought."

The cross default obligation is then used as an example of where it should be easier for an Appointee to evidence why the grant of the consent for the arrangement is in the interest of customers (although the consultation makes no reference to the licence wording we set out above, and is included in the list in Annex A without referencing the wording that is in some licences). The consultation therefore does not really make the distinction in the way that the licence does/did, that there is currently a different obligation on Ofwat for the example given. For instance, are there examples from the past where cross-default is not appropriate, where consent has been reasonably withheld, in order to assess the current proposals about whether the guidance is fit for purpose, or has unwanted consequences in terms of delay or withholding consent, which the Licence is clearly structured to avoid.

The consultation then suggests *"Where appropriate, any consent may include bespoke conditions to help mitigate any risks to customers or to protect the financial resilience of the Appointee, including, where appropriate, to take account of any potential relevant changes in circumstances. Any conditions will be decided on a case by case basis."*

It is not clear whether this should apply to any consent – whilst there may be some consents where bespoke conditions are appropriate given the nature of the derogation being sort (e.g. the purposes of what an intercompany loan is used for, what happens if the ultimate controller changes etc), there are others where it is not so clear that there should be conditions applied to the consent. It is not clear the

extent to which bespoke conditions might be appropriate for those consents where the presumption in the licence as originally drafted was not to prohibit them, but just to provide Ofwat with the opportunity to raise concerns. The guidance should set out more distinction and criteria so we can simplify and standardise licences without introducing a sense of materiality of what the consent relates to, and where the default implied by the licence was towards agreement, rather than objection.

We support the key principle in the guidance, that the consents themselves should become transparent for all, including both Ofwat and companies, and they should include clearly the reason why consent has been given, and any conditions on this. We separate this support from our views on whether the guidance and process proposed are clear enough and appropriate to do this.

On the guidance on requesting a consent, for some arrangements all of this information will clearly be needed, although we are far from convinced that the "Alternative options" section will apply in many of the circumstances we describe in this response. Even for financing arrangements, there is a question as to whether it is always relevant to set out the alternative, if the purpose of the proposed arrangements and how customers are protected and it is in their interests is set out. For major financing or restructuring, it may well be otherwise implied as part of other categories of the requested information, and so is useful to show separately. Our challenge is there is no scaling in the guidance that every circumstances and consent that is required is of this same scale. It may be that our earlier points in this consultation are not the intention and can easily be clarified, in which case the guidance may be proportionate.

Ofwat's advice in the guidance on early discussion to agree what information is required is appropriate, and we accept Ofwat cannot guarantee that a consent or decision within a particular timeframe is always possible. However, the Licence was in the past quite clear that some of these consents cannot be unreasonably delayed, and the guidance suggests that the formal request will require the information set out in the table shown in the consultation in order to meet a timetable, but also that an initial steer will set out the kind of information that is required. So, unfortunately we are not convinced the approach is workable based on the consultation guidance as written – it may be that all the information is required, and even if it is not relevant, not submitting it may delay the decision. Equally any initial steer may be that some information isn't required, but a consent could then be delayed if a full suite isn't provided. We think the guidance needs to be clearer, as we don't believe the full information, or the wording on timescale, is appropriate for all the different types of consents or circumstances that the guidance could cover, particularly depending on the approach to existing consents as new ones are applied for. Where circumstances require quick action in order to protect customers' interests, it is not clear whether Ofwat will balance the level of information required and timescale to match this need.

The points that we raise earlier are then reiterated in section 5 of the consultation on "demonstrating the impact". These statements are appropriate, and for new financing arrangements or intercompany

loans are necessary for the reasons the consultation sets out. However, because the consultation doesn't distinguish circumstances, it is not clear which "statutory duties" should be considered. For instance, the previous Licence expectations for consents on Ofwat not to unreasonably withhold or delay consent are not statutory duties, but did relate to the efficiency to companies of Ofwat's application of them. The consultation does not recognise the cost of delay or uncertainty on consent, and suggests this is entirely a matter for companies.

We would welcome the opportunity to discuss these points further, and recognise that we would normally have done this during the consultation period to help refine our response, but that was not possible during this consultation period due to the overlap of PR19 draft determinations and other Ofwat consultations.

Yours faithfully

[redacted]

Iain McGuffog
Director of Strategy & Regulation