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Conclusions on guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework

About this document

On 23 July 2019 we consulted on 'draft guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework'¹ ("**the consultation**"). The consultation closed on 3 September 2019.

This conclusions document sets out both our consideration of the issues raised in the responses to the consultation and a summary of the consultation alongside our decisions following the consultation exercise.

In addition to this publication we are publishing "**the guidance**" which has been updated to clarify our policy on requests for consent. Changes versus the draft guidance are listed in the 'Conclusion' to this document.

Our wider objectives for the guidance

The objective of the guidance is to ensure that Appointees² are aware of the processes that we have in place to ensure a robust, consistent and transparent assessment of requests for consents. It does not create new requirements, but it clearly explains the type of information we need in order to assess a request. We expect it to help Appointees submit appropriate evidence to help us carefully consider any proposed arrangement that would otherwise be prohibited without consent.

It is the responsibility of each company to ensure that it is compliant with its licence and that it has all the relevant consents that it needs. We were concerned when, through the consultation exercise, some companies suggested that they considered their financing subsidiaries to be included within the regulatory ring-fence. This is clearly not the case; any financing company is a separate legal entity from the Appointee, and therefore, Appointees need to consider whether any arrangement with a financing subsidiary or an associated financing company is prohibited by their licence without the consent of Ofwat.

¹ In this document we use the term "regulatory ring-fencing framework" to refer to the ring-fencing licence conditions in all Appointees' licences (noting that at present there are differences between licences). We use the term "regulatory ring-fence" to refer to the ring-fencing licence conditions for a specific Appointee.

² A reference to an Appointee or 'company' means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991

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Introduction and background

The regulatory ring-fence provides an important protection for Appointees and their customers. Its purpose is to ensure that the regulated company maintains sufficient financial and management resources to enable it to carry out its functions in a sustainable manner. One of the ways in which it achieves this is by protecting the regulated company from the activities of other entities in the corporate group.

Each company's Instrument of Appointment ("**licence**") contains regulatory ring-fencing conditions which place specific obligations on that company, including that the company will not enter into certain types of arrangements without Ofwat's consent. How we consider and decide whether to grant derogations from the ring-fencing framework is an important part of the ring-fencing protections.

We consulted on draft guidance on Ofwat's approach to granting consent to arrangements that would otherwise be prohibited by the licence. In the consultation we explained that we consider it timely to issue guidance for Appointees on our approach to consents and to clearly set out our expectations of companies when they seek consent, including the process to be followed and the information required when they approach us to request a consent. This is in part motivated by our understanding, informed over time as more information has been revealed, that certain financial arrangements such as intercompany loans to parent companies can create issues. Because of this we have welcomed companies acting to remove intercompany loans.

Following the consultation, we have now published the guidance which sets out an approach that aims to ensure that we only agree to arrangements where we are satisfied that they are in the interests of customers, and that companies remain financially resilient and able to carry out their functions.

Overall, respondents were supportive of the objectives of the guidance, however, a number of points were raised for us to consider.

The next section provides a summary of respondents and the rest of the document looks at the detail of their responses and Ofwat's views and decisions on those responses.

Responses to our consultation

We received 10 responses to the consultation – nine from water companies and one from a body representing water customers. Responses were received from:

- Affinity Water;
- Bristol Water;
- Northumbrian Water;
- South Staffordshire Water;
- South West Water;
- United Utilities;
- Welsh Water;
- Yorkshire Water;
- A single response covering the views of Severn Trent Water and Hafren Dyfrdwy; and
- CC Water.

We are publishing all the responses alongside this document.

The rest of this document provides summaries of the responses received³ and our responses and decisions on those points, presented under key themes from the consultation.

³ Note that even if listed separately, in some cases several of the points listed came from a single respondent. Direct quotations are statements made by an Appointee; statements not in quotation marks have been paraphrased for brevity particularly where several very similar comments could be collectively captured with a brief statement.

1. On timing

Respondents' views

Five respondents made comments related to timing or delays in executing new arrangements due to the amount of time the consents process will take.

- 1.1 Two respondents said that delays in granting consent may jeopardise the ability to secure the most competitive terms and rates in the debt capital markets so Ofwat should reflect on the speed that may be required for financing transactions to ensure that consents are provided on a timely basis. One of the two added that additional information requirements will have “resource, cost and timing implications” especially if external advisers need to be engaged.
- 1.2 One respondent said the table in the guidance setting out information requirements should include a point about being informed as soon as possible about any timings relevant to the granting of a consent or the entry into the proposed arrangement.
- 1.3 One response said more information is needed in the guidance on timescales and also that some sort of scaling is needed to differentiate straightforward from complex consents. Another said it would be helpful to provide an indicative timeline for different types of requests.

Our views and decision

- 1.4 Ofwat recognises that companies often need to act expediently in order to secure the opportunity to enter into certain financing transactions and the guidance confirms that “we will always aim to process requests as soon as practicable”. However, the guidance further states that the nature and complexity of a request will impact the speed of our assessment.
- 1.5 We expect companies to engage with us in a reasonable timeframe, which may be as soon as they know that there is a possibility of entering into an arrangement that is prohibited by their licence, to discuss the timetables in advance so that expectations are clear. Early notification is helpful for our work-plan.
- 1.6 The table in the guidance has been adjusted to include a note that it is helpful to let us know as soon as possible any timings which are relevant either to the grant of consent or to the entry into a proposed arrangement.

- 1.7 The unique circumstances of each request for consent means setting indicative timings may ultimately not be very helpful in predicting how long a specific case will take to assess. However, companies can influence timing by providing us with all the relevant information we need to assess a request as soon as possible including a full and clear explanation of the proposed arrangement. In addition, we do not believe producing a scale to differentiate simple from complex cases is particularly helpful given such a scale would not be able to capture the full range of cases we might be approached to consent to, including requests to consent to multiple derogations.
- 1.8 We acknowledge that resources including financial resources may be required by the Appointee to support a consent request and in order to demonstrate the key requirements set out in the guidance, however, the existence of the guidance does not change the resource requirement as the process we follow is not changing. The onus has always been on the Appointee to ensure it is able to fully evidence why a consent may be required and that it meets all of the requirements. We only request information that is essential for us to assess whether a proposed arrangement is in line with our statutory duties, is demonstrably in the interests of customers and we are proportionate in our requests throughout the consents process.

2. On information requirements

Respondents' views

Two respondents raised concerns related to the potential burden created by the level of information requested by Ofwat to assess a proposed arrangement.

- 2.1 One respondent said we should not require large volumes of evidence to support consent requests that fall within the ordinary course of business (e.g. cross default obligations for financing companies). Another said it would be useful to set out more details of the evidence companies are required to submit to support a proposed arrangement to help limit the number of subsequent queries.
- 2.2 One of these two respondents said “the statement that Ofwat will not begin to engage with a consent request, until it has been provided with every item of information it requires” needs to be reconsidered.

Our views and decision

- 2.3 The information that Ofwat requires in order to assess a request for consent has not changed, rather, the change is that the information requirements are now transparently set out in the guidance. By laying out the information requirements in the guidance, we hope to reduce the amount of time spent asking companies for further information in order to ensure that we have all the information we need. It is up to companies to respond to us promptly with additional information when we contact them about information gaps that we have identified so that their execution timeline is not impacted.
- 2.4 To confirm, the guidance does not state that “Ofwat will not begin to engage with a consent request, until it has been provided with every item of information it requires” as one respondent suggested. The guidance says that “Where information submitted is incomplete and does not enable us to assess the consent request with an appropriate level of scrutiny, there may be a delay in processing the request. In addition, we may ask for additional information during the process and we expect companies to be responsive and to provide such information in a timely manner. Failure to do so is likely to result in delays or in Ofwat being unable to assess the request. Requests that are submitted without sufficient time for Ofwat to assess them with the appropriate level of scrutiny may not be assessed under the timescales desired by the Appointee.”

- 2.5 Good regulatory practice requires that we take account of the regulatory burden we are placing on companies. We therefore only ask for evidence that we deem proportionate and necessary for us to make an informed decision.
- 2.6 The table in our consents guidance lists examples of the type of information that we might need to make an informed decision; we will engage with companies during the evidence gathering period and recognise that not all information listed in the guidance table will be necessary in all cases.

3. On the publication process and wider impact

Respondents' views

Five respondents had queries related to the publication of consents or the impact of the consents process on other arrangements.

- 3.1 One respondent said it would be helpful if Ofwat periodically set out the applications it has received, its decisions and its rationale for those decisions. They also said it would be helpful if we published the reasons why a consent was not granted in addition to publishing our reasons for granting a consent.
- 3.2 Another respondent said, "In certain circumstances some of the detail required may be commercially sensitive and publication of information ahead of any transaction may be detrimental."
- 3.3 One response said consent documents should be as standardised as possible so that a third-party could quickly understand what we had consented to.
- 3.4 One response asked how the guidance impacts its pension funding plans and arrangements. Another asked what the impact was of Ofwat's determination power under the proposed definition for Issuer Credit Rating, which is part of a separate consultation.

Our views and decision

- 3.5 We will publish the consent letter for each grant of consent and will include the reasons for the grant of that consent in accordance with our statutory duty. We do not currently publish any other consent-related documentation. However, where we do not grant consent, there may be cases when it is appropriate for us to publish the reasons for our decision.
- 3.6 We will check with companies whether anything they have provided to us is commercially sensitive in advance of publication.
- 3.7 To the extent possible, we will standardise consent documents as the respondent in 3.3 suggested, however, as each request is unique, each consent decision letter will contain bespoke elements.
- 3.8 Where Appointees have raised bespoke issues in their response, such as their particular pension arrangements, we are dealing with these directly. For our

proposals on the definition of Issuer Credit Rating, see our [‘Conclusions on strengthening the regulatory-ring-fencing framework’](#).

4. On existing consents

Respondents' views

Three respondents queried how the guidance impacts arrangements that Ofwat has given consent for in the past. A fourth respondent queried why the consents process is necessary at all.

- 4.1 One respondent said we should signal what types of changes to existing arrangements would result in a new request for consent being required.
- 4.2 Another said that we should clarify that consents granted in the past, or existing arrangements that did not require consent under the licence in place at the time, can continue to remain in place without impact due to the guidance. The same respondent asked if we have “considered how the consents process interacts with the ultimate controller process.”
- 4.3 Similarly, one respondent said it would be helpful if Ofwat expressly confirmed to each Appointee that this new guidance only applies to consents submitted to Ofwat after the date that the new guidance is implemented, and that all existing grants of consent remain in full force and effect, as long as any applicable terms of the consents are continuing to be met in all material respects.
- 4.4 One response said the requirement to submit a ring-fencing certificate annually should mean Ofwat consent is not necessary at all.

Our views and decision

- 4.5 The guidance applies to new requests for consent and does not affect the status of existing consents that have been granted by Ofwat. As has always been the case, a material departure from arrangements to which we have previously consented or a breach of any condition of a consent would invalidate that consent.
- 4.6 Appointees are responsible for seeking consent where there may be a material change to the arrangement originally consented to before implementing a change that is outside the scope of the initial consent. For example as the named beneficiary of a particular arrangement, if there is a plan to change this entity then the Appointee will need to request a new consent from Ofwat before the plan is implemented. Where a specified ultimate controller is named in a consent, if there is a change in that ultimate controller then the Appointee will

need to request a new consent from Ofwat. As set out in the guidance, we consider each request for consent on its merits.

- 4.7 If Appointees are concerned that they may have arrangements in place for which they do not have consent, or for which they may no longer have consent as the arrangements have materially changed in some way, then they should engage with us as soon as they become aware that this might be the case. Appointees should not rely on us having previously granted consent for similar arrangements as being justification for the grant of any new consent. There may also be circumstances where a company did not have a particular prohibition in its licence at the time an arrangement was entered into but the licence has subsequently been modified to include more up to date ring-fencing conditions and now a particular consent may be required for those pre-existing arrangements.
- 4.8 Note that the ring-fencing certificate performs a different function to the consents process. Through the ring-fencing certificate companies confirm that they have sufficient resources to sustain operations for at least the next 12 months. Ring-fencing certificates are not an approval process nor a derogation from a licence prohibition. The fact that an Appointee would be in a position to submit a ring-fencing certificate after entering into a prohibited arrangement would not be a sufficient reason for us to approve that arrangement.

5. On minimising the need for repeat requests

Respondents' views

Five respondents queried whether the consents process could be streamlined so that future similar arrangements are captured by a previous grant of consent or by granting consents that are valid for the life of a particular financing transaction.

- 5.1 Three respondents said that to avoid delays and/or repeated requests for consent, rather than requesting consent for each individual arrangement, the consents process could focus on the purpose and nature of the arrangement as a reference point for the consent of future similar transactions (e.g. one-off approvals for arrangements between Appointees and their financing subsidiaries). One of the three said that doing so would be in the best interest of customers.
- 5.2 One respondent said "It would be helpful to explain whether consents are likely to be time limited or in perpetuity." Another similarly said, where possible consent granted should be irrevocable for the life of a particular financing transaction, so that the Appointee does not need to go back to lenders in the future to amend existing financing documentation, as this can prove "disruptive, expensive and time consuming."
- 5.3 One response said, "Once arrangements have been approved by Ofwat, the approved arrangement should be transferable across entities in the group regardless of whom the arrangement was initially granted to."

Our views and decision

- 5.4 We agree with respondents that the consents process should, where appropriate, be streamlined. Depending on the circumstances, we may consider it appropriate to grant consent for arrangements in a way that also covers future transactions. If the consent covers future arrangements it is likely to contain a condition that these future arrangements are similar in all material respects to past arrangements. Any material differences would mean a fresh consent is needed.
- 5.5 There may be circumstances when it might be appropriate to limit the time over which the consent is valid. For instance, if a company requests consent to temporarily enter into a prohibited arrangement while it plans a more permanent

financing structure, it would make sense for the consent to be time-limited to reflect what the company has requested.

- 5.6 Consents granted by Ofwat cover only the entities specified in the consent letter and are not transferable. This point has been added to the final guidance. Different entities in a group may have different risk profiles and we consider the risk exposure each time we grant consent. For instance, some group companies may generate revenue from business activities that are not related to the Appointee. As a result, as has always been the case, any change in counterparty triggers the need for the Appointee to request a fresh consent.

6. On the approvals process and conditions of consent

Respondents' views

Two respondents wanted clarification on how the approvals process will work and the type of conditions that may come with our consent to an arrangement. One of the two queried the impact of the absence of a given phrase from the guidance.

- 6.1 One respondent said that we should make it clearer that our approach to consent requests will not be so formal that it effectively denies companies access to certain types of financing. The respondent said that our approach needs to be practical so that it does not create extra work without any apparent customer benefits. They added that to the extent possible, consent should be provided with no further conditions attached such as additional oversight requirements or further controls over the capital structure.
- 6.2 The other respondent said that conditions are not appropriate in cases where the licence did not intend to prohibit an arrangement, but just to provide Ofwat with the opportunity to raise concerns about that arrangement. The respondent added that the guidance as written would allow Ofwat to introduce new bespoke conditions that go beyond the original intention of the licence which the respondent said was to allow companies financial flexibility unless there was a material weakening of the regulatory ring-fence as a result.
- 6.3 The respondent said the guidance will result in a disconnect with the tools that companies currently have available to manage their actual financing against notional assumptions. The respondent also said that, to manage their capital structure some companies may, for example, wish to use temporary injections of equity or debt from an associate company. So, if the financing tools that companies can use are limited, then the additional steps required to use other tools may cause significant delays and costs as the guidance adds uncertainty to the process.
- 6.4 The respondent also said they are not convinced that 'alternative options' are always available or relevant, if the purpose of the proposed arrangements and how the interests of customers are protected is set out.
- 6.5 The same respondent asked why the phrase "such consent not to be unreasonably withheld or delayed" has not been included in the guidance. They said that some of the prohibited ring-fencing arrangements that are listed in the Annex to the guidance "were balanced with an onus on application of Ofwat to agree to them unless there is some reason not to."

Our views and decision

- 6.6 The consents guidance only applies to arrangements that are explicitly prohibited by the licence. These prohibitions are set out in the Annex to the guidance. The guidance is intended to ensure that arrangements are in the interests of customers and that our decisions are consistent with our statutory duties.
- 6.7 The objective of the guidance is to set out the process Ofwat goes through when we are approached to grant consent to otherwise prohibited arrangements as we recognise that there are occasions when exceptions to those prohibitions are required. The guidance does not introduce any new prohibitions and the licence provisions that require an approval or consent from Ofwat remain unchanged.
- 6.8 We understand Appointees' need for financial flexibility and access to financing. We confirm that the financing tools available to companies remain unaffected by the guidance.
- 6.9 Our approach is intended to ensure that there is a robust, consistent and transparent assessment of each request for consent to enable Ofwat to ensure that proposed arrangements are in the interests of customers, both short and long term.
- 6.10 Where appropriate, we will attach conditions to a consent to help mitigate the risks of any proposed arrangements or to protect the financial resilience of the Appointee. Any conditions we set will be proportionate, targeted and focused on the outcomes that our guidance aims to achieve and will be aligned with our statutory duties, for example, when we approve guarantees to an associated financing company or a financing subsidiary we are likely to make it a condition that the financing company cannot raise finance for any entity other than the Appointee; this would ensure that the failure of an associated company should have only a negligible impact (if any) on the regulated business.
- 6.11 Equity injections and intercompany loans to the Appointee are not prohibited by the licence as the respondent in 6.3 suggested. Loans from associated companies are subject to the usual transfer pricing rules – that is, they need to be made on an arm's length basis.
- 6.12 We expect companies to set out any alternative options "if relevant" as the guidance states, that is, where they are available; and the reasons why these potential alternatives are considered inappropriate. If, as one respondent suggested, there are no viable alternative options for a proposed arrangement, then the Appointee should tell us, so we know that the question was considered.

6.13 Ofwat already has a duty to act reasonably therefore we do not consider it necessary to add the phrase “such consent not to be unreasonably withheld or delayed” to the consents guidance. To confirm, the absence of this phrase from the guidance does not have the effect of allowing us to unreasonably delay or withhold consent. We also do not agree with the view expressed by the respondent in 6.2 that the guidance is going beyond the original intention of the licence. The guidance applies only to arrangements that are specifically prohibited by the licence and we only agree to arrangements in cases where we are satisfied that they are demonstrably in the interests of customers and are in line with our statutory duties.

7. On customer interests

Respondents' views

Two respondents asked for clarity on the scope of the customer interest test.

- 7.1 One respondent said, "It would be helpful if Ofwat could provide examples of where arrangements will be deemed to be in the interests of customers – for example, where commercial subsidiaries are working to business plans which envisage distributable profit being applied to reduce bills for customers or to provide additional investment."
- 7.2 The other respondent also asked for more detail on the types of things we consider to be in customers' interests. The respondent said their understanding of the licence is that prohibited arrangements were fine as long as they did not clearly work against customers' interests.

Our views and decision

- 7.3 It is for the Appointee that is making the request for consent to explain to us why a particular arrangement that is otherwise prohibited, is demonstrably in the interests of customers and the Appointee. We see factors that are in the interests of customers as a broad concept and this can include direct benefits, e.g. reductions in customer bills or improvements in customer service; or indirect benefits such as arrangements that improve efficiency, resilience of the business or environmental sustainability. This latter point could include a consideration of standard financial or organisational arrangements where a departure from the usual standard might have negative cost or efficiency implications.
- 7.4 For instance, in a recent request to consent to a guarantee from an Appointee to a financing subsidiary, we acknowledge the Appointee's explanation that guarantee arrangements are typically required by lenders. We also note the Appointee's assessment that the guarantees provided in that case do not increase customer risk more than if the funds had been issued directly by the Appointee. In addition, the Appointee explained that the guarantee arrangements are in the interests of customers because they provide access to deeper pools of capital at a lower cost (helping to keep customer bills lower) than would be the case without the guarantee arrangements in place and this funding is essential to deliver the Appointee's investment programmes.

Conclusion

The final consents guidance has been updated to include the following changes:

- The table setting out the information required from companies when submitting a request for consent now includes a note on timing.
- We have added a note on the status of existing consents.
- We clarify that any consent granted by us only applies to the specific arrangement(s) that are set out in our approval/consent letter.
- We clarify that consents granted by Ofwat cover only the entities specified in the consent letter and are not transferable.
- We have added a note that depending on circumstances, grant of consent to arrangements may include a time limit.
- We clarify that conditions attached to a grant of consent will be proportionate, targeted and focused on the outcomes that our guidance aims to achieve. We provide an example to this effect.
- We clarify that we see 'the interests of customers' as a broad concept that can include direct or indirect benefits.

The final '[guidance on Ofwat's approach to granting derogations from the regulatory ring-fencing framework](#)' has been published alongside this document. Appointees should refer to the final guidance when they are preparing a request for consent.

Ofwat (The Water Services Regulation Authority)
is a non-ministerial government department.
We regulate the water sector in England and Wales.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gov.uk

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Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gov.uk.

