9 July 2019

Trust in water

Conclusions on strengthening the regulatory ring-fencing framework

Ofwat

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About this document

This document provides a summary of the issues raised in response to our consultation on strengthening the regulatory ring-fencing framework[1] to bring all licences up to the industry leading standard (the "consultation") and our decisions after considering those responses.

The consultation was published on 20 November 2018 and closed on 8 January 2019.

Background to this consultation and our wider objectives

We believe that all customers across England and Wales should have the same standard of protection. Where it is practical, we achieve this by ensuring that the regulatory ring-fencing framework comprises licence conditions which are consistent across the industry.

Alongside other recent steps, including our updated Board Leadership, Transparency and Governance (BLTG) principles and our expectations on Long Term Viability Statements, these proposed changes are aimed at improving accountability, transparency and legitimacy across the water sector. We will continue to review the operation of the ring-fencing framework and will bring forward additional proposals, if necessary, to improve it further.

[1] In this document we use the term "regulatory ring-fencing framework", or simply "ring-fencing framework", to refer to the ring-fencing licence conditions in all companies' licences (noting that at present there are differences between licences and that the proposals in this document may not cover all aspects of these ring-fencing provisions). We use the term "regulatory ring-fence", or simply "ring-fence", to refer to the ring-fencing licence conditions for a specific company.

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Introduction

Each company's[2] regulatory ring-fence consists of licence conditions which place specific obligations on it, for example, to ensure that it "has at its disposal sufficient financial and managerial resources to carry out the Regulated Activities (including the investment programme necessary to fulfil its obligations as an Appointee)".

We have identified areas of the ring-fencing framework where there are inconsistencies between companies' licence conditions. However, this may not be appropriate because all customers across England and Wales should enjoy an equivalent level of protection. We therefore sought views on specific changes to bring the regulatory ring-fencing framework up to an industry leading standard in our November 2018 consultation.

The proposals in our consultation built on previous consultations and discussions in workshops, and specifically related to:

- maintaining an investment grade credit rating;
- adjusting the definition of issuer credit rating;
- including the most up-to-date cash lock-up provision;
- providing ring-fencing certificates; and
- reporting material issues.

[2] For the purpose of this document, a reference to a water company or company means a company holding an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991.

The proposals in this document apply to the 17 largest regulated water companies (Appointees) in England and Wales.

The consultation asked the following specific questions on our proposals:

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? (Condition P7) Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.

2) Do you agree with the proposal to adjust the definition of issuer credit rating to explicitly allow for the use of a corporate family rating? (Condition P7)

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

4) What are your views on the changes we have set out to bring the provisions relating to ring-fencing certificates into line with industry-leading standards? (Condition P9)

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

6) Do you agree with our proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance? (Condition P10)

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

Responses to our consultation

We received 18 responses to the consultation: responses from all the water companies (including a single response covering the views of Severn Trent and Hafren Dyfrdwy), one from The Consumer Council for Water (CCWater) and one from Bazalgette Tunnel Limited (Tideway). We are publishing all the responses alongside this document.

There was broad support for strengthening the regulatory ring-fencing framework and increasing the consistency of licences, so that water customers across England and Wales receive an equivalent level of protection. However, there were some objections, as well as some requests for clarification on specific matters and suggested improvements to proposed licence wording.

Several responses commented on the change of control provisions that were the subject of our 'General policy on change of control and its application to Thames Water' (the "Change of Control Consultation") published in May 2018. We analysed the responses to that consultation and set out our decisions on the proposed licence modifications relating to change of control, along with our reasons for those decisions, in 'Thames Water: Conclusions on Change of Control and Modification of Instrument of Appointment' (the "Change of Control Conclusions") . The Change of Control Conclusions, like the ring-fencing consultation, was published in November 2018. No new issues were raised and therefore our views remain the same.

The next step will be to implement the licence modifications from both this decision document and the Change of Control Conclusions (as set out in Appendix 2). We plan to proceed with a section 13 consultation[3], in due course, to modify all licences.

In the sections below we provide a summary of the responses received in relation to each question and our decision following consideration of the issues raised.

[3] Under section 13 of the Water Industry Act 1991 ('WIA91'), the Water Services Regulation Authority ('Ofwat') may modify the conditions of a water company's Instrument of Appointment ('licence') if the company consents to the modifications. Before making modifications under section 13 of the WIA91, Ofwat must give notice in accordance with that section.

1. Requirement to maintain an investment grade credit rating

1.1 The current licence provisions with respect to maintaining an investment grade credit rating vary across Appointees. While the licences of some require them to use "**reasonable endeavours**" to maintain an investment grade credit rating, more up to date licences (those of Severn Trent Water, Hafren Dyfrdwy, South West Water, Portsmouth Water and Thames Water) require that the Appointee "**must ensure**" that an investment grade credit rating is "maintained at all times".

1.2 We proposed to insert a "must ensure" requirement in all licences.

Respondents' views

1.3 While there was broad support for this proposal in principle, twelve respondents (two-thirds of responses) expressed concerns: 10 respondents were concerned about what would happen if a breach was the result of a factor outside of their direct control; 5 (including 4 of the 10) expressed concerns related to how enforcement procedures would work in response to a breach; two respondents said that the "reasonable endeavours" requirement provided sufficient protection for customers and a strong-enough incentive to maintain an investment grade credit rating so there was no need for the change.

1.4 Rather than leading to an automatic breach when the licence condition is not met, some respondents suggested we implement a "cure period" (essentially, a grace period perhaps with specific conditions attached to it) to allow time for understanding the root causes of a downgrade and the possible remedies or to restore an investment grade credit rating. In this case, the Appointee would only be in breach of the provision once the cure period had lapsed or if given conditions were not fulfilled.

1.5 One respondent said that credit ratings had limitations in that they were only one element of financial resilience, and that they were focused on providing information to creditors, so to put too much emphasis on them might not be appropriate.

1.6 Another respondent said that securitised companies already had a requirement similar to the "must ensure" requirement in their financing documents so adding it to licences was not necessary.

1.7 One respondent noted that the suggested wording that obliged an Appointee to "ensure that it **and** any associated company which issues corporate debt on its behalf maintains" the required investment grade credit rating might create issues for existing arrangements. It was suggested that we should replace the word 'and' with 'or'. More recently updated licences have 'and' (i.e. South West Water, Thames Water, Portsmouth Water, Severn Trent Water and Hafren Dyfrdwy), all other Appointees have 'or' in this provision.

Our views and decision

1.8 On the rating requirement itself, we do not agree that the "reasonable endeavours" requirement provides customers with the same level of protection as the "must ensure" requirement because a 'reasonable endeavours' test is inherently more difficult to apply especially in circumstances where there are significant concerns about the stability of the company concerned. At a critical time for the Appointee's resilience, the focus should be on addressing the substantive issues. The 'must ensure' requirement addresses this concern by providing complete clarity over whether or not a breach has occurred. In any case, our enforcement approach would be proportionate and targeted as set out in our enforcement guidance. In deciding what action we should take, we would take account of whether circumstances genuinely outside of a company's control led, or contributed, to a breach.

1.9 In addition, we have decided not to add a "cure period" to the provision. We believe that without a cure period the incentive to design and implement remedies and take preventative action is stronger and more immediate.

1.10 As noted by one respondent, we recognise that credit ratings have some limitations. However, they are helpful for monitoring Appointees because they provide a widely recognised and independent, forward-looking view of an Appointee's financial strength and resilience.

1.11 We acknowledge that securitised companies may have a similar provision to the "must ensure" requirement, however, the regulatory ring-fencing framework needs to include all the protections that we believe are necessary even if similar protections are repeated elsewhere, e.g. in lender's documents.

1.12 We accept that requiring both the Appointee **and** any Associated Company which issues corporate debt on its behalf to be rated increases the burden on some Appointees for little practical benefit. In light of this, the licence wording now recognises an issuer credit rating assigned to the Appointee or an issuer

credit rating given to its dedicated financing company; this should be helpful, for instance, where the Appointee is not rated because it does not issue publicly listed financial instruments.

What we intend to do

1.13 We intend to implement the “must ensure” requirement for all Appointees because the clarity gained from the amended condition would mean that no time is lost in judging whether or not a company has used reasonable endeavours before determining if breach has occurred, allowing solutions to be considered and implemented faster.

1.14 In addition, following the concern detailed in 1.7, for the proposed wording on credit ratings, we intend to retain the word ‘or’ rather than change it to ‘and’; for licences with ‘and’, we intend to revert to ‘or’. This impacts slightly on the trigger for cash lock-up so, for logical coherence, we intend to adjust it: as the licence explicitly recognises instances in which a credit rating is given to an ‘Associated Company which issues corporate debt on the Appointee’s behalf’ rather than to the Appointee, the cash lock-up trigger needs to be realigned to recognise such cases too (see clauses 7.2 and 7.3 in Appendix 2 for updated wording).

2. Proposal to add a corporate family rating ("CFR") to the definition of Issuer Credit Rating

2.1 Credit ratings provide an important indicator of a company's financial resilience. We want to ensure companies have a flexible range of rating options available to them and where we have determined that a given rating offers equivalent protection to customers as other accepted ratings, the option to use it should be reflected in the licence.

2.2 We therefore consulted on whether the changes made to include corporate family rating ("CFR") explicitly in the definition of "Issuer Credit Rating" in Thames Water's and Portsmouth Water's licences should also be made to the licences of all Appointees.

2.3 Licences already explicitly include issuer credit ratings. Adding an explicit reference to CFRs on the face of the licence, including a definition of CFR, would make it transparent that companies may rely on these ratings in appropriate circumstances.

Respondents' views

2.4 All respondents that commented on the proposal to add a CFR to the definition of Issuer Credit Rating were broadly supportive of the addition. Some respondents suggested expanding the definition, e.g. to capture the different terminology used by different ratings agencies or to allow for **issue** ratings. One respondent asked what our approach would be if Moody's decided not to issue CFRs in the future.

2.5 A couple of respondents sought confirmation, based on their current financial arrangements, that they would not be in breach if the new definition of "Issuer Credit Rating" was adopted, To clarify their understanding, one respondent asked what would happen if an Appointee held both a sub-investment grade CFR and an investment grade Class A issue rating. One respondent said they did not recognise the S&P entity named in the proposed licence wording for "Credit Rating Agency" and "Lowest Investment Grade Rating".

Our views and decision

2.6 We consider that the licence definition of "Issuer Credit Rating" encapsulates what some credit rating agencies might call a "corporate credit rating" or an "issuer default rating" therefore we do not see the need to change the

definition to include these terms, despite a call for such a change from a respondent.

2.7 We have assessed that the CFR for an approved group is broadly equivalent to an issuer credit rating and therefore warrants being explicitly added to the licence. A CFR may be an appropriate option for a securitised company so long as it is linked to an appropriate group and therefore reflects the credit risk of the regulated business. Broadly, we are comfortable with a corporate group in which the only operating business is the Appointee, and associates included in the corporate group are limited to entities that serve the Appointee, i.e. holding companies and financing vehicles. If CFRs were no longer available as an option in the future, as one response queried, that should not raise any specific issues as companies would still need to maintain a credit rating which complies with the licence and if CFRs were not available in the future there are other rating options provided for in the definition.

2.8 Some Appointees cannot access an issuer credit rating or a CFR or may want to rely on another type of rating. To accommodate this, we consider it appropriate to include an additional provision to the definition of issuer credit rating to enable them to request an appropriate alternative credit rating, such as an issue rating. We are likely to approve alternative ratings where we determine that it is clear that the proposed type of rating reflects the credit risk of the regulated business as a whole and provides an equivalent level of protection for customers as other ratings. For instance, where an Appointee only holds Class A debt and no subordinated debt, we are likely to determine that an issue rating is appropriate. Before the licence changes are effected, we will work with each Appointee that is affected to ensure their arrangements are compliant.

2.9 In response to the request for clarification, where an Appointee has more than one credit rating that fits the definition of Issuer Credit Rating, if **at least one** of those ratings is investment grade, it is in compliance with the requirement that the Appointee "must ensure" that an investment grade credit rating is "maintained at all times". The Appointee would, however, be in cash lock-up **if one or more** of those ratings is not investment grade (see section 3).

2.10 If there was the hypothetical situation under our proposed approach which was posed by one respondent, in which an Appointee has both a CFR and a Class A issue rating, and we had not agreed in writing that we accepted the Class A rating as falling within the definition of 'issuer credit rating', then only the CFR would fit the definition. This would mean that if the CFR were downgraded to a sub-investment grade level, the Appointee would be in

breach of the requirement that they must ensure that they maintain at least one Issuer Credit Rating at an investment grade level and they would also be in cash lock-up.

2.11 Following comments, we propose changing the named entities in the definitions of "Credit Rating Agency" and "Lowest Investment Grade Rating" to "S&P Global Ratings", "Moody's Investors Service, Inc" and "Fitch Ratings, Inc". Reference to these nationally recognised statistical rating organisations, NRSROs[4], is helpful because it captures all entities in the group including those based in the UK, Europe and elsewhere. This change means that ratings from subsidiaries are automatically captured by the definition. The definition of Credit Rating Agency[5] has also been amended to accommodate successor companies for all three named agencies.

What we intend to do

2.12 We intend to clarify the licence definition of "Issuer Credit Rating" by explicitly including, on the face of the licence, both a CFR and an alternative rating agreed with Ofwat following a written request.

2.13 We intend to amend the named entities in the definitions of "Credit Rating Agency" and "Lowest Investment Grade Rating" as outlined above and to expand the definition so that successor companies are captured.

[4] For more on NRSROs, see: https://www.sec.gov/ocr/ocr-current-nrsros.html
[5] See Appendix 2 for the updated proposed licence definition of Credit Rating Agency.

3. Proposal to include the most up-to-date cash lock-up provisions across all licences

3.1 Of the 17 water companies, only 3 do not have a cash lock-up licence provision of any form: Bristol Water, Welsh Water and Wessex Water. We proposed adding the most up-to-date cash lock-up provision in all licences.

3.2 Cash lock-up would be triggered, either where an Appointee does not hold an issuer credit rating which is investment grade, one or more issuer credit ratings held by an appointee is not investment grade, or where the rating outlook as specified by the credit rating agency which has assigned the lowest investment grade rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation or has been changed from stable or positive to negative. Once the Appointee was in cash lock-up, they would be restricted from making certain payments, e.g. dividends, in cash or any other form.

3.3 Two companies, South West Water and Hafren Dyfrdwy, are currently exempt from the requirement to maintain an investment grade credit rating. Their licences contain provisions for their Board to certify on an annual basis that in the Board's opinion, they "would be able to maintain an issuer credit rating which is an investment grade rating", together with a statement of the main factors which the Board has taken into account. Cash lock-up in these cases would be triggered when the Appointee is unable to deliver the annual certificate to Ofwat.

Respondents' views

3.4 All but one respondent who commented on this question were supportive of the proposal. The company that opposed the proposal suggested that cash lock-up would encourage Appointees to maintain a relationship with only one rating agency (i.e. the most optimistic); that cash lock-up was a more natural complement to a "reasonable endeavours" credit ratings standard; and that cash lock-up might deter new equity investors.

3.5 A couple of respondents suggested that the definition of "Lowest Investment Grade Rating" should be restricted to Class A debt because it represented the rating for the majority of publicly issued debt or because it better reflected their securitised structure.

3.6 One response said that it was hard to see how companies that provided an

annual credit rating certificate were in an equivalent position to other companies in that they have more flexibility to manage their financing arrangements. It was also suggested that their cash lock-up trigger should be explicitly linked to key credit ratios. In addition, two respondents raised a general concern over the equivalence of annual certificates themselves, i.e. that they were not as reactive or as forward-looking as credit ratings. Therefore for consistency, fairness and to eliminate administration risk, they suggested that all Appointees should be required to maintain at least one credit rating with no dispensations.

3.7 Under a cash lock-up scenario, an Appointee would only be able to continue making scheduled interest and capital payments to a financing company if that financing company fits the licence definition of "Financing Subsidiary". One company asked us to acknowledge, in writing, that we considered their financing company to be a "Financing Subsidiary" as defined in the licence.

Our views and decision

3.8 Cash lock-up has become a standard provision across the water industry and is also standard in the energy sector.

3.9 We do not consider cash lock-up to be a more natural complement to a "reasonable endeavours" credit ratings standard as it serves a different purpose to the investment grade credit rating requirement explained in section 1. The purpose of the cash lock-up provision is to protect the regulated business and to ensure that there is no further deterioration in its available resources when there are concerns about the resilience of the business.

3.10 We are not persuaded that cash lock-up encourages an Appointee to maintain credit ratings with only one agency. A range of factors, including management choice or the requirements of lenders or shareholders, are likely to influence whether an Appointee holds ratings with more than one credit rating agency. As credit ratings are a third-party view, the objective element of a company's rating should not change significantly based on the credit rating agency chosen.

3.11 In response to the view that cash lock-up may deter new equity from investing in an Appointee in financial distress, we note that there are a variety of options available to revive a struggling business. Having the cash lock-up provision places the regulated business in a better position because it reduces the rate at which the company deteriorates and means that there are more resources available to improve operations.

3.12 We do not agree with the suggestion to restrict the definition of "Lowest Investment Grade Rating" to higher-rated Class A debt ratings particularly when an Appointee also holds subordinated debt because it would not necessarily reflect the position of the regulated business as a whole.

3.13 We have reflected on the concerns raised about the equivalence of the cash lock-up trigger for companies that use annual certificates, and think these warrant further consideration. Therefore, we have asked the two companies that currently provide annual certificates to clearly set out the steps that their Board takes to produce the certificate including supporting evidence and third-party assurances. We will review these explanations alongside the certificates published in the 2019 Annual Performance Reports to determine whether further measures are necessary to enhance customer protection for those companies. We will publish any proposals in a future consultation.

3.14 We will write directly to the company that has asked us to consider their financing company a Financing Subsidiary as defined in the licence. As a reminder, the licence defines a Financing Subsidiary as "(a) a subsidiary company 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** which Ofwat has agreed in writing will be considered a Financing Subsidiary."

3.15 If an Appointee's financing company does not fit the specified licence definition, the Appointee needs to ask us to agree to that entity being a "Financing Subsidiary". If the Appointee has not obtained our agreement, it follows that, should the Appointee find itself in cash lock-up, they would not be able to make any payments to a financing vehicle that does not fall within a) and b) of the licence definition.

What we intend to do

3.16 We intend to insert the cash lock-up provision in all companies' licences.

4. Proposal to bring the provisions on ring-fencing certificates in line with industry-leading standards

4.1 The annual ring-fencing certificate provides assurance to Ofwat and other stakeholders that the Appointee has adequate facilities, systems, financial resources and management resources to enable it to carry out its Regulated Activities for at least another 12 months. This enhances the protection for customers provided by the regulatory ring-fencing framework.

4.2 It places an obligation on the Board of the Appointee to acknowledge and comply with the ring-fencing conditions, transparently reinforcing their accountability to stakeholders. This enhances stakeholders' confidence in the Appointee's ability to carry out its functions in the coming year.

4.3 Currently there are minor variations between companies' licence requirements on ring-fencing certificates. In the consultation we proposed changes to make the requirements consistent with the current industry-leading standard.

Respondents' views

4.4 None of the respondents objected to the proposal to update the ring-fencing certificate provisions to bring them in line with industry-leading standards.

What we intend to do

4.5 To enhance transparency and accountability, we intend to update each Appointee's licence with the most up to date ring-fencing certificates provision.

5. Views on the form and consistency of information provided with ring-fencing certificates ("RFCs")

5.1 Our goal is for Appointees to produce ring-fencing certificates ("RFCs") that cover consistent key areas across Appointees, and are clear, sufficiently evidenced and easy to find in their Annual Performance Report ("APR"). Currently, Appointees' approaches to the RFCs vary.

5.2 In the consultation, we asked whether additional guidance is needed to improve the form and consistency of RFCs submitted. We set out our expectations and reminded Appointees to clearly explain how they have come to the opinion asserted in their RFC and to signpost RFCs clearly in their APR.

Respondents' views

5.3 Three respondents thought that more guidance on the form and consistency of RFCs might be helpful. One of these said guidance would only be helpful provided that appointees maintained responsibility and it did not narrow the scope of companies' thinking. Another said it would be helpful if it was not placed in the licence but located elsewhere. A further two respondents suggested that Ofwat should give ongoing or regular feedback on examples that have best met expectations, and that Ofwat should periodically share examples of good practice that have occurred.

5.4 Another three respondents said that our expectations were clear enough. One said that this view was based on the assumption that their current disclosure was sufficient.

What we intend to do

5.5 Having set out clearly our expectations in the consultation document, we will review the RFCs for the year ending March 2019 against these expectations, and we will decide if additional guidance on RFCs is needed in light of that review. If necessary, we will provide guidance in time for the March 2020 accounts.

6. Proposal to bring all licences up to the same standard in relation to the reporting of material issues, but not to develop guidance

6.1 We proposed a provision requiring the Board of the Appointee to inform Ofwat as soon as possible when they become aware of any circumstance that might materially affect the Appointee's ability to carry out its Regulated Activities. This provision has already been added to more up to date licences.

Respondents' views

6.2 The majority of respondents were supportive of adding this provision into all licences; one of these respondents said that while they were supportive they needed more detail to properly assess the proposal[6]. One respondent thought that the change was not necessary because reporting material issues was already covered under the obligation to notify Ofwat of anything that would invalidate the previous ring-fencing certificate.

6.3 A third of respondents thought that guidance would help to remove uncertainty and to ensure companies did not over-report which would increase regulatory costs. However, another third were satisfied that additional guidance was not required; one respondent specifically suggested that it might be counterproductive for Ofwat to be too prescriptive. A couple of respondents suggested that Ofwat provided feedback, regular updates or examples of good practice to help achieve consistency between companies.

6.4 One response suggested that Ofwat should explicitly note that business and operational changes in the ordinary course of running a company would not typically meet the materiality test. Another response asked us to define timeframes, channels and contacts for reporting material issues.

6.5 One respondent thought that the condition should be limited to material issues that occurred after the date that this provision was inserted into the licence. Another respondent said that this should be presented as notification of issues that affect a company's ability to meet its licence obligations and not as

[6] This respondent did not clarify what further information might have been helpful and this was not a point made by other parties.

a request or requirement for regulatory approval, which could fetter Ofwat's legal position for any future action.

Our views and decision

6.6 The provision to report material issues to Ofwat is designed to make us aware of significant issues to help us better discharge our regulatory responsibilities. This obligation is a notification requirement and not a regulatory approval process. Confining this to circumstances that may raise questions about licence compliance would not meet the broader objective of this condition; the provision is designed to capture all relevant material issues even those that are not specifically connected to licence compliance.

6.7 The requirement to report material issues will not be applied retrospectively for issues that have been resolved. It will come into effect with the licence modification. At this point any ongoing material issues that we have not already been made aware of should be reported to Ofwat.

6.8 After considering the responses we have concluded that, given the range of potential circumstances that companies may face, including circumstances that cannot be reasonably foreseen, issuing specific guidance on notification of material issues or on the timing of such notifications may unduly narrow the scope of reporting and we do not want to limit reporting in this way. However, we will keep this decision under review.

6.9 We acknowledge that material issues already need to be reported to the extent that they invalidate a ring-fencing certificate; this will continue to be the case. However, some issues may not be so severe that they invalidate a ring-fencing certificate but may still be important enough to report to Ofwat.

6.10 We expect all companies to use their own judgement to assess **when** to notify us of material issues and to decide **which** issues have a 'material' impact on their financial, operational or corporate resilience. We expect to be notified about significant or urgent material issues as soon as possible. If debating whether or not Ofwat should be notified about an issue, the safest option may be to notify us. The appropriate contact and channel will depend on the specific issue. We expect companies to judge who the appropriate contact within Ofwat is. When notifying Ofwat it would be helpful to clarify the context and the relevant Regulated Activities that may be affected.

What we intend to do

6.11 We intend to insert the requirement to report material issues into all licences.

7. Other issues raised in the consultation

7.1 The consultation offered respondents the chance to make other comments on the issues discussed.

Respondents' views

7.2 A couple of responses noted that the proposed licence wording did not incorporate some of the changes made following our recent exercise on licence simplification[7] such as the change from 'the Water Services Regulation Authority' to 'Ofwat'.

7.3 One respondent said that harmonising licences might not necessarily lead to harmonised outcomes because each regulated company has different financing, governance and management structures. Another respondent said consistency in ring-fencing arrangements across the sector was not needed, as existing arrangements have proven resilient.

7.4 One respondent wanted to understand whether the implementation of these proposals meant that the past approach of evolving standards over time through consultations on change of control would cease, to remove potential for inconsistency being reintroduced.

7.5 One respondent queried why the licence condition on dividend policy was not being introduced to all licences for consistency.

7.6 Tideway raised a number of issues around the fact that many of the proposals were inappropriate for them due to their unique circumstances.

7.7 Several queries related to provisions on change of control that were proposed in our Change of Control Consultation. One respondent said they did not support the need for the introduction of a licence condition for Ofwat to issue a direction to the Appointee to enforce an Ultimate Controller undertaking in Appointees' instruments of appointment. They were concerned that it could possibly result in a wide range of new scenarios in which Ofwat could issue a

[7] We published our decisions in relation to licence simplification in December 2018. Our intention was to simplify, consolidate and modernise licence conditions, while maintaining the protections for customers and the balance of risk for companies.

direction, suggesting specific safeguards and minimum conditions for us issuing a direction should be included.

Our views and decision

7.8 Our intention was always that changes made under licence simplification would be reflected in the final version of the proposed licence conditions. However, those changes had not been finalised at the time of our consultation in November 2018, so were not included at that time.

7.9 Our objective in increasing consistency across licences is to ensure that customers across England and Wales receive an equivalent level of protection. Consistency in licence wording is not an objective in itself. We recognise that in specific circumstances we need to consent to different wording or procedures to accommodate unique circumstances.

7.10 While broadly similar, we acknowledge that some Appointees do not have identical provisions on dividends. Obligations related to dividend policy may be the subject of a future consultation.

7.11 We agree that the updated provisions may not be fully appropriate for Tideway and do not intend to amend their licence as part of this exercise. Their credit rating and other provisions are different in nature to those held by other regulated companies because they reflect the activities and risks of that company, which is construction of an infrastructure asset rather than the delivery of water and sewerage services.

7.12 As stated earlier in this document, questions related to change of control were addressed in the Change of Control Conclusions document published in November 2018 and our decisions related to these matters remain the same. Among other things, we proposed an obligation to require the Appointee to comply with any direction from Ofwat to enforce an Ultimate Controller's undertaking. To clarify, this provision relates to enforcing the undertaking that is already in place; Ofwat is not seeking to direct the Appointee to make investors take actions other than those they are currently already expected to undertake by virtue of having provided the undertaking.

What we intend to do

7.13 We propose to insert the provisions related to change of control that we set out in the Change of Control Conclusions into all licences and to incorporate changes made under licence simplification into proposed licence wording.

8. Next steps

The precise wording and placement of each Appointee's ring-fencing provisions currently varies between licences, for example many Appointees' licences currently contain ring-fencing provisions in Condition I. For clarity and to achieve a consistent regulatory ring-fencing framework across all licences, all ring-fencing provisions will be drawn into Condition P. In addition, the specific changes required for each Appointee will vary depending on that Appointee's current licence wording. We intend to discuss and process these changes directly with individual Appointees.

We now plan to proceed to consultation to make relevant modifications to water companies' licences by notice under section 13 of the Water Industry Act 1991 (WIA91). The section 13 consultation will include modifications decided in the Change of Control Conclusions.

Some issues highlighted in this document, notably annual credit rating certificates and the form of ring-fencing certificates, require further analysis. Once we have reviewed the annual credit rating certificates and the ring-fencing certificates for the year ending March 2019, we will determine whether further measures are necessary to enhance customer protection for companies using annual credit rating certificates, and we will consider the need to provide further guidance on the form and content of ring-fencing certificates.

We will also continue to monitor existing regulatory ring-fencing provisions to determine if the current standards remain fit for purpose. Where necessary we will consult on improving provisions so that they continue to be effective.

Appendix 1: List of respondents to the consultation

Water Only and Water and Sewerage Companies

Affinity Water

Anglian Water

Bristol Water

Northumbrian Water

Portsmouth Water

Severn Trent Water and Hafren Dyfrdwy

South East Water

South Staffordshire Water

Southern Water

South West Water

Sutton and East Surrey Water

Thames Water

United Utilities

Welsh Water

Wessex Water

Yorkshire Water

Other

Bazalgette Tunnel Limited

Consumer Council for Water

Appendix 2: Proposed licence amendments

This appendix contains the proposed updated text that we have decided to incorporate into Appointees' licences. Our intention is to add the below definitions to Condition A, or to amend the definitions for those who currently have them. We intend to update the Condition P of those Appointees whose licences currently contain ring-fencing provisions in Condition P with the amended provisions set out below. For Appointees whose licences currently contain ring-fencing provisions in Condition I, we will move those provisions into a consolidated Condition P and update that condition with the provisions below.

To aid understanding, we have put the definitions or provisions that we propose to amend either for clarity or as a result of our consideration of consultation responses, in **bold**.

Condition A

We propose the modification where relevant of Condition A as follows:

1. In construing these Conditions:

…

(3) references to a liability shall be taken to include the creation of any mortgage, charge, pledge, lien or other form of security or encumbrance, the making of a loan and the taking on of a debt; and

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

2. Unless the context otherwise requires, in these Conditions:

"**Corporate Family Rating**" means a credit rating assigned by a Credit Rating Agency to reflect its opinion of the ability of a corporate group to honour all of its financial obligations, as if there was a single class of debt **and the corporate group was a single legal entity**, where the corporate group is as determined by the relevant Credit Rating Agency.

"**Credit Rating Agency**" means:

(a) S&P Global Ratings (or any of its affiliates or its successors);

(b) Moody's Investors Services, Inc (or any of its affiliates or its successors);

(c) Fitch Ratings, Inc (or any of its affiliates or its successors); or

(d) any credit rating agency which has been notified to and agreed by Ofwat as having comparable standing to S&P Global Ratings, Moody's Investors Services, Inc or Fitch Ratings, Inc.

…

"**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 Ofwat has agreed in writing will be considered a Financing Subsidiary.

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

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

"**Issuer Credit Rating**" means:

(a) an issuer credit rating assigned to **the Appointee or any Associated Company which issues corporate debt on its behalf** by a Credit Rating Agency;

(b) a Corporate Family Rating assigned by a Credit Rating Agency **to a corporate group of which the Appointee is a member** and which has been approved for this purpose by Ofwat; or

(c) a rating assigned by a Credit Rating Agency, for so long as Ofwat has determined in writing this is appropriate in all the circumstances.

"**Lowest Investment Grade Rating**" means:

(a) an Issuer Credit Rating of BBB- by S&P Global Ratings or Fitch Ratings, Inc or an Issuer Credit Rating of Baa3 by Moody's Investors

Services, Inc or such Issuer Credit Rating as may be specified from time to time by any of these credit rating agencies as the lowest Investment Grade Rating; or

(b) an equivalent rating from any other Credit Rating Agency.

"Ring-fencing Certificate" means a certificate, submitted to Ofwat by the Appointee, which states that, in the opinion of the Board of the Appointee:

(a) the Appointee will have available to it sufficient financial resources and facilities to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted;

b) the Appointee will have available to it sufficient management resources and systems of planning and internal control to enable it to carry out the Regulated Activities, for at least the twelve month period following the date on which the certificate is submitted; and

(c) all contracts entered into between the Appointee and any Associated Company include the necessary provisions and requirements in respect of the standard of service to be supplied to the Appointee, to ensure that it is able to carry out the Regulated Activities;

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

"**Ultimate Controller**" means any person which, whether alone or jointly and whether directly or indirectly, is, in the reasonable determination of Ofwat, in a position to control or in a position to materially influence the policy or affairs of the Appointee or any Holding Company of the Appointee;

"United Kingdom Holding Company" means a Holding Company which is registered in the United Kingdom and which is not a subsidiary of any company registered in the United Kingdom;

Provisions relating to Condition P

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

P3 The Role of the company's Ultimate Controller and United Kingdom Holding Company

P3.1 The Appointee must ensure that, at all times:

P3.1(a) there is an undertaking in place which is given by the Ultimate Controller of the Appointee in favour of the Appointee; and

P3.1(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.

P3.2 The Appointee must ensure that any undertaking given pursuant to paragraph 3.1 provides:

P3.2(a) that the person giving the undertaking must, and must procure that each of its subsidiaries other than the Appointee and its subsidiaries:

P3.2(a) (i) provides to the Appointee such information as is necessary to enable the Appointee to comply with; and

P3.2(a) (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

P3.3 Where:

P3.3(a) an undertaking required to be given by a person in accordance with paragraph 3.1 is not in place; or

P3.3(b) there has been a breach of the terms of such an undertaking by the person that gave it and that breach has not been remedied,

the Appointee must not enter into any new contract or arrangement with such a person or the subsidiaries of such a person other than subsidiaries of the Appointee, without the prior written approval of by Ofwat.

P3.4 The Appointee must provide to Ofwat such certified copies of any undertaking given pursuant to paragraph 3.1 as are requested by Ofwat.

P3.5 The Appointee must immediately inform Ofwat in writing if the Appointee becomes aware that:

P3.5(a) an undertaking given by a person pursuant to paragraph 3.1 has ceased to be legally enforceable; or

P3.5(b) there has been a breach of the terms of such an undertaking by the person that gave it.

P3.6 The Appointee shall inform Ofwat as soon as reasonably practicable if the Appointee becomes aware that:

P3.6(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; or

P3.6(b) arrangements have been put into effect which might be considered to have led to a change to the Ultimate Controller(s) of the Appointee; or

P3.6(c) any person intends to submit a merger control filing to the Competition and Markets Authority or the European Commission with respect to an actual or potential change of control of the Appointee.

P3.7 The Appointee must comply with any direction given by Ofwat to the Appointee to enforce the terms of an undertaking given to it pursuant to paragraph 3.1.

…

P7 Credit Ratings and “Cash Lock-Up”

P7.1 The Appointee must demonstrate its ability to service its debt obligations by complying with paragraph 7.2.

P7.2 The Appointee must ensure that it **or** any Associated Company which issues corporate debt on its behalf maintains, at all times, an Issuer Credit Rating which is an Investment Grade Rating.

P7.3 The “Cash Lock-Up” provisions set out in paragraph 7.4 apply in any circumstances where the Appointee **or any Associated Company which issues corporate debt on its behalf**:

P7.3(a) does not hold an Issuer Credit Rating which is an Investment Grade Rating; or

P7.3(b) holds more than one Issuer Credit Rating and one or more such Issuer Credit Ratings is not an Investment Grade Rating; or

P7.3(c) holds an Issuer Credit Rating which is the Lowest Investment Grade Rating and:

P7.3(c)(i) the rating is on review for possible downgrade or is on "Credit Watch" or "Rating Watch" with a negative designation; or

P7.3(c)(ii) otherwise where the rating outlook of the Appointee **or any Associated Company which issues corporate debt on its behalf** as specified by the Credit Rating Agency which has assigned the Lowest Investment Grade Rating has been changed from stable or positive to negative.

P7.4 Where paragraph 7.3 applies, the Appointee must not, without the prior approval of Ofwat, transfer, lease, licence or lend any sum, asset, right or benefit to any Associated Company, other than where:

P7.4(a) the Appointee makes a payment to an Associated Company which is:

P7.4(a)(i) pursuant to an agreement entered into prior to the circumstances referred to in paragraph 7.3 arising, which provides for goods, services or assets to be provided on an arm's length basis and on normal commercial terms; and

P7.4(a)(ii) properly due in respect of the **relevant** goods, services or assets;

P7.4(b) the Appointee transfers, leases, licences or lends any sum, asset, right or benefit to any Associated Company (excluding a dividend payment, a distribution out of distributable reserves or a repayment of capital), where:

P7.4(b)(i) the transaction is on an arm's length basis on normal commercial terms; and

P7.4(b)(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;

P7.4(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:

P7.4(c)(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

P7.4(c)(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

P7.4(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.

…

P9 Ring-fencing Statement and Certificate

P9.1 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.

P9.2 No later than the date on which the Appointee is required to deliver to Ofwat a copy of each set of accounting statements prepared under Condition F, the Appointee must submit a Ring-fencing Certificate to Ofwat.

P9.3 Where the Board of the Appointee becomes aware of any activity of the Appointee or any Group Company which does not form part of the Regulated Activities, and which may be material in relation to the Appointee's ability to finance the Regulated Activities, the Appointee must:

P9.3(a) inform Ofwat; and

P9.3(b) within fourteen days of becoming aware of the activity, submit a new Ring-fencing Certificate to Ofwat.

P9.4 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 Ofwat of this in writing.

P9.5 Whenever the Appointee submits a Ring-fencing Certificate to Ofwat, the Appointee must submit a statement of the main factors which the Board of the Appointee has taken into account in giving its opinion for the Ring-fencing Certificate.

P9.6 A Ring-fencing Certificate must be:

P9.6(a) signed by all directors of the Appointee on the date of submission; or

P9.6(b) approved at a meeting of the Board of the Appointee, convened in accordance with the Appointee's articles of association, in which case the Ring-fencing Certificate must:

P9.6(b)(i) be signed by a director of the Appointee or the Appointee's company secretary; and

P9.6(b)(ii) have appended to it a certified copy of the minutes of the approval.

P9.7 Each Ring-fencing Certificate shall be accompanied by a report prepared by the Appointee's Auditors and addressed to Ofwat, stating whether they are aware of any inconsistencies between that Ring-fencing Certificate and either the statements referred to in **Condition F6.1** or any information which the Auditors obtained in the course of their work as the Appointee's Auditors and, if so, what they are.

P10 Reporting of Material Issues

P10.1 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 Ofwat as soon as possible.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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