south east water

CONSULTATION ON STRENGTHENING THE REGULATORY RING-FENCING FRAMEWORK

South East Water response

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1. Introduction

This is South East Water's response to Ofwat's consultation on strengthening the regulatory ring-fencing framework.

In respect of the proposed changes to ensure that investment grade credit ratings are maintained, Ofwat should formally clarify its enforcement approach before requesting companies to consent to the change.

We welcome the reference to the corporate family rating which reflects current practices and have made comments on the definition of issuer credit rating that would more completely reflect these practices.

We remain concerned with the proposed introduction of a direction to take legal proceedings to enforce a condition P undertaking against an ultimate controller. We believe that Ofwat should provide additional clarity on the purpose of this change and examples of the circumstances in which Ofwat would anticipate having the need for such provision.

We welcome this early engagement on potential changes to licence conditions but a better process would be to complete a consultation process with the industry as a whole before considering applying the changes to a particular company.

2. Responses to questions

QUESTION 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? (See Annex: 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.

We agree that water companies should maintain an investment grade credit rating as an indicator of their ability to access capital markets and creditworthiness. We also agree that companies should put in place resilient financial structures.

Changing the standard of obligation from "reasonable endeavours / all reasonable endeavours" to "must ensure" would require companies to achieve an investment grade credit rating in every possible circumstances.

The practical consequences of being required to meet an absolute obligation becomes an issue for boards when considering cases where the loss of an investment grade credit rating is genuinely caused by circumstances beyond the reasonable control of a company that could not be avoided by reasonable mitigation plans and the resilience built into its financial structure.

This could include a significant and sudden downturn in the economy affecting financial markets, a rating methodology change, government actions relating to the water sector as a whole, or even regulatory actions resulting in a downgrade by rating agencies. We anticipate that such circumstances would be exceptional and are likely to be temporary until planned remedial actions are implemented and can produce their effects. However, exceptional circumstances cannot be ruled out and this leads to the issue of enforcement actions by Ofwat. We believe that such circumstances should not lead to enforcement by Ofwat.

We acknowledge that Ofwat has stated in the consultation document that it would take account of the circumstances that have caused the contravention to the obligation when deciding what steps to take.

Our preference would be to have a statement in the licence condition itself about ensuring that any enforcement action is proportionate having regard to the circumstances that caused the downgrade. Alternatively, Ofwat should formally state its enforcement policy in relation to any failure to maintain an investment grade credit rating.

We are concerned that Ofwat may have limited its enforcement flexibility by imposing an absolute obligation and that non-compliance with the requirement to maintain an investment grade credit rating may only be dealt with under sections 18 and 19 of the Water Industry Act

1991. The clarification of Ofwat's enforcement policy should for example consider whether Ofwat believes it would still have additional flexibility and also how Ofwat may consider the exceptions set out in section 19(1) about the extent to which a company actually contributed to a contravention as well as how Ofwat may use undertakings especially in circumstances that are beyond the reasonable control of companies. In this respect, care would need to be taken to make sure that any enforcement process or undertaking is designed to allow a company the means and the time required to take necessary actions having regard to requirement of and rights of third parties set out in its finance documentation.

Such clarifications would provide our board some comfort that enforcement actions would be proportionate based on an objective statement of policy. This is a consideration all boards would be able to take into account when deciding whether or not to consent to the revised condition provided that the clarifications are published with any formal consultation on licence modification under section 13 of the Water Industry Act 1991.

QUESTION 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? (See Annex: Condition P7)

We agree with the proposal which reflects current practices. Please see our comments on the drafting of this definition set out in our response to question 7 below.

QUESTION 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? (See Annex: Condition P7)

We agree with the proposal.

QUESTION 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? (See Annex: Condition P9)

We agree with the proposal.

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

We believe that providing regular feedback on good practice and Ofwat's expectations will help companies achieve consistency in reporting.

QUESTION 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? (See Annex: Condition P10)

We recognise that it would be difficult to issue exhaustive guidance in advance covering all possible topics but regular updates on actual reporting received, Ofwat's expectations and examples of good practice would be helpful to achieve consistency between companies. Ofwat would also need to define the timeframes (out of hours or next working day for example), channels and contacts for reporting. Will it be centralised or will different channels be used for different topics? What follow up steps may be required following the initial notification?

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

New obligation to comply with a direction to enforce a condition P undertaking

We comment on two particular areas of concern that relate to the direction to enforce a condition P undertaking. The first relates to the grounds under which this would be issued and the second relates to the procedural steps that should be included to ensure a better overall outcome and alignment with good regulatory practice.

We maintain as set out in our previous response that we do not support the need for the introduction of a licence condition to enforce a condition P undertaking in appointees' instruments of appointment.

An appointee would only have grounds to enforce a condition P undertaking against an ultimate controller if it was itself contravening an obligation as a result of the act or omission of that ultimate controller. In such circumstances, Ofwat already has relevant powers under the Water Industry Act 1991 to require the appointee to comply with its obligations (which in turn would force the appointee to consider and if necessary to exercise its rights under the condition P undertaking against the ultimate controller). A failure by the appointee to comply with an order would also open up liability to third parties who may suffer a loss as a result of

the breach by the appointee. There are also existing restrictions on the ability of the appointee to enter into new arrangements with ultimate controllers and relevant associates when there is a breach of an undertaking.

As has been raised by several respondents, we do not believe that imposing such a condition is therefore necessary or proportionate. The decision to start legal action should also remain a prerogative of the boards of appointees making a proper assessment of the circumstances and following legal advice.

The proposed new condition is drafted as follows: "The Appointee must comply with any direction given by the Water Services Regulation Authority to the Appointee to enforce the terms of an undertaking given to it […]."

Ofwat's right to issue a direction is not subject to any express condition or legal test. A direction should logically only be issued in cases where the appointee contravenes an obligation (because only then would a condition P undertaking be enforceable) but this is not set out as a condition for issuing a direction.

Even if in practice a direction was issued where the appointee is contravening an obligation, the direction to enforce the undertaking itself would not per se be an enforcement measure (it is a direction to the appointee to enforce a right against a third party not an order requiring the appointee to comply with an obligation).

In addition there is also a lack of clarity about the purpose of the new provision and when would Ofwat expect to use this new power. We are particular keen to understand for which purposes Ofwat would use this new right.

We considered a range of scenarios ourselves and would like to thank Ofwat for giving us the opportunity to discuss some of them and for providing additional details.

This new condition would not come into play if an appointee failed to obtain a condition P undertaking from an ultimate controller as required in the instrument of appointment. This could only be enforced by Ofwat against the appointee under section 18 of the Water Industry Act 1991. It would not be possible for Ofwat to issue a direction to the appointee as there would not yet be any undertaking that the appointee could enforce.

Ofwat would obviously need to ensure that any direction is issued for the purpose of and in compliance with its general duties but this still allows a wide range of possible scenarios that cannot be identified at this stage (especially in the absence of specific criteria or conditions in the wording of the new provision).

This new condition also opens up the theoretical possibility that Ofwat could over time impose obligations or outcomes on companies through regulatory mechanisms that it may only be possible to achieve through specific actions taken by shareholders. Ofwat would then be able to direct companies to enforce the undertaking to ensure shareholders act accordingly. This could result in obligations being imposed on shareholders indirectly outside of the intended regulatory regime and the controls and safeguards associated with it in a way that we cannot predict. We do not suggest it is Ofwat's intention to impose such obligations,

but note that the consultation document did not address the issue and that the wording of the condition does not include provisions designed to address this risk.

The combination of insufficient clarity on the possible use of this right by Ofwat and the absence of express conditions or legal test to issue a direction creates legal uncertainty. This is also a governance issue for our board who may be requested to consider whether or not to express their consent to a licence modification without having sufficient information or adequate provisions in the condition itself to be able to assess its effect on the company. Additional clarity from Ofwat would support companies in following good governance.

Ofwat should therefore provide in its decision document or in support to any further consultation, specific examples of circumstances in which it would need to use this new power explaining why other powers it already has would not allow it to take appropriate actions.

In our view, Ofwat's proposal needs to be reviewed to reduce this uncertainty. Minimum conditions for issuing a direction such as the existence of a breach of an obligation by the appointee and some safeguard against imposing obligations on shareholders should be included in the wording.

We understand that it would be difficult to set out in the condition the purposes for which a direction may be issued. However, once the changes suggested in the previous paragraph have been made, the remaining uncertainty could be mitigated by including some procedural steps within the licence modification.

Currently the main procedural requirement relating to a direction would be under section 195A of the Water Industry Act 1991 which only requires Ofwat to publish reasons after issuing the direction. However, any effective procedural safeguard would need to be before the direction is issued and a consultation process on the intention to issue a direction would provide such safeguard.

We also believe that including a consultation stage which would provide additional proportionality, transparency and help targeting any regulatory intervention would ensure that a new condition would more closely follow the principles of best regulatory practice.

This would ensure that the issues and solutions have been considered by all parties and that all relevant facts have been properly provided to and considered by Ofwat.

Issuing such a consultation would be as effective as issuing a direction but would be a more progressive approach that would help limit the cost and disruption for companies.

If a consultation was published by Ofwat, the pressure on the ultimate controller would be considerable from the board of the appointee including its independent non-executive directors, other shareholders and interested third parties. There would also be significant reputational damage for the company and the ultimate controller. We believe that in all but the most exceptional cases this would lead to a quick resolution of the issues raised by Ofwat.

For these reasons we also believe that the time spent in consultation would not delay the regulatory outcome for Ofwat. If a direction and formal enforcement of the undertaking was ultimately required any proceedings to enforce the condition P undertaking would take time to complete and it would always be worth going through the consultation process first to try and avoid lengthy court proceedings and reach a quicker outcome.

Comments on the drafting of the obligation to maintain an investment grade credit rating

The new condition P 7.2 includes a different requirement from our existing condition where an associated company issues corporate debt on behalf of the appointee. A comparison between South East Water's current condition and the new condition P 7.2 is shown below.

SEW CURRENT CONDITION	**NEW STANDARD CONDITION P**
F 6A.6 (1)	**P 7.2**
The Appointee shall use **all reasonable endeavours to ensure** that it, or any Associated Company as an issuer of corporate debt on its behalf, maintains at all times an Issuer credit rating which is an Investment grade rating.	The Appointee **must ensure** that it and any Associated Company which issues corporate debt on its behalf maintains, at all times, an Issuer Credit Rating which is an Investment Grade Rating.

As highlighted above there is a change of drafting which means that when, as is the case for South East Water, an associated company issues corporate debt on behalf of the appointee the new requirement is that both the appointee itself and the associated company issuer must maintain an investment grade credit rating. The previous obligation was satisfied if the associated company (but not necessarily the appointee) maintained an investment grade credit rating.

We have considered the revised condition P 7.2 in the context of the other changes proposed and we believe that the use of "and any" in the new condition P 7.2 can be mitigated by the introduction of the concept of Corporate Family Rating in the definition of Issuer Credit Rating. However, we would prefer that the use of "or any" be maintained.

South East Water is a member of a corporate group with a Corporate Family Rating and by virtue of being a member of that group holds an investment grade credit rating. Therefore both South East Water and its associated company issuer hold an investment grade credit rating.

However, for greater certainty, we would also require the following amendments shown in bold underlined to the definition of Issuer Credit Rating:

"**Issuer Credit Rating**" means, either;

(a) an issuer credit rating assigned to an issuer of corporate debt by a Credit Rating Agency; or

(b) a Corporate Family Rating assigned by a Credit Rating Agency **(1)** to the Appointee **directly; or (2) to any Associated Company which issues corporate debt on behalf of the Appointee (and for these purposes, the Corporate Family Rating of an Associated Company which issues corporate debt on behalf of the Appointee shall be deemed to be the Corporate Family Rating of the Appointee also)** for so long as **such Associated Company and** the Appointee continues to be a member of ***that*** corporate group approved for this purpose by the Water Services Regulatory Authority**; or**

(c) where the Appointee does not have an Issuer Credit Rating as defined in a) or b) above, a credit rating assigned by a Credit Rating Agency to the senior debt issued or guaranteed by the Appointee or an Associated Company which issues corporate debt on behalf of the Appointee.

The amendment in b) above is to take account of the fact that the Corporate Family Rating may not technically be assigned to the Appointee directly but may be more accurately described as being assigned to the relevant corporate group or to the issuer within that group (which may be an associate of the appointee) and benefit the other members of that group.

The amendment in (c) above is to take account of the fact that certain rating agencies only provide credit ratings in respect of the debt obligations (i.e. the actual bonds) of an issuing entity, rather than providing a rating for issuing entity and so the current proposal for the Issuer Credit Rating definition does not capture this aspect of the nature of credit ratings. The reason for this approach by the rating agencies is that the debt of a corporate may have different ranking and features – and hence a different credit profile. For example, if an appointee was to issue bonds which were Subordinated Debt, these would likely have a different rating to Senior Debt.

We also seek specific written confirmation from Ofwat that the proposed change (with or without our proposed amendments) would not put South East Water in a technical breach if the new condition was introduced in its instrument of appointment.

We would also like Ofwat to clarify how the approval of the relevant corporate group (as provided in the definition of Corporate Family Rating) may be formally confirmed by Ofwat when it introduces the new condition in companies' instruments of appointments.

Finally, we would welcome some clarification on the following statement made on page 9 of the consultation document:

"*It should be noted that the form of licence condition included in Condition P requires that companies maintain at least one investment grade credit rating, but does not require that every one of its ratings should be investment grade."*

When an appointee holds more than one issuer credit rating the lock-up provisions are triggered if any one or more is not an investment grade credit rating (i.e. they must all be investment grade). Please refer to condition F6A.7 (1) for our existing condition and the new condition P 7.3. This is difficult to reconcile with the highlighted sentence above and we would like to obtain clarification on the intended overall effect of the new credit rating and lock-up provisions.

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