Wessex Water
YTL GROUP

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Ofwat

Direct line: [redacted]
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by email

Dear Rachel

Wessex Water's Response to Ofwat Consultation on Strengthening the Regulatory Ring-fencing framework

Thank you for the opportunity to respond to this consultation. We appreciate the effort made to give us time to fully consider these potential changes. We have now done so and have set-out the responses to your specific consultation questions in an appendix.

Overall, we are not persuaded that there needs to be complete consistency in the ring-fencing arrangements across the water sector. Our existing arrangements have proved to be resilient and we are not aware of evidence that would explain why the existing provisions are no longer fit for purpose.

The changes proposed could also act against the public interest, in particular:

- The change to "must" maintain an investment grade introduces a cliff-edge breach of licence that would be undesirable particularly if it was precipitated by an external event over which management had no control and if it required a reduction in service levels.
- The cash lock-up provisions encourage companies to limit the number of ratings agencies to the bare minimum (i.e. one).
- They may have impeded the smooth sale of Wessex Water to YTL in 2002 when Enron was in financial difficulty.

We assume that the cash lock-up is designed to delay or forestall a more serious deterioration in an appointee's financial condition, and recognises that – in most but not all circumstances – there will be warning signals to which the appointee must respond. The cash lock-up clause itself would therefore in our view potentially sit much better alongside the existing all reasonable endeavours requirement for an investment grade rating.

The Board is also concerned about the uncertainty created by introducing a licence obligation to report material issues without guidance on what would constitute a material issue. Similarly, the proposed definition of change of control is imprecise and so we have suggested a form of words that could usefully be used to ensure that company Boards can be clear that they are meeting their obligations.

I hope you find this helpful. We would be pleased to have further discussions on this matter, in particular to understand how we can give you greater confidence that the existing licence provisions and how they are applied by the Board are sufficient to protect the public interest.

Very best wishes,

Andy

Andy Pymer
Managing Director

Appendix: Wessex Water Services Ltd - Responses to consultation questions

Investment grade credit rating

[1] Do you agree with, or have any further comments to make with respect to, the proposal that all Appointees' licences require that they "must ensure" they maintain an appropriate investment grade credit rating at all times? Do you think that this would give rise to any particular issues of a practical nature? If so, please explain and provide evidence of these impacts.

Reasonable endeavours obligations have a fairly well understood meaning under English law, requiring an obligor to take reasonable steps to achieve the stated end without sacrificing its own commercial interests. These obligations sit at one end of a spectrum of possible formulations that also includes (in increasing order of onerousness on the obligor) "all reasonable endeavours"; and most exacting of all, an absolute obligation such as "the Appointee shall procure that x" or "must ensure y".

Absolute obligations are unconditional, i.e. they require the obligor to carry out the obligation no matter how difficult or costly it becomes to do so. An absolute obligation to maintain a certain credit rating may necessarily require an appointee to take actions that lead to a deterioration in customer service: the maintenance of an investment grade credit rating might be good overall for customers in the long term, but remedial actions necessary to maintain such a rating in a situation where an appointee is subject to a "must ensure" obligation would not necessarily be in customers' interests.

Investment grade credit ratings by their very nature do not sit naturally with an absolute obligation because they depend not only on the actions of individual appointees, but also on the structural and regulatory features of the industry as well as the economy as a whole, many of which are entirely or partly outside of the obligor's control (and some of which fall squarely within Ofwat's remit). Absolute obligations are normally only agreed to in circumstances where an obligor has full confidence in being able to achieve the specified outcome both now and on an ongoing basis (or where breach is a possibility but the obligor is unconcerned about the consequences).

Given that maintaining an investment grade credit rating depends to a significant extent on external factors over which appointees do not have control, a "must ensure" standard is arguably not appropriate in these circumstances. For this reason, we would consider an "all appropriate steps", "best endeavours" or "all reasonable endeavours" standard (to which Wessex Water is currently subject) more appropriate, as it would be breached by culpable failures to stop a deterioration in the company's financial condition over time, but not by unavoidable changes that damage a company's credit rating.

In addition, a "must ensure" standard necessarily invites an undesirable cliff-edge effect in a way that "best endeavours" type obligations do not: appointees could effectively be put in breach of their licences overnight. We note that this point was made by some respondents to the Thames Water consultation earlier this year. Ofwat notes in the November Consultation that "we understand that events may happen which reflect factors in the wider economy or which appear to be outside the control of the Appointee and which can impact the sector as a whole rather than individual companies. We consider that such circumstances can properly be taken into account in our consideration of the approximate, proportionate action to take under our enforcement procedures, for example, in terms of our consideration of any action the company is taking to address a failure to comply with their obligation." This will presumably not be in the terms of the licence and so is of limited comfort.

In circumstances where a remedy may not be readily available, the appointee would be in jeopardy of losing its licence. It is therefore not enough to rely on Ofwat's enforcement policy to determine what it is appropriate for the appointee to have done. The concept of the quality of the appointee's endeavours, or steps taken to ensure compliance, should be enshrined in the licence.

Finally, this requirement and the cash lock-up (see below) ought to be seen in the round. The cash lock-up is designed to delay or forestall a more serious deterioration in an appointee's financial condition, and recognises that – in most but not all circumstances – there will be warning signals to which the appointee must respond. In that sense, the presence of a cash lock-up where there is a prospect of a downgrade from investment grade is a more natural complement to an "all reasonable endeavours", "all appropriate steps", or "best endeavours" standard.

Cash lock-up

[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?

We do not agree that the cash lock-up provisions proposed are appropriate in the context of a separate absolute requirement to maintain investment grade rating.

The purpose of a cash lock-up is to prevent management from using cash for the prohibited purposes, in circumstances in which the business needs it for financial security. Financial security is not, however, necessarily shored up by restricting the uses to which the company's cash may be put, and indeed such restrictions can stand in the way of financial security.

This is most obviously the case where a cash lock-up deters equity investors, and so perversely reduces the availability of capital. The more uncertain a company's future credit rating is, the stronger this effect becomes – resulting in a risk of the equity markets closing suddenly and unpredictably for companies subject to a cash lock-up, even in response to small and relatively immaterial financial setbacks. Wessex Water itself was sold out of the financial difficulties of its previous parent Enron in 2002, and this sale may have been complicated if a cash lock-up had applied to it at that time.

Cash lock-up provisions address essentially the same issue as the "must ensure" investment grade rating proposal, which enables Ofwat to impose such controls as it sees fit where the credit rating falls below the stipulated threshold. A cash lock-up therefore fits much more naturally with a "best endeavours" clause than an outright obligation:

(i) the "best endeavours" clause will be breached by culpable failures to stop a deterioration in the company's financial condition over time, but not by unavoidable changes that damage a company's credit rating, which arguably are not the proper subject of a condition intended to incentivise the company to maintain financial security;

(ii) a ny such unavoidable changes would, however, trigger the cash lock-up, which prevents cash haemorrhage and acts as an early warning to encourage remedial action.

We also note that that the cash lock-up would create an incentive for appointees to reduce the number of rating agencies with whom they maintain relationships, to reduce the risk that they are locked up by one rating agency taking a more negative stance than the others.

Ring-fencing certificates
[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?
[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 are content with the proposals in the consultation.

Given that this requirement has been in place for some time and that Ofwat may request any further information it requires in particular cases, we are content with the expectations that Ofwat has set-out.

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

We do not agree.

The requirement to report material issues is in our view superfluous, as it addresses the same issue as the obligation to notify Ofwat of circumstances which would cause the company to change the opinion on which its last ring-fencing certificate was based. If an event occurred which invalidated the latest certificate, it would by definition be material to the carrying out of the appointee's Regulated Business.

The meaning of "material" in this context is unclear and open to debate – so introducing a "material issues" reporting obligation works against Ofwat's desire to provide clarity, and to move away from qualitative judgments and towards tests based on observable fact. This potential confusion is compounded by the examples that given in the consultation, some of which clearly fall by necessary implication into the category of matters that the certificates cover; and some of which would do so in the event they were material.

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

We view the obligation to inform Ofwat of likely changes of Ultimate Controller as problematic, for a number of reasons:

- There is no necessary reason why a company should know of a "likely" change in its Ultimate Controller, and indeed it may be totally unaware of such a change until it becomes public, or unable to assess the substance or otherwise of rumours, and therefore whether the change is "likely" to occur.
- If a company does become aware of a likely change of Ultimate Controller, it may be forced to choose between breaching confidentiality and breaching its licence. This could be made especially complicated where public companies are involved and the information is price sensitive.
- Assessing whether a change is "likely" is inherently uncertain, and necessarily viewed in a different light once the relevant change has actually taken place. It will be difficult for appointees to demonstrate that they chose the correct time to notify Ofwat and therefore difficult for them to know whether they are in compliance with the obligation.

Additionally, Ofwat's definition of "change of control" is imprecise. Different strands of corporate and commercial law adopt differing definitions of "control" or "influence", including >50% of voting rights (positive control), >25% of voting rights (negative control), "decisive influence" (the EU merger control test) and even lower thresholds (e.g., the CMA's definition of "material influence" could include shareholdings of ≤15%).

In practice, any assessment of material influence or control (positive or negative) requires consideration of both legal rights (for example, to block a special resolution) and contractual rights (typically contained in a shareholders' agreement or joint venture agreement). There is, however, an established line of EU and UK case law governing what constitutes "control" or "material influence" for merger control purposes. Companies and their advisers are, as a result, well able to determine whether a change of control or material influence falls within the jurisdiction of the EU or UK merger authorities, and we recommend adopting this criterion for that definition.

We would therefore propose revised wording as follows:
"3.6 The Appointee shall inform the Water Services Regulation Authority as soon as reasonably practicable if the Appointee has reasonable grounds to believe that arrangements have been put into effect which, or are in progress which if carried into effect would:
(a) constitute a change of control or material influence affecting the Ultimate controller(s) of the Appointee, and
(b) fall, or be likely to fall, within the jurisdiction of the European Union and/or United Kingdom merger control authorities."