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

1. Introduction

Ofwat is a statutory body with responsibility for regulating water and sewerage companies in England and Wales. Ofwat has powers¹ to insert conditions into companies' licences that prohibit an Appointee from doing things that are specified in the licence without the consent, agreement or approval of Ofwat, as well as the power to provide a determination on a particular issue. These are variously referred to as consents, approvals, determinations and agreements throughout the licence and are all collectively referred to as 'consents' in this guidance.

This guidance specifically relates to those consents that are part of the regulatory ring-fencing framework² where we are most commonly approached for consent and where there are particular licence conditions that aim to protect the financial resilience of the company and to protect its customers while recognising that there may be occasions where exceptions to those provisions are required. For clarity, this guidance covers those provisions in the regulatory ring-fence where an Appointee is expressly prohibited from entering into an arrangement without the consent of Ofwat. The Annex to this guidance sets out the particular consent provisions to which this guidance applies.

There are other licence conditions which provide for Ofwat to grant consent to an Appointee as well as consenting provisions in the definitions of certain terms in the regulatory ring-fence. While this guidance is not directly applicable to those other conditions or definitions as they are not express licence prohibitions, and our assessment will need to reflect the nature of each of those provisions and the circumstances, we think it is appropriate for companies to aim to follow the process set out in this document when seeking consent under those provisions and we expect our assessment framework to adopt the relevant parts of the guidance. In any event, we encourage companies to engage with us in a timely manner when considering the need for any consent under their licence.

The aim of this guidance is to ensure that companies are aware of the processes that we have in place to ensure a robust, consistent and transparent assessment of requests for consents, including the need for submission of the appropriate evidence to enable Ofwat to carry out a careful consideration of the proposed arrangement. We set out in this document our expectations when an Appointee makes a request to Ofwat for a grant of consent. We also set out our process including how we will assess that request.

¹ Under the Water Industry Act 1991

² In this document we use the term "regulatory ring-fencing framework" to refer to the ring-fencing licence conditions in all companies' 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 company.

We want to ensure that we are fully equipped to consider any requests for consents thoroughly and to ensure, consistent with our statutory duties, that the interests of customers are protected, and that companies remain able to carry out their functions and to be financially resilient. Overall, therefore, such arrangements must be in customers' interests, both short and long term.

The regulatory ring-fencing framework

The regulatory ring-fencing framework 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 their corporate group.

Each company's regulatory ring-fence consists of licence conditions which place specific obligations on it. The ring-fencing provisions, amongst other things, restrict the Appointee's ability to enter into transactions with associated companies and its ability to maintain agreements which include cross default obligations or guarantees, without the prior approval or agreement of Ofwat.

The ability to seek a derogation from the underlying prohibition acknowledges that there may be circumstances where departures from these protections are appropriate. A company who wishes to enter into an arrangement that is otherwise prohibited by their licence will need to get the prior, written approval of Ofwat to that arrangement before it can be entered into.

2. Our assessment framework

This section sets out our expectations of companies when they come to us with a request for consent and the approach that we intend to take.

The purpose of our assessment is to ensure that the entry of the Appointee into a particular arrangement, otherwise prohibited, is demonstrably in the interests of customers and the Appointee in line with our statutory duties.

It is the responsibility of the Appointee to demonstrate how their proposed arrangement meets this requirement. It is intended to be a high bar and there should be no expectation that we will necessarily provide consent to certain arrangements even if they are similar to arrangements which we have consented to in the past. We will examine each request on its own merits.

Certain arrangements may carry risks to customers and/or to the financial resilience of the Appointee. We expect companies to explore these risks objectively and to present evidence as to how the risks considered could be mitigated or avoided. If we are not persuaded that a particular arrangement – such as where an Appointee makes a loan to a parent company – can demonstrate to our satisfaction that these risks can be adequately addressed in both the short and long term, or if the arrangement is demonstrably against the interests of customers or the Appointee, then Ofwat will not grant consent to that arrangement.

In contrast, there are other arrangements where we expect that it will be more straightforward for an Appointee to evidence why the grant of a consent for that arrangement is in the interests of customers. One example of such an arrangement may be where we are asked to approve an Appointee entering into a cross-default obligation with a financing company where that financing company is acting purely on behalf of the Appointee and this arrangement would allow the company to put in place efficient finance which could not otherwise be secured.

In the event that Ofwat decides that it is appropriate to do so, we will grant the requested consent to the Appointee and publish our reasons for the grant of that consent. Where appropriate, any consent may include bespoke conditions to help mitigate any risks to customers or to protect the financial resilience of the Appointee, including to take account of any potential relevant changes in circumstances. For each consent we will consider whether it is in customers' interests to time-limit the consent. Any conditions will be decided on a case by case basis and will be proportionate, targeted and focused on the outcomes that our guidance aims to achieve, for example, when we approve guarantees to an associated financing company 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 would have only a negligible impact on the regulated business.

It is the responsibility of the Appointee to ensure that it possesses all the necessary consents before entering into any arrangement. Companies should alert us whenever they intend to enter into an arrangement that may need consent. This guidance applies to new requests for consent and does not affect the status of existing consents that have been granted by Ofwat. However, as has always been the case, a material departure from arrangements to which we have previously consented or a breach of any condition of the consent would invalidate that consent. The onus is on the Appointee to ensure any material changes to existing arrangements to which Ofwat has previously granted consent are notified to Ofwat, for example, where there is a change to the parties to an arrangement. Such changes will be considered according to the framework set out in this document. Consents granted by Ofwat cover only the entities specified in the consent letter and are not transferable within a corporate group. For the avoidance of doubt, in the event that the consent letter is silent on this point, the consent granted only applies to the particular arrangements set out in the consent letter.

Guidance on submitting a request for consent

We expect Appointees to set out in their request for consent how the intended arrangements are consistent with our statutory duties, and ensure that the interests of customers are protected and that companies remain able to carry out their functions and to be financially resilient. We want to see evidence from the company when requesting a consent that they can clearly demonstrate these points and therefore how, overall, the proposed arrangements are in customers' interests, both in the short and long term. We see factors that are in the interests of customers as a broad concept that can include direct or indirect benefits.

The table below sets out the information required from companies when submitting a request for a consent. If there is more than one licence condition that is applicable to a proposed arrangement, then the information should be clearly set out for each particular consent that is required.

| Information category | Explanation of the proposed arrangement |
|---|--|
| Description | <ul style="list-style-type: none"> • Set out the licence condition that is applicable to the proposed arrangement. • Set out the details of the proposed arrangements including the key contractual structures, named entities, structure charts, key responsibilities and liabilities, and any terms or conditions that are attached to the proposed arrangement. |
| Purpose of proposed arrangement | <ul style="list-style-type: none"> • Provide a detailed explanation of the purpose of the proposed arrangement including as to why it is necessary for the Appointee to enter into it and why it is in the interests of customers. |
| Alternative options | <ul style="list-style-type: none"> • Set out if relevant: whether there are any alternative approaches (which may or may not require consent), for example other potential financing options that could be taken by the Appointee; to what extent they have been explored; and why the proposed arrangement that requires the consent is the most appropriate and will allow the Appointee to deliver the stated purpose. |
| Impact of the proposed arrangement | <ul style="list-style-type: none"> • Provide any qualitative assessment which is appropriate to demonstrate how the proposed arrangement ensures that the interests of customers are protected, and the expected impact of the proposed arrangement on the Appointee. • Provide quantitative analysis with key inputs, assumptions, calculations and models where applicable to support your assessment. |
| Risk assessment | <ul style="list-style-type: none"> • Provide a risk assessment setting out the risks that may arise as a result of putting the arrangement in place, including the risks to customers (actual or potential) that may arise as well as risks to the ability of the Appointee to carry out its functions both in the short and longer term. • Provide key inputs, assumptions, calculations or models where applicable to support your assessment. • Provide any risk mitigation or avoidance actions that could be taken by the Appointee to minimise or eliminate risk to customers or the Appointee. |
| Supporting evidence | <ul style="list-style-type: none"> • Provide supporting evidence to justify why the consent should be granted to the Appointee. This might include (but is not limited to), depending on the nature of a request, financial analysis/models, relevant legal documentation, market reports etc. |
| Timing | <ul style="list-style-type: none"> • It is helpful to let us know as soon as possible any timings which are relevant either to the grant of consent or the entry into the proposed arrangement. |

We encourage companies to provide us with as much notice as feasible before submitting a formal notification of a request for consent. We advise companies to contact us in advance of their submissions to discuss the nature of their consent request and seek an initial steer from Ofwat on the kind of information we might require in order to be able to assess the proposed arrangement.

We will always aim to process requests as soon as practicable, but the length of our assessment will depend on the nature of the proposed arrangement, the consents requested and the complexity of the issues to which they give rise. We can therefore not guarantee the grant of a consent or any decision within a particular timeframe.

As a general principle, companies should only submit their formal requests to Ofwat when they have sufficiently robust information and evidence to provide to us so that we are able to conduct a meaningful assessment. Companies need to ensure that they have followed the table above as a guide to the kind of information that we require and we will not commence our assessment if there are obvious missing elements.

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.

In the section below, we set out in more detail what we expect companies to demonstrate when setting out why they believe consent should be granted to their proposed arrangement.

Demonstrating the impact

For each consent request, we ask that the Appointee considers and clearly evidences the impact of their proposed arrangement and the risks it may present. The presentation of any impact and risk needs to show how both the entry into the proposed arrangement and the grant of the consent to that arrangement is consistent with our statutory duties, protects the interests of customers and ensures that companies can remain able to carry out their functions and to be financially resilient, both in the short and long term.

The Appointee should follow the guidelines set out in the table in order to be able to robustly substantiate its case in terms of the impact of the proposed arrangement.

The following, non-exhaustive examples may assist companies when they come to determining whether the impact of their proposal is consistent with Ofwat's statutory duties:

- Companies should consider and fully explain the impact of the proposed arrangement on customers: we want to understand how the proposed arrangement is in customers' interests as well as how these interests will be sufficiently protected through the proposed arrangement. This will be one of the key determinants in our decision making process. Companies should outline any potential risks to customers and the protections that are in place, while also clearly setting out how they intend to mitigate or avoid those risks from occurring and the likely success of this. Where practicable, the Appointee should quantify the benefit and provide the analysis underpinning the numbers.
- Companies should also be able to explain how they consider the proposed arrangement and the requested consent are necessary to deliver any benefits to the Appointee. This should also include an assessment of these benefits against any risks of entering into the arrangement. We encourage companies to discuss these potential benefits and risks with us in advance.

Annex – The Ring-Fencing Consents within the scope of this guidance

| | Summary description of Consent Provision | Condition ³ |
|---|--|------------------------|
| | Ultimate Controller: | |
| 1 | The Appointee shall not, without Ofwat's written approval, enter an agreement with its ultimate controller or its subsidiaries, other than subsidiaries of the Appointee, while there is no ultimate controller undertaking in place or there has been an unremedied breach of the ultimate controller undertaking | P3.3 |
| | Transfer Pricing and Cross-Default Obligations | |
| 2 | The Appointee must not, without prior approval from Ofwat, give a guarantee in relation to any liability of an Associated Company | P6.3(a) |
| 3 | The Appointee must not, without prior approval from Ofwat, make a loan to Associated Company | P6.3(b) |
| 4 | The Appointee must not, without prior approval from Ofwat, enter into an agreement or other legal instrument incorporating a cross-default obligation or continue to permit to remain in effect an agreement or commitment incorporating a cross-default obligation | P6.3(c) |
| 5 | The Appointee must not, without prior approval from Ofwat, continue to permit to remain in effect an agreement or commitment incorporating a cross-default obligation. | P6.4 |
| 6 | The Appointee shall not, without the consent of Ofwat, transfer to any Associated Company particular rights or assets that fall within P6.14 in the event of a special administration order. | P6.5 |
| | Cash Lock-Up | |
| 7 | 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 in the event of cash lock-up other than in particular specified circumstances. | P7.4 |

³ This column sets out where these provisions appear in the licences of those companies with an updated Condition P as some companies currently have these provisions in Condition I and some in Condition P. We are intending to draw all ring-fencing provisions into Condition P of the 17 largest regulated companies.

⁴ P6.1 states that the Appointee must ensure that:

- (a) every transaction between the Appointed Business and any Associated Company is at arm's length, so that neither the Appointed Business nor the Associated Company gives a cross-subsidy to the other; and
- (b) the Appointed Business neither gives nor receives any cross-subsidy from any other business or activity of the Appointee

in accordance with Regulatory Accounting Guideline 5 (Transfer Pricing in the Water and Sewerage Industry) published by Ofwat and revised from time to time.

Ofwat (The Water Services Regulation Authority)
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