

The proposed acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig - Proposed licence modifications

Ofwat today published *The Proposed Acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig – A position paper by Ofwat*. In Annex B, of this paper Ofwat set out the broad purpose and principles of the licence conditions proposed by Ofwat and referred to this document for further detail.

Should the proposals proceed, Ofwat will require Glas to agree to a package of licence modifications and new licence conditions. These are set out below along with the licence modifications agreed with Western Power Distribution upon its acquisition of Dwr Cymru.

If Glas agree to these modifications the Director General of Water Services (the Director) will instigate a period of statutory consultation on them. If Glas were not to agree to the proposed modifications then the Director has the power to refer them to the Competition Commission for a decision.

If the National Assembly for Wales was opposed to a proposed modification then it has the power to request the Director not to make it. If the Director considered that not to make the modification would be against the public interest, then he could refer the modification to the Competition Commission.

The text in bold relates to the purpose of the licence condition/modification and can be referenced to Annex B of *The Proposed Acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig – A position paper by Ofwat*. Text not in bold provides more detail.

Procurement of services

A new licence condition requiring Dwr Cymru to submit a Procurement Plan to the Director including guidance on internal controls, to be issued by the Director, to ensure that Dwr Cymru meets its legal obligations and can carry out its functions.

- 1 This condition is required to ensure that the Appointee achieves effective and fair competitive tendering of whatever services it may, from time to time, decide not to provide for itself in the performance of the Regulated Activities. To the extent that any of those services is already contracted to be performed by any third party on the date when this condition comes into effect, it will require that those services be subjected to competitive tendering, or brought in-house.
- 2 All procurement of services by the Appointee must comply with the law – especially the Transfer of Undertakings (Protection of Employment) Regulations 1981, Utilities Contract Regulations 1996 and the Competition Act 1998.

- 3 The Appointee's procurement of the activities must be such as to ensure, as far as possible, that no existing contractor has any competitive advantage over other prospective contractors.
- 4 The Appointee's procurement of activities must facilitate the development of a fully-competitive market for the provision of out-sourced services necessary for the discharge of its functions as a water and a sewerage undertaker; and demonstrate that it retains full control of all its assets, and its ability at all times discharge its functions as a water and a sewerage undertaker (including those occasions when a contractor's performance is in breach of its obligations, or a change of contractor is required for any reason).
- 5(1) The Appointee shall submit to the Director, not later than [], a Procurement Plan covering in detail at least the following three financial years. Thereafter the Appointee shall submit no less frequently than every 18 months a revised and updated Procurement Plan. The Plan shall set out how the Appointee intends to comply with the primary obligations in paragraphs 2 to 4 of this condition.
 - (2) Without prejudice to the second sentence in sub-paragraph (1) above the Director may at any time require the Appointee to submit a revised Procurement Plan if, following any reports submitted under paragraph 9 below, it appears to him that the Appointee's performance of its obligations in paragraphs 2 to 4 above is unsatisfactory.
6. The Procurement Plan shall include the following:
 - 6(1) An explanation of the activities to which the plan relates;
 - 6(2) An assessment of the current contestability of market(s) associated with each of the Regulated Activities, where relevant, as they may be performed in different parts of its Water Supply Area or, as the case may be, its Sewerage Service Area;
 - 6(3) An explanation of the number, mix and type of contracts which are currently let or proposed to be let under the plan, which must be clearly linked to and consistent with the assessment required under 6(2);
 - 6(4) Details of the procurement process(es), terms and conditions of contract, clauses and specifications. These must be supported by an explanation of how the Appointee intends to ensure that it retains proper and effective control over the prospective contractor's operations. Particular attention must be paid to the regulatory requirements relating to the quality of drinking water (and associated matters), the protection of the environment, the provision of proper service to its customers and conformity with the guidance of the Director.
 - 6(5) Details of how the Appointee will ensure that its assets, which are to be operated by any contractor will be properly maintained to deliver stable or improving serviceability to customers.

7. The Reporter shall submit to the Director at the same time as the Appointee submits the Procurement Plan to the Director a report assessing the viability and completeness of the Procurement Plan in light of the purpose and general provisions of this condition.
8. The Appointee will, at the request of any person or body, supply them with a copy of the current Procurement Plan and a summary of the report on the Plan prepared by the Reporter under clause 7.
9. At the same time as the Appointee submits its accounting statements, and at other such times as the Director may require, it must submit to the Director a written report on its procurement activities.
10. The report shall set down the extent of its compliance with the Procurement Plan, together with the a full schedule of the number and content of the contracts let or activities that have been brought in-house.
11. In all cases of non-compliance with the Procurement Plan the report must set down a full explanation of the reasons and of the measures taken or proposed to remedy each deficiency.
12. Each report to the Director shall be reviewed by the Appointee's Reporter, who shall submit his or her assessment to the Director, copied to the Appointee.
13. The Appointee must co-operate with the Reporter to enable him or her to carry out the activities required of the Reporter under this condition.

Control of operations

- i. **Strengthen existing licence clause F6 requiring water companies to have adequate financial and management resources and formally certify this to Ofwat. Amend to require Dwr Cymru to ensure that as well as having adequate financial and management resources it has adequate systems of planning and control to carry out its regulated activities. Guidance on minimum internal controls required by water undertakers is provided in Annex A**
- ii. **A licence modification prohibiting Dwr Cymru from delegating responsibility for the proper performance of its statutory functions to any other party.**

The Appointee will not either –

make any arrangement (whether contractual or otherwise) whose effect (actual or intended) is that responsibility for the proper performance of any of its functions as a Relevant Undertaker is (or may be) whether wholly or in part, transferred or delegated to any other person; or

if it is prosecuted for any alleged offence contrary to any provision in the Water Industry Act 1991 [or the Water Resources Act 1991] or any regulations made under [it/either Act], which is alleged to have been

committed in relation to any of its functions as the Appointee whose performance was, at the relevant time, covered by any agreement or arrangement with any other person, -

raise any defence of due diligence except to the extent that the defence would have been available to it if the contract or other arrangement with that other person had not been made.

Strengthening the financial ring fence

- i. A new licence modification prohibiting Dwr Cymru from holding or acquiring investments of any kind except for investments in companies that carry on one or more of the activities permitted to Dwr Cymru (but no other activity), subsidiary companies formed solely for the purpose of raising finance for Dwr Cymru's permitted activities, and investments acquired in the ordinary course of Dwr Cymru's treasury management operations provided it has appropriate risk controls and other governance procedures in place.**
- ii. A licence modification prohibiting Dwr Cymru or any of the other subsidiary of Glas from carrying out activities other than those required of, or connected with a water and sewerage undertaker.**
- iii. A licence modification requiring prohibiting the raising of any finance for the regulated business on terms which include cross default covenants.**

The Appointee shall not, without the consent of the Director (such consent not to be unreasonably withheld or delayed), enter into an agreement or incur a commitment incorporating a cross-default obligation, or continue or permit to remain in effect any agreement or commitment incorporating a cross-default obligation.

Where liability under the cross-default obligation would arise only on a default by a subsidiary company of the Appointee, the Appointee may permit that cross-default obligation to remain in effect for the period for which it was fixed by the instrument which created it, so long as its potential liability is not increased and no changes are made in the terms under which that liability might arise.”

- iv. A licence modification requiring Dwr Cymru to use all reasonable endeavours to maintain at all times an investment grade corporate rating.**

Corporate governance

- i A licence modification requiring Dwr Cymru to obtain a legally enforceable undertaking from Glas that prohibiting Glas from making**

any changes to its Memorandum and Articles of Association without Ofwat's consent.

- ii A licence modification requiring Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will provide such information as the Director may reasonably require relating to the activities and financing of Glas.**
- iii A licence modification requiring Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will provide it with the necessary information to allow Dwr Cymru to comply with its Licence.**
- iv A licence modification requiring Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will refrain from any action that would make the water company breach its Licence.**
- v A licence modification requiring the board of Dwr Cymru to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the Listing Rules of the UK Listing Authority.**
- vi A licence modification requiring the board of Dwr Cymru to have a majority of non-executive directors.**

Those companies providing the undertakings will ensure that at all times the Board of the Appointee contains not less than three independent non-executive directors, who shall be persons of standing with relevant experience and who shall collectively have connections with and knowledge of the areas within which the Appointee provides water and sewerage services and an understanding of the interests of the customers of the Appointee and how these can be respected and protected.

Availability of market and other information

- i A licence modification requiring Dwr Cymru to publish information relating to its financial and trading position and the results of its operations in line with Listing Rules for a company with ordinary shares listed on the London Stock Exchange.**

The Appointee shall, at such times and in such ways as may from time to time be required by the Listing Rules of the London Stock Exchange, publish such Information about its annual interim and final results as is by those rules required to be announced by a company whose ordinary shares are for the time being listed on the London Stock Exchange. Furthermore the Appointee shall meet on an annual basis with the relevant consumer committees to discuss its operational performance over the past financial year and its investment programme for the coming financial year.

ii A licence modification requiring Dwr Cymru to maintain the listing of a Dwr Cymru financial instrument (either a bond with a coupon related to rating or a preference share).

The Appointee shall maintain the listing of a financial instrument (Bond or Preference Shares) on the London Stock Exchange.

If the financial instrument referred to in this paragraph is a Bond, it shall bear a variable rate of interest, linked to the credit rating of the Appointee, as ascertained by reference to two independent rating agencies operating in London.

The obligation applies unless the Appointee satisfies the Director that market conditions make it inappropriate for the Appointee to maintain such a financial instrument.

GUIDANCE ON MINIMUM INTERNAL CONTROLS REQUIRED BY WATER UNDERTAKERS

1. Objective

This guidance sets down the minimum internal controls that need to be in place and in use in a water undertaker (or water and sewerage undertaker) to ensure and demonstrate that it meets its legal obligations and can carry out its functions. This guidance will be revised from time to time in the light of experience and normally only after consultation with interested parties.

2. Turnbull Report

The Institute of Chartered Accountants in England and Wales published in a *Combined Code of the Committee on Corporate Governance* and followed this up with the Turnbull Report: *Internal Control – Guidance for Directors on the Combined Code* in September 1999. Compliance with this code and guidance is necessary for companies to safeguard shareholder's investment and the company's assets and meet the requirements for listing on the London Stock Exchange.

3. Essential Services Provided By Water (And Sewerage) Undertakers

The special responsibilities and duties of water (and sewerage) undertakers arising from water legislation reinforce the need for such an enterprise to operate at all times with effective internal controls in order to comply with and carry out its statutory functions. Water (and sewerage) undertakers have onerous responsibilities where they provide essential services to customers and/or the community.

These essential services are set out below.

- Provision of wholesome drinking water to the curtilage of every customer's premises.
- The safe conveyance of raw sewage to its point of disposal vis-à-vis public health hazards
- The treatment and disposal of sewage to reduce to an acceptable minimum the risks of serious pollution of the water environment

4. General Internal Controls

Where a water undertaker provides directly all the essential services (see above) full compliance with the Turnbull Report will be sufficient to demonstrate the adequacy of its planning and internal controls. Such compliance is a precondition for a water undertaker to sign its annual F6A certificate required by Ofwat. The water company's Auditor, where appropriate assisted by its Reporter, will provide expert and independent endorsement of this compliance for Ofwat.

5. Supplementary Internal Controls Where Essential Services Are Contracted Out

Where a water undertaker enters into contracts with third parties for them to provide any or all of the essential service(s) then supplementary internal controls (in addition to 4 above) are necessary. These are necessary to demonstrate the retention of adequate direct management control of key aspects of these services that is consistent with the undertaker's statutory duties.

□ Water Service Supplementary Internal Controls

- (1) There should be a *Water Quality Committee* (WQC) whose responsibility is advising on all aspects of the undertaker's policies for maintaining compliance with the Drinking Water Regulations, reviewing performance against these on at least a monthly basis and submitting a monthly report of any contraventions of drinking water quality standards and an annual Water Quality Report to the Drinking Water Inspectorate (the content of which to be agreed with the Inspectorate). A non-executive member of the board of the undertaker should chair the WQC. The membership of the committee should include undertaker's executive director responsible for the proper provision of water services – Operations Director, and independent experts in both the health aspects of water supply and water service operations. The minutes of the WQC should be received by the board and annexed to the Water Quality Report. Any decisions of the WQC that are **not** endorsed and acted upon by the undertaker must be drawn to the attention of the DWI immediately.
- (2) Any contract for the formal water quality sampling and analysis required by the Regulations should be separate and completely independent of any operational service contract. Results of the analysis should be sent to both the undertaker and the operating contractor.
- (3) All water quality compliance policies and practices must be the sole responsibility of the water undertaker. In deciding on these policies and practices the undertaker must take full and proper account of guidance issued by the DWI and the advice of the WQC.
- (4) The operating contractor must comply fully with the policies and practices stipulated by the undertaker and as directed by the Operations Director irrespective of the terms of the contract.
- (5) The operations contractor must provide the Operations Director with information on a daily basis as to its activities as they may affect drinking water quality and the water quality performance of each water treatment works. These daily returns should be summarised in a weekly report from the contractor to the undertaker. There should be weekly meeting between the Operations Director (and his/her staff) and the contractor reviewing both performance and the forward programme of work as it relates to maintaining drinking water compliance. The contractor must obtain the Operations Director agreement to the forward programme of work on a week by week basis.

- (6) The operating contractor must inform the Operations Director immediately of any incident notifiable under the Information Direction 1998 (or future replacement issues). Once notified, the Operations Director, or a senior member of his/her staff, must satisfy himself/herself that the incident is being handled effectively in the protection of public health, and in the avoidance of supplying water unfit for human consumption and, if not so satisfied, to take direct control with the full executive authority to manage the operation until the incident is over. Should there be an incident requiring an Outbreak Control Team, the Operations Director or a senior member of his/her staff would be involved together with appropriate staff from the operating contractor.
- (7) The undertaker's Reporter will be required to review, audit, challenge and report to Ofwat and the DWI on the effectiveness of the supplementary internal controls.

□ **Sewerage Service Supplementary Internal Controls**

- (1) There should be a *Environmental Quality Committee* (EQC) whose responsibility is advising on all aspects of the undertaker's policies for maintaining a safe sewerage system and compliance with the Environment Agencies consents, reviewing performance against these on at least a monthly basis. The EQC should submit an annual Environmental Quality Report to the Environment Agency. A non-executive member of the board of the undertaker should chair the EQC. The membership of the committee should include undertaker's executive director responsible for the proper provision of sewerage services – Operations Director, and independent experts in both the water environment and safe operation of sewerage systems. The minutes of the EQC should be received by the board and annexed to the Environmental Quality Report. Any decisions of the EQC that are **not** endorsed and acted upon by the undertaker must be drawn to the attention of the EA immediately.
- (2) All environmental quality compliance policies and practices must be the sole responsibility of the sewerage undertaker. In deciding on these policies and practices the undertaker must take full and proper account of guidance issued by the EA and the advice of the EQC.
- (3) The operating contractor must comply fully with the policies and practices stipulated by the undertaker and as directed by the Operations Director irrespective of the terms of the contract.