



The proposed acquisition of
Dwr Cymru Cyfyngedig
by
Glas Cymru Cyfyngedig

A position paper by Ofwat

January 2001

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THE DIRECTOR'S SUMMARY AND CONCLUSIONS

I have considered carefully the responses to Ofwat's consultation on proposals by Glas Cymru Cyfyngedig (Glas) to purchase Dwr Cymru Cyfyngedig (Dwr Cymru).

In the light of these and other considerations explained in this paper, I conclude that, on balance, provided that Glas:

- (i) agrees to the licence modifications described in Annex B;**
- (ii) gives a public commitment to customer benefits;**
- (iii) makes public its incentive schemes for executive management;**
- (iv) provides a public statement on its commitment to limiting its activities to the single purpose of providing water and sewerage services;**
- (v) gives a public commitment to appointing the members of Glas on the basis of best practice;**
- (vi) confirms that the rights proposed for bondholders do not impede the Director's duties under the Water Industry Act 1991;**

Ofwat should not object to the proposals and that Glas should be allowed to proceed to test whether it can secure the financing required, at an investment grade credit rating consistent with its financing plan.

Ofwat has to examine any proposals put to it. It would be inappropriate to reject proposals on the basis that hypothetical alternative structures or buyers might in theory, produce a better outcome. In approaching such proposals, Ofwat takes the view that it must be satisfied that the interests of customers are protected and that regulatory effectiveness, both for the specific appointee and the industry as a whole, is maintained. These are continuing requirements over the long term. Ofwat must ensure that issues of safety and quality are properly safeguarded and that the risks of failure are minimised. Where there are additional risks that could affect customers, Ofwat must be satisfied that the benefits to customers are clearly established and outweigh these uncertainties.

The consultation showed broad support in Wales for Glas, notably from the National Assembly for Wales (NAfW), but this was subject to the protection of customers' interests. Outside Wales, respondents expressed a variety of views. The key questions raised in the consultation were:

- (i) Would the wholly debt-financed structure be sufficiently robust to withstand cost shocks and the consequences of poor management, when compared to shareholder-owned, equity-financed water companies?
- (ii) Would the absence of shareholders mean that the incentives for continuing efficiency would be inadequate?
- (iii) Would the complete outsourcing of its operations leave Dwr Cymru in a position to maintain proper control over its functions?

These questions expose the key risks in the proposals and they cannot wholly be avoided. Some of the risk arises because companies that rely wholly on debt finance and contractors for services are, as yet, untried by the water industry in England and Wales. However, there are extensive precedents, both within and beyond the water

industry for outsourcing and there is a general pattern of increased gearing (debt in proportion to equity) among water companies.

Against those risks, Glas, if it succeeds in its financing proposals, should achieve a significant initial reduction in its weighted average cost of capital compared to water companies generally. Financing costs account for about one third of customers' bills and although there may be offsetting costs, for example to reflect the risk to be borne by contractors, the proposals offer the prospect of significant benefits to customers.

Glas has also sought to minimise these risks, and to meet the other criteria identified by Ofwat in the consultation paper and in Ofwat's response to the restructuring proposals advanced by Kelda in June 2000.

In addition to Ofwat's requirements set out in this paper, Glas is proposing further safeguards for customers and other stakeholders. They include arrangements for the appointment and functioning of the members of Glas designed to ensure that they remain focussed on its commercial success together with close scrutiny of Glas' performance on behalf of bondholders, especially by the credit insurer. The initial purchase price agreed between the parties represents a discount on the regulatory capital value (RCV) on which price limits are based. This has been negotiated in circumstances which help to confirm the independence of Glas from the current owner, Western Power Distribution (WPD). Glas has undertaken an appropriate programme of customer consultation on its proposals directed at ensuring that customers are properly informed. The degree of overall support from customers is harder to judge but those who expressed a view tended to favour the proposals.

Uncertainties about the longer-term success of Glas can only be tested over time. In particular, whether its structure will provide sufficient flexibility or incentives to respond efficiently to future developments in the water industry or in financial markets can not be conclusively assessed at this stage. Prospective financiers must judge for themselves the risks and benefits of the structure.

As a licensed undertaker, Dwr Cymru would continue under Glas' ownership to be subject to regulation on the same basis and in the same manner as for all other companies. Price limits would be set by reference to comparisons between all companies. For example, no special concessions would be made to take account of contract prices secured by Dwr Cymru. To ensure clarity, I am writing to the managing directors of all water companies on how Ofwat will continue to perform its functions. I am also consulting on a licence modification concerning the so-called 'shipwreck' clause (at present included in the licences of less than half of the companies), which for clarity and consistency I propose should be included in the licences of all companies.

Finally, concerns have been expressed by respondents, including UK Government ministers, about the precedent which the Glas proposals might establish for water companies in England. Ministers have told me that they are concerned about the risks inherent in the new structure. However, they recognise that it is for Ofwat to reach an independent regulatory view and that democratic accountability for issues concerning Dwr Cymru, rests with the NAFW.

A model which appears suitable for the particular circumstances of Dwr Cymru would not necessarily be appropriate for the English water industry as a whole, where the equity shareholder model has performed well. A number of factors in the Glas case might not be readily replicated in other cases. These include the broad support of the democratically accountable body, the NAFW; the wish by the current owner, WPD, not to be involved in the water sector; the significant discount in the purchase price to RCV; and the clear independence of the purchaser and seller.

Although I consider that the possible precedent effect cannot determine the approach to Glas, I would share the UK Government's concern if significant numbers of water companies were to seek to follow, before the model of a wholly debt-financed, outsourced company had been tested. However, Ofwat will continue to review with care and fairness any proposals put to it.

A handwritten signature in black ink that reads "Philip Fletcher". The signature is written in a cursive style with a large, sweeping initial 'P'.

Philip Fletcher
Director General of Water Services

1. THE PROPOSAL

The board of Glas announced on 3 November that it had agreed terms with WPD for the acquisition of Dwr Cymru. Glas is a company limited by guarantee incorporated under the Companies Act 1985. It will be owned by a body of members who have no financial interest, rather than shareholders, and its board would be accountable to these members. It will be wholly debt-financed and its purpose would be limited to ownership of Dwr Cymru's assets, which would be managed through a series of outsourced contracts.

Ofwat issued a consultation paper on 10 November 2000¹ setting out what it thought were the key issues arising from the proposals and invited views by 18 December 2000. This paper sets out Ofwat's assessment of the proposals following the consultation.

2. CONSULTATION

Ofwat received over 50 responses to the consultation paper. The consultation did not identify any significant new issues. Most respondents' concerns were similar to those identified in Ofwat's consultation paper, albeit with different groups emphasising different aspects more strongly than others.

Welsh stakeholders, notably the NAFW², and the Customer Service Committee (CSC) for Wales broadly welcomed the proposals. Other stakeholders expressed a range of views but the majority focused on three key questions:

- (i) Would the wholly debt-financed structure be sufficiently robust to withstand cost shocks and the consequences of poor management, when compared to shareholder-owned, equity-financed water companies?
- (ii) Would the absence of shareholders mean that the incentives for continuing efficiency would be inadequate?
- (iii) Would the complete outsourcing of its operations leave Dwr Cymru in a position to maintain proper control over its functions?

All three issues had been identified in Ofwat's consultation paper. That paper also focused on whether Glas was fully independent of the seller, on the adequacy of consultation with customers and the role of the members of Glas. In that paper Ofwat gave its preliminary view that Glas' proposals did not, on balance, give rise to any insurmountable issues, provided that the package of licence modifications is fully implemented and that the appropriate investment grade credit rating is secured.

Outside Wales, respondents expressed concern about the implications of Glas as a precedent for the rest of the water industry in England & Wales.

¹ *The proposed acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig: A consultation paper by Ofwat*, Ofwat, November 2000.

² In relation to Dwr Cymru, the National Assembly for Wales has similar duties to the Secretary of State for the Environment, Transport & the Regions with respect to companies operating wholly or mainly in England.

Glas also carried out its own customer research, in consultation with Ofwat and the CSC. Overall this research revealed neither strong support nor strong opposition to the proposal, with, on balance, a measure of support for some aspects of the proposal.

Details of Glas' customer research along with a summary of the views of respondents are contained in Annex A and copies of the non-confidential responses to Ofwat's consultation have been placed in the Ofwat library.

3. OFWAT'S ASSESSMENT

Glas is proposing a new structure for a water company in that it would be owned by members and not shareholders; would be wholly debt financed; and would separate asset ownership from operations.

There are examples of each of these features in other industrial sectors, but, in the water sector, the combination raises issues about how robust it will be in the long-term compared with the current shareholder-owned, equity-financed model that was put in place at privatisation.

Ofwat welcomes innovation directed at improving the efficiency and effectiveness of the water companies. It holds no particular view of the forms or structures that might be adopted. However, Ofwat must be satisfied that the interests of customers are protected and that its ability, and that of the quality regulators, to carry out their statutory duties is not impaired.

Ofwat's consultation paper set out what it considered to be the key issues and concerns arising from the proposals and a framework and criteria for assessing them. Since then, Ofwat has further considered the issues in the light of responses to the consultation. Ofwat's assessment of the proposal for each of the criteria in this framework, including the three key issues identified by respondents, is set out below.

Financing plan

Ofwat has had extensive discussions on the financing plan with Glas, the credit rating agencies and other City institutions both during and since the consultation, and has taken advice from its financial advisors Deloitte & Touche. Glas' structured debt approach is a new form of financing for a regulated water company and therefore there must be an element of risk to the proposals. However, the elimination of risk from diversification into non-regulated activities is significant in terms of securing the required financing terms. Ofwat believes the restriction on activities should apply to Glas and all its subsidiaries and has proposed a new licence condition to secure this.

Ofwat has confirmed that Glas has secured commitments from its financiers, including MBIA (a US-based credit insurance company) which will be insuring a large proportion of the bond issue, and most of Dwr Cymru's existing lenders.

The risk of the company failing is also reduced because the purchase price is at a discount to the RCV. This provides implicit reserves in terms of the borrowing capacity of the company from the beginning. It intends to add to these reserves through the retention of trading surpluses, up to a projected level of £350m by 2004-

05. Ofwat understands that Glas will initially also have committed credit facilities of around £150m to provide additional liquidity to meet unanticipated capital needs. Ofwat accepts that these reserves should provide a measure of protection against cost shocks.

Provided that Glas can secure the appropriate credit ratings, there appears to be the potential for significant savings in financing costs. Financing costs represent around one third of Dwr Cymru's total expenditure. Glas believe that their proposals will enable them to reduce these costs by around 25%. Although there may be offsetting costs, for example to reflect the risks borne by contractors, this could provide significant benefits for customers. To emphasise the importance of the potential benefits to customers, Ofwat believes it is essential that Glas make a public policy statement on customer rebates, analogous to a statement of dividend policy by an investor-owned company, to provide reassurance that these benefits will flow to customers as soon as possible.

In the short-term therefore the financing plan appears to be satisfactory. Assuming Glas achieves trading surpluses, the arrangements should not compromise Glas' ability to issue new debt to fund its capital investment requirements in the period 2000-05. This is important given the difficulties experienced by the equity-financed Hyder plc, the previous owner of Dwr Cymru.

In the longer term there is greater uncertainty. There can be no guarantee that contract prices will be reflected in price limits. There is, therefore, a risk that if Glas does not retain sufficient flexibility in its operations contracts or its financing, it may be unable to make the efficiency savings required at future Periodic Reviews. It would then need to fall back on its reserves and that would test its robustness. Furthermore the advantage of lower financing costs may itself be eroded over time if the capital markets indicate that higher levels of gearing are sustainable for equity-financed companies.

Ultimately, it is for the market to decide if the financing plan is feasible and whether it is prepared to provide the necessary finance on terms that will enable Glas to build up reserves and deliver customer rebates.

Incentives for efficiency

In principle, Ofwat remains of the view that the incentives for Glas, as a company limited by guarantee, to make continuing efficiency savings are unlikely to be as strong as under shareholder ownership. Members may not, individually, have sufficient incentives to monitor performance and exert continuous pressure on management to achieve efficiency savings. Lenders are likely to focus largely on protection of their interest payments and capital rather than maximisation of efficiency.

However, Ofwat recognises that Glas has sought to build in other mechanisms designed to mitigate the loss of shareholder pressure. Management remuneration will be closely linked to performance both in terms of delivering customer rebates and improving Dwr Cymru's standing in Ofwat's relative efficiency and service performance assessments. Ofwat's comparative analyses show Dwr Cymru to have

been one of the least efficient water and sewerage companies. So (under any ownership) Dwr Cymru will have opportunities to demonstrate significant improvement.

The existence of a majority of non-executive Directors should help Glas and Dwr Cymru maintain a commercial focus. Glas will be required to give an undertaking to ensure that the Board maintains this majority. Customer pressure on Glas to adhere to its public statement on rebates should provide further incentives.

The involvement of MBIA, which is to insure a large proportion of Glas' bond issue, will also reinforce these pressures, as it will have stronger incentives and resources to monitor Glas' performance than ordinary bondholders, and should therefore provide an external commercial pressure to perform.

Control of operations and outsourcing

Outsourcing of contracts in the water industry is commonplace but the scale proposed by Glas is new. Ofwat agrees with the Drinking Water Inspectorate (DWI) and the Environment Agency (EA), that this must not lead to a blurring of responsibilities for safety and environmental outputs.

Glas is fully aware of the need to ensure that Dwr Cymru is able to maintain control of its responsibilities and Glas has agreed licence modifications and guidance on internal controls for Dwr Cymru with Ofwat, the DWI and the EA to underline its liability for safety and quality. All parties are clear that all responsibilities remain with the licence holder, Dwr Cymru.

The success of Glas' outsourcing strategy will depend both on the extent to which there is a proper market for the provision of these services and on the quality of Glas' management. Nevertheless, to the extent that the outcome is unknown there is a potential risk.

Ofwat attaches particular importance to the fact that the operations and customer service contracts will be competitively tendered from the outset. This will reduce the risk that might occur if the incumbent was to provide the services initially, and thus wished to retain key staff itself rather than transfer them to the asset owner. The available anecdotal evidence suggests that the contracting market has developed sufficient depth to ensure competition for these contracts.

There may be practical difficulties for Ofwat in making robust cost comparisons due to the inclusion of profit and risk margins in contract prices. These difficulties may complicate the current arrangements for comparative competition. However, Ofwat believes that it will be possible to assess Dwr Cymru's efficiency and use its performance in comparison with other undertakers. The proposed procurement condition includes a clause which would require Glas to provide transparent information in relation to contractors' costs to Ofwat.

Customer consultation

Customers will not become the owners of Glas or Dwr Cymru, as under a mutual body, so a ballot of all customers is not necessary. Ofwat is satisfied that Glas has conducted as full a consultation as could be expected. This consultation is described in Annex A.

Independence from the current owner

Ofwat is satisfied that Glas is independent of the current owner, WPD. It has a board that is led by independent non-executive Directors and the purchase of Dwr Cymru appears to have been negotiated on an arms-length basis. The price agreed is below the RCV on which price limits are based.

Membership

Ofwat shares the concerns raised by respondents that there is potential for the members of Glas to be captured by special interest groups. Ofwat would expect Glas to make clear the principles governing the appointment process and to conduct the recruitment process in an open and transparent manner in line with best practice, to ensure that these risks are mitigated.

Members will have the formal power to direct the policies of the Glas board. Consequently, as a further safeguard a new licence condition will be introduced requiring Dwr Cymru to obtain an undertaking from Glas prohibiting it from making changes to its Memorandum and Articles of Association without Ofwat's consent.

Ofwat does not believe it is necessary to name all the members in advance of the transaction.

4. CONCLUSIONS

In examining Glas' proposals, Ofwat takes the view that it must be satisfied that the interests of customers are protected and that regulatory effectiveness, both for Dwr Cymru and the industry as a whole, is maintained. These are continuing requirements over the long term. Ofwat must ensure that issues of safety and quality are properly safeguarded and that the risks of failure are minimised. Where there are additional risks that could affect customers, Ofwat must be satisfied that the benefits to the customers of Dwr Cymru are clearly established and outweigh these uncertainties.

Most importantly, Glas believes its proposals offer the potential for reductions of up to 25% in its financing costs (compared to those underlying the present price limit assumptions). Financing costs account for about one third of customers' bills. Although there may be offsetting costs, if this advantage can be sustained it would enable Dwr Cymru to provide potentially significant benefits for customers in terms of bill reductions. To emphasise the importance of this, the Board of Glas should make an early public commitment on the timing and scale of reductions in customers' bills.

However, there are clearly elements of risk in the Glas proposals as highlighted by the three key issues arising from the consultation. Some arise because the Glas model has not previously been tested in the water industry in England and Wales. No other water undertaker is wholly debt-financed, although there is a general pattern of increased gearing. The model of a company limited by guarantee rather than investor-owned carries risks for incentives, but has precedents in other sectors, albeit in a competitive environment. The degree of outsourcing carries risks for the proper control of operations.

Glas has as far as possible taken suitable action to address these risks and the criteria set out in the consultation paper. This includes:

- (i) the proposal to have significant initial reserves, to be increased over time by the retention, initially, of all trading surpluses, as a guard against uncertainty;
- (ii) scrutiny on behalf of bondholders, especially by the monoline credit insurer, MBIA;
- (iii) a board led by independent non-executive directors, and an arms-length negotiation of the purchase price, which is below the RCV;
- (iv) performance incentives for the executive management of Glas and Dwr Cymru which are specifically related to objective measures of performance on quality and price to customers, underlined by;
- (v) a policy statement on target reductions in customers' bills from 2003/04 onwards;
- (vi) arrangements for the appointment and functioning of the members of Glas designed to ensure that they remain focused on its commercial success;
- (vii) a procurement strategy designed to ensure Dwr Cymru's ability to carry out its business and to step in if contractors perform unsatisfactorily.

Glas has also taken steps to meet the other criteria identified by Ofwat in the consultation paper and in Ofwat's response to the restructuring proposals advanced by Kelda in June 2000. It is fully independent from the owner of the existing licence holder and has carried out an adequate programme and period of consultation directed at ensuring customers are informed about and understand the proposals.

It is impossible to eliminate all risk. However, the management of Dwr Cymru by Hyder showed that the normal equity shareholder model is also vulnerable to market shocks and poor management. Whether the structure of Glas will provide sufficient flexibility or incentives to respond efficiently to future developments in the water industry or in financial markets can not be conclusively assessed at this stage. Only over the longer-term will it be possible to judge whether one model has inherent and lasting advantages over another for customers and financiers.

A further important consideration is that stakeholders in Wales, notably the NAFW and the CSC have expressed broad support for the proposals and there is no evidence that customers have any strong objections to the proposals.

In the light of these and other considerations explained in this paper, the Director has concluded that, providing Glas fulfil the six conditions set out in his summary, Ofwat should not object to the proposals and Glas should be allowed to proceed to test whether it can secure the financing required, at an investment grade credit rating consistent with its financing plan.

It is now properly a matter for the market to decide whether it is prepared to provide the long-term financing at the level and on the terms required by Glas for the transaction to proceed and to allow Glas to build up the required reserves and generate rebates for customers. In doing so, investors will carry out their own due diligence but should do so in full knowledge of Ofwat's position as set out in this paper and in the letters to water companies' Managing Directors (MD166 and MD167) issued today³.

Finally, concerns have been expressed by respondents, including UK Government Ministers, about the precedent which the Glas proposals might establish for water companies in England. Ministers are concerned about the risks inherent in the new structure. Ofwat would itself be concerned if a significant number of companies were to seek to follow, before the model of a wholly debt-financed, outsourced company had been tested.

A model which appears suitable for the particular circumstances of Dwr Cymru would not necessarily be appropriate for the English water industry as a whole, where the equity shareholder model has performed well. A number of factors in the Glas case might not be readily replicated in other cases. These include the broad support of the democratically accountable body, the NAFW; the wish by the current owner, WPD, not to be involved in the water sector; and the significant discount in the purchase price to regulatory capital value and the clear independence of the purchaser and seller. However, Ofwat will continue to review with care and fairness any proposals put to it.

5. THE REGULATORY FRAMEWORK

If the Glas proposal goes ahead, Dwr Cymru will receive no special or preferential treatment from Ofwat. It will continue as the Appointee with all the licence obligations of a water and sewerage undertaker. It will be regulated in the same way as other companies.

Its performance in terms of efficiency and customer service will be assessed in exactly the same way and compared against other companies. Price limits will be reset every five years using an industry-wide methodology. Efficiency assumptions derived from comparative performance will be used to inform price limits. Glas will, therefore, need to ensure that it retains flexibility to respond to future changes in price limits. There can be no assurance that costs incurred will be passed on to customers. This applies equally to financing, operating and capital costs.

To ensure clarity on these issues, Ofwat has today issued a statement on the performance of its functions in an open letter to the Managing Directors of all water companies (MD166).

Ofwat will ensure that customers' interests continue to be protected through the provisions in the Water Industry Act 1991 and the Director will not hesitate to act in the interests of customers. As for all companies this includes, in the last resort, powers to apply for the appointment of a Special Administrator.

³ Copies of these letters are available on the Ofwat website (www.ofwat.gov.uk) or from Ofwat's library.

6. LICENCE MODIFICATIONS

Should the proposals proceed, Ofwat will require Glas to agree to a package of proposed licence modifications. Glas has agreed, in principle, to these modifications which will address, to the extent that is possible at this stage, the regulatory consequences of the proposals. They are aimed at ensuring that Dwr Cymru:

- (i) maintains control over its statutory duties when services are provided by third parties;
- (ii) maintains a proper ring-fence around the regulated business;
- (iii) follows best practice with regard to corporate governance;
- (iv) is able to provide Ofwat with the information (including information relating to contractors) required to regulate Dwr Cymru and compare it with its peers in England & Wales.

Glas is seeking modifications to the conditions in Dwr Cymru's licence which allow for the resetting of price limits between Periodic Reviews. These are; reinsertion of a symmetrical relevant change in circumstance for capital price inflation; reinsertion of a symmetrical "shipwreck clause"; and modification of the interest cover test for interim determinations to reflect the debt financing of Dwr Cymru. Some other water companies licences have similar conditions and Glas believes that making these modifications would emphasise to lenders the low risk nature of the business.

In respect of the third of these conditions the change is necessary as the current wording of the condition would be unworkable for a wholly debt-financed company. Ofwat is therefore content that this condition should be modified.

The licence condition on capital price inflation allows companies to have their price limits reviewed if inflation for capital expenditure materially exceeds that forecast at the time of the last Periodic Review. The 'shipwreck clause' provides for price reviews following major unforeseen events which are inherently beyond the control of individual companies' prudent management which are expected to have a major impact on its financial position.

Ofwat does not intend to make these two modifications at this stage. Ofwat has issued a second MD letter today⁴, which begins the process of removing variations in companies' licence conditions. As part of this process, all companies are being offered, in this MD letter, the 'shipwreck' clause. Ofwat will consider the capital price inflation condition as part of its wider review of consistency between companies' licences.

All of the proposed licence modifications are summarised in Annex B. The full text of the proposed licence modifications is available on the Ofwat website (www.ofwat.gov.uk).

⁴ Copies of this letter (MD167) are available on the Ofwat website (www.ofwat.gov.uk) or from Ofwat's library.

ANNEX A: CONSULTATION

The views of interested parties on Glas' proposals were sought in three ways:

- Ofwat's consultation paper;
- Glas' own customer consultation; and
- Public meetings chaired by the CSC for Wales.

Main themes emerging from Ofwat's consultation paper

Over 50 responses to the consultation paper were received. A list of respondents is given at the end of this Annex and copies of the responses (except those marked confidential) have been placed in the Ofwat library. The views expressed by different groups of respondents are summarised below.

Financial institutions

Whilst some respondents from the City were proponents of the existing equity model, others recognised the potential advantages of the proposed structure.

Some concern was raised about the long-term sustainability of a company financed entirely by debt and its ability to raise any new debt required to fund its capital programme in the future. There was also concern that the financing of the proposed structure rests on a perceived guarantee within the Water Industry Act 1991 that Ofwat must ensure that companies can finance their regulated activities. Consequently it would be important for the regulator to make clear his duties with regards to the financing of the licensed companies. (Ofwat has made its position clear today in an open letter to Managing Directors of all water companies (MD166)).

Others believed that the water industry is a low-risk business; that the proposed structure is attractive to investors both now and in the future; and it has the potential to achieve savings from a reduction to the weighted average cost of capital, without increasing risks to customers.

Opinion was divided on whether bondholders and members of Glas would, in the absence of shareholders, exert sufficient pressure on management to achieve continuing efficiencies. One suggested that the remuneration of Glas' senior managers should be linked to the maintenance of an investment grade credit rating.

Customers and consumer groups

The CSC for Wales expressed no objection to the principle of a debt-funded company. It is not convinced that the equity-financed model had brought big gains for customers in Wales. In its response it emphasised the importance of ensuring that the new model is workable and contains adequate safeguards for customers. It noted that an explicit statement on price cuts would be welcome and emphasised the need to ensure that the members of Glas are not 'captured' by sectional interests.

The potential for customer rebates was welcomed but there was recognition that the payment of customer rebates should not jeopardise the company's ability to react to cost shocks.

Other respondents also expressed concern about the possibility of the ‘capture’ of Glas’ members by special interest groups.

One respondent commented that there is no inherent reason why levels of service should be inferior a result of outsourcing but recognised that the company must retain the necessary core competencies.

Two customers believed that the consultation period should be extended. One believed that a ballot of all customers would be appropriate.

Other regulators and government

The NAFW expressed broad support, in principle, for the Glas proposals. The First Minister, on behalf of the NAFW, welcomed the fact that Dwr Cymru would be based, managed and controlled from Wales but emphasised that the interests of customers must be paramount both in terms of price and continued investment in environmental improvements.

Other respondents considered that there are significant risks to customers from Glas’ proposal, which are not present in the current equity model and specifically that, should the reserves not be sufficient to cover cost shocks, there would be pressure for customers to meet the shortfall.

The importance of all of the water companies being treated equally at price reviews was also highlighted along with the need for flexibility within Glas to enable it to provide services in the event of contractor failure. It was stressed that the proposed structure should not be seen as a “new model” for all utilities.

Environmental groups

The majority of the environmental groups that responded were based in Wales and were in general, in favour of the proposal. Most respondents believed that the structure proposed by Glas would have benefits for the environment. The prospect of customer rebates was welcomed. One respondent highlighted the importance of the company retaining adequate reserves. Two respondents welcomed the licence modifications proposed by Ofwat.

The regulated water companies in England

A variety of views were expressed on the most appropriate structure for a water company. Some companies, whilst in favour of the separation of assets from ownership, were not proponents of mutual or not-for-profit asset ownership. Some consider that the structure proposed by Glas is a positive way forward for the industry and believe there to be genuine benefits for customers and the water companies. Other companies continue to believe that the existing equity model should prevail. It was stressed that no alternative structure should be forced upon any company.

On the issue of incentives for efficiency, opinions were divided with some suggestion that incentives for efficiencies will be provided by the bondholders’ desire to see the company’s credit rating maintained.

Respondents recognised the importance of the company retaining adequate control over its operations and noted that the company's ability to do this will in part depend on the terms and conditions of the contracts agreed with its service providers.

One company believed that Glas' request for the reinstatement of the "shipwreck" clause was evidence of a transfer of risk from the company to the customer. Another stated that the licence modifications sought by Glas should not be granted to Dwr Cymru alone as this amounts to preferential treatment.

Glas customer consultation

Glas has carried out, in consultation with Ofwat and the CSC for Wales, its own market research consisting of a quantitative survey of around 1,000 customers to establish overall reaction to and awareness of the Glas proposal and eight focus group discussions conducted in four parts of Wales.

The key result of the quantitative survey was that customers are little interested in the ownership of Dwr Cymru, with only 3% being aware that it had been bought by WPD. On being prompted, 22% of customers were aware of the Glas proposal. Of the 22 %, over half thought the proposal was a good thing with only 1 in 10 seeing it as a bad thing; the remainder did not express a view.

The main findings of the focus groups were that ownership, control and structure of Dwr Cymru is not a major issue. Customers would like to see it as Welsh owned but would not be overly concerned if it is not. Quality and cost of service are the main issues and while customers would like to see substantially lower bills, quality and continuity of service is of paramount importance. There were concerns about outsourcing, including possible lack of control of contractors and loss of local jobs. Customers like the concept of a not-for-profit company and the fact that it would only be concerned with providing water and sewerage services. There were however, some concerns that the members of Glas Cymru might be another quango providing "jobs for the boys".

Overall the research has revealed neither strong support nor strong opposition to the proposal. There was a measure of support for some aspects of the proposals but there was also concerns focused on the outsourcing aspects.

In addition, Glas has surveyed a small sample of opinion formers. These were broadly supportive with the main concerns focusing on the selection and role of the members and on the outsourcing of services.

Public meetings chaired by the CSC for Wales

Two public meetings were held, one in South Wales (Cwmbran) and the second in North Wales (Llandudno). The purpose of these meetings was to inform attendees of the detail of the Glas proposals and the issues that warranted consideration. Attendees were invited to pose any questions to any or all of the represented parties (Glas, DWI, and Ofwat).

Despite considerable publicity, attendance by members of the public was low. No issues additional to those raised in Ofwat's consultation paper emerged at either meeting. There was a large representation of Dwr Cymru employees at the Llandudno meeting and hence security of employment became the main topic of discussion.

List of respondents to the consultation paper

Financial Institutions

Credit Suisse	Royal Bank of Scotland
M & G*	St David's Capital*
Merrill Lynch*	Scottish Widows
Gerald Holtham	

Customers and consumer groups

Campaign Against Monopoly Abuse	John Owen
Consumer Association	Menter a Busnes
Councillor G Jones	Public Utility Reform Group (PURGe)
Customer Service Committee for Wales	Simon Thomas, MP
Francis Balsam Associates	Welsh Consumer Council
Griffith Einion Owens	

Other regulators and government

Drinking Water Inspectorate	National Assembly for Wales
Environment Agency	Ofgem

Environmental groups

Elan Valley Trust	Oxford Centre for Environmental Ethics & Society
Countryside Council for Wales	Surfers Against Sewage
Green Sea Partnership	Sustainable Wales
Marine Conservation Society	Tidy Britain
National Botanic Garden	
National Trust	

The water companies in England & Wales

Albion Water	South East Water
Bristol Water	South West Water
Glas Cymru Cyfyngedig	Southern Water Services
Northumbrian Water	Vivendi Water UK
Severn Trent Water*	Yorkshire Water / Kelda

Others

Alan Booker	Independent Wales Party
CBI Wales	John Hall
Centrica	National Eisteddfod
CEW & Cymuned Cymru	Partnerships UK
Eleri Carrog	Unison
GMB	

* These responses were marked as confidential.

ANNEX B: SUMMARY OF THE PROPOSED LICENCE MODIFICATIONS

Should the proposals proceed, Ofwat will require Glas to agree, on behalf of Dwr Cymru, to a package of licence modifications and new licence conditions. These are set out below and include the licence modifications agreed with WPD upon its acquisition of Hyder.

Glas has already agreed, in principle, to these modifications. If Glas agree these in detail then the Director will instigate a period of statutory consultation on the modifications. If Glas was not to accept the modifications then the Director has the power to refer them to the Competition Commission for a decision. The NAFW also has the power to request that the Director does not make particular modifications. If the Director believes that it would not be in the public interest to not make such modifications then he must refer them to the Competition Commission for a decision.

Procurement of services and control of operations

- A new licence condition requiring Dwr Cymru to submit a Procurement Plan to the Director.
- A licence modification prohibiting Dwr Cymru from delegating responsibility for the proper performance of its statutory functions to any other party.
- 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. Dwr Cymru will be required to adhere to guidance on internal controls, to be issued by the Director, to ensure that it meets its legal obligations and can carry out its functions.

Strengthening the financial ring-fence

- A new licence condition 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.
- A licence modifications prohibiting Dwr Cymru or any other subsidiary of Glas from carrying out activities other than those required of, or connected with, a water and sewerage undertaker.
- A licence modification requiring prohibiting the raising of any finance for the regulated business on terms which include cross default covenants.

- A licence modification requiring Dwr Cymru at all times to maintain an investment grade corporate credit rating.

Corporate governance

- Licence modifications requiring Dwr Cymru to obtain a legally enforceable undertaking from Glas:
 - prohibiting Glas from making any changes to its Memorandum and Articles of Association without Ofwat's consent.
 - that Glas will provide such information as the Director may reasonably require relating to the activities and financing of Glas.
 - that Glas will provide it with the necessary information to allow Dwr Cymru to comply with its Licence.
 - that Glas will refrain from any action that would make the water company breach its Licence.
- 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.
- A licence modification requiring the board of Dwr Cymru to have a majority of non-executive directors.

Availability of market and other information

- 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.
- 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).