



New Ownership Structures in the Water Industry

(A consultation paper
by the Directors General
of Water Services)

NEW OWNERSHIP STRUCTURES IN THE WATER INDUSTRY

A CONSULTATION PAPER BY THE DIRECTOR GENERAL OF WATER SERVICES

SUMMARY OF ISSUES RAISED BY NEW OWNERSHIP STRUCTURES IN THE WATER INDUSTRY

Introduction

1. There have been a number of recent announcements by the Boards of water companies that they are considering a strategy which separates asset ownership (and responsibilities under the Licence) from operations. In some cases the companies are looking at options for the introduction of a new form of corporate structure and ownership for the appointed business in conjunction with the introduction of a greater proportion of debt finance into the regulated business.
2. A number of ownership structures have been suggested, amongst them mutual trusts, not-for-profit companies limited by guarantee, companies registered with the Registrar of Friendly Societies (sometimes referred to as an RCAM – Registered Community Asset Model) and companies with a thin layer of participating shares (but not ordinary shares). For the purpose of this paper all such structures are referred to as a mutual.
3. The Director General of Water Services (“DGWS”) in a speech on 11 May 2000 to launch his 1999-2000 annual report raised a number of important issues relating to the constitution of such bodies and their incentives for efficiency. He said that licence amendments would be sought to deal with both these constitutional and efficiency issues.
4. The DGWS would like to consult formally on the issues raised by the new ownership structures in the water industry. He would particularly welcome the views of interested parties on:

Restructuring and incentives for efficiency

- What are the benefits or otherwise of separating the ownership of a water company's assets (and the licence) from the operation of those assets? (section 6)
- Should the DGWS regulate a mutual water company in the same way as other investor-owned Appointees, including allowing the mutual to go into Special Administration? (section 11)
- Would the incentives for efficiency for a mutual water company be harmed by the absence of shareholder pressure? (sections 14 to 25 and section on procurement)
- What mechanisms could there be to strengthen management independence and drive company performance? Could licence amendments requiring the Board of the licenced undertaker to contain a majority of non executive directors, to maintain a management incentive scheme and to comply with the London Stock Exchange ("LSE") codes relating to corporate governance be appropriate? (sections 16 to 25)
- Should the managers and or executive directors of the mutual and the Appointee be publicly accountable on a regular basis and if so how? (section 25)
- Should there be a new licence condition requiring the Appointee's loan facilities to be maintained at investment grade ratings? (section 21)

Constitutional arrangements

- What are the appropriate constitutional arrangements for a company structured as a mutual, such that the Board would remain commercially focused? (section 17)
- How could the DGWS be confident that the ownership and governance structures for the mutual are adequate to ensure that managers and the Board could be replaced should they not act in an efficient manner? (sections 48 to 52)
- Are licence modifications necessary in order to maintain the focus solely on the regulated business? These could require the mutual to: consult the DGWS of any proposed change to its Articles and Memorandum of Association; provide information as reasonably required by the DGWS relating to its activities and financing; and prohibit the Appointee from engaging in any activity other than those required to carry out its proper functions. (section 47)
- What is the role of the Customer Service Committee in relation to such new structures? (section 53)

Procurement of services

- What is an appropriate timescale for the contracting-out of services to operate the Appointee's assets? How fast an exposure to competition is possible or desirable? What proportion of services should have been put out to competitive tender by the next price review? (section 29)
- What might be the appropriate contract duration for operational, customer service and capital maintenance contracts? (section 30)
- Would a market for the provision of the outsourced activities be well enough developed and contestable? In particular, is the market sufficiently well established or might it develop to an extent that an Appointee would not be dependent on a single service provider? (sections 32 to 33)
- Is the initial provider of services to the Appointee likely to enjoy an unfair competitive advantage in any contract bidding process, given that it will hold the contracts for service provision in the first instance? (section 32)
- Should a new licence condition on procurement be included in the Appointee's licence and, if so, is the proposed condition appropriate? (sections 34 to 35)

Competition

- Could the implementation of a strategy to separate asset ownership from operations and introduction of a new ownership structure create a comparator for the DGWS that might enhance the comparative competition regime? (section 37)
- Alternatively could provision of services to one water company by another Group including a UK water company lessen the value of the comparative information provided to the DGWS for both? (section 36)
- Would the proposed licence modification requiring the Appointee to maintain a financial instrument on the London Stock Exchange and to publish results as required by the listing rules address the DGWS's concerns regarding the potential loss of an ordinary share listing? (section 39)
- Should pressure from the threat of take-over be maintained for a mutual organisation and, if so, how? (section 40 to 41)

Finance and risk

- Would the proposals for mutuals change the overall risk profile of the licenced utility? (section 55)
- Does the lack of equity finance place too great a risk on customers in the event of poor performance by the Appointee in a mutual structure or is an equity buffer necessary? Are customers being asked to bear a disproportionate amount of risk in relation to the potential future benefits of lower bills? (section 56 to 57.)

5. Comments on the issues raised should be sent by Friday 23 June 2000 to:

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ISSUES FOR CONSIDERATION

Restructuring proposals

6. Some water companies are looking at innovative restructuring ideas. In its most radical form this involves the creation of a licensed entity entirely financed by debt that owns the assets of the utility. This then contracts out its operations to service providers. The licence holder and the asset owner would have all the responsibilities of the Licence but would be dependent on the service providers to discharge them. In some versions this asset-owning body would in turn be owned not by shareholders, as now, but by its customers (or a selection of them) or Members in the form of a mutual or company limited by guarantee (or other not-for-profit vehicle).
7. This consultation paper sets out the issues for the DGWS which would arise from such proposals including those related to the constitution of these new ownership structures and also incentives for efficiency in a body structured in this way. It also sets out the package of licence modifications that the Director might seek from the licensee should such a proposal be contemplated.
8. The majority of the proposed licence modifications set out in this consultation paper are not new. In all cases where there has been a significant change in corporate structure the DGWS has to consider the adequacy of the ring fence around the regulated business. For example, when Azurix Europe plc acquired Wessex Water plc it was required to agree licence amendments to provide the DGWS with access to information about the performance and costs of the regulated water business and also to secure the financial separation and management independence of the water utility. These licence modifications were required to enable the Director to regulate effectively the water utility, within the wider group, and to provide the Director with assurances that those with responsibility for key regulatory decisions have an adequate degree of independence. Some of these amendments were agreed by Dwr Cymru, and included in its licence, in 1996 when it acquired Swalec to create the Hyder Group.
9. In the joint consultation paper issued with Ofgem on 28 April 2000, following the bid by St David Capital plc for Hyder and in a separate consultation paper issued today in relation to Western Power Distribution Limited's bid for the same company, the DGWS has also proposed licence modifications. In particular these modifications aim to strengthen Dwr Cymru's management and financial independence and to allow the Director to continue to judge how the markets and investors view the company.

Duties of the DGWS

10. The duties of the DGWS are set out in the Water Industry Act 1991 (as amended). The DGWS has to ensure that companies properly carry out their functions and that they can finance the proper provision of those services. He also has a duty to protect customers and a further duty to promote efficiency and economy by the regulated businesses and to promote the efficient use of utility services by consumers. He also has duties towards the development of competition in the provision of utility services and in minimising anti-competitive behaviour in the water industry. These powers have been recently strengthened by the Competition Act 1998.

Regulation of ‘mutuals’

11. The DGWS is concerned to ensure that a mutual (or other not-for-profit enterprise) would not receive preferential treatment and that a level playing field is maintained enabling proper comparison of companies to be made. The price limits accepted by the Appointee for 2000-05 would continue to apply. It would continue to be regulated in the same way as other Appointees. It would operate under a price cap and be subject to periodic reviews alongside existing investor-owned water companies. Its performance (in terms of efficiency and customer services) would be judged in relation to these companies both at a price review and through the league tables that Ofwat publishes annually relating to service performance.
12. If a mutual fails to deliver an efficient service, for whatever reason, and finds itself in financial difficulty, it would be vulnerable to the Special Administration regime set out in the Water Industry Act 1991. Special Administration provides for the replacement of the Appointee by a successor and as such the services could be then delivered by a shareholder owned public limited company again.
13. Some believe that the introduction of new ownership structures would reveal the low risk nature of the monopoly element of the water and sewerage business by reducing regulatory and political risk. In doing so the regulated business could achieve a lower cost of capital commensurate with this lower risk. This could be lower than that assumed by the DGWS when he set prices for the period 2000 to 2005. If so the benefits of this lower cost of capital would ultimately lead to lower prices for customers.

Incentives and efficiency

14. The water companies have become more efficient following privatisation in consequence of the combination of pressure from shareholders and the system of incentive-based regulation that they have operated under for the last ten years. This has been reflected both in the price cuts to customers achieved by the 1999 Periodic Review and in the level of shareholders’ returns in recent years.

15. Following such an incentive-based framework, the DGWS has set price limits which allow companies to cover the cost of efficient provision of operations and maintenance and allow a reasonable return on capital. He does not control profits or dividends. Companies have the scope to increase efficiency, and hence profitability, and to share these rewards with shareholders and customers. When considering the new ownership structures the DGWS must consider whether incentives to become more efficient remain sharp and comparable to those of an investor-owned water company. It would be unsatisfactory if the incentives were such as to result in the mutual being consistently ranked as relatively inefficient when compared to its investor-owned peers.

Board structure

16. The structure and membership of the Board is important in creating the right pressures for efficiency.
17. In a company structured as a mutual, as with a listed company, the Chairman will be fundamental in shaping the Board and in implementing a culture capable of delivering efficiency savings. Notwithstanding the absence of shareholder pressure, overall the Board should be driven by commercial principles.
18. In view of the lack of shareholder pressures on management it seems appropriate that under mutual ownership that the Board of the Appointee should contain a majority of independent non executive directors, capable of imposing strong disciplines on executive directors to deliver a cost effective service to customers.

Management incentives

19. A mutual company would have no recourse to equity markets but would be reliant on the debt market both to finance the initial purchase, and then on a continuing basis in order to finance the improvement programme allowed for in the price limits set by the DGWS at periodic reviews.
20. In a highly leveraged company the debt markets do provide incentives to act efficiently and adopt good management practices. Scrutiny by the credit rating agencies and the obligations relating to financial performance imposed by, for example, bond covenants impose important disciplines.
21. It may be appropriate for the inclusion of a licence condition that requires the Appointee to make all reasonable endeavours to ensure that all borrowings should retain investment grade ratings or equivalent. This could keep the Board focused on achieving the satisfactory financial performance of an efficiently financed company within the financial covenants attached to any bond issue.

22. However the DGWS's concern is that these incentives for efficiency may not be as strong as those provided by shareholders. Debt holders' chief concerns are that the interest and principal are paid and that the company remains creditworthy. Shareholders, on the other hand, are continually seeking additional returns and this focuses the management on consistently seeking ways to improve efficiency.
23. When assessing proposals the DGWS must therefore consider whether the boards of the mutual and the Appointee have sufficient pressures to seek continuous improvements in efficiency. These pressures could derive from various aspects of business operations, for example through proposals for contracting out of operations, the constitutional arrangements and possibly through the introduction of new types of management incentive schemes.

Maintenance of management incentive scheme

24. In addition, the DGWS considers that it would be appropriate to seek agreement with the Appointee for a licence condition requiring it to maintain an incentive scheme designed to attract and retain a high calibre management team and to incentivise them for the part they play in delivering efficiency in business operations. This would act as a surrogate for the incentives offered by listed investor-owned companies through long-term incentive plans. In accordance with best practice, it would be appropriate for the Board to seek prior approval, in broad terms, from its owners for this scheme. This process might also involve the Board seeking independent advice on the structure of the incentive scheme and the financial and service performance indicators that might be part of the scheme.

Other mechanisms for providing incentives

25. An effective way to incentivise executive directors and management to act efficiently could be to require them to be publicly accountable on a regular basis. In the United States the managers of some public utilities are accountable to their customers on a monthly basis and the DGWS understands that this provides a real incentive for them to operate effectively. As well as being publicly accountable the DGWS recognises that the Appointee would be accountable to government and to its Customer Service Committee.

Procurement

26. In the absence of shareholder pressure to retain incentives for greater efficiency, any mutual body must be committed to a regular programme of competition in the market

for the operations to be provided by arm's length suppliers and in accordance with a formal procurement plan.

27. The DGWS would expect there to be competitive outsourcing on a rolling basis in four main areas: service delivery and asset operation contracts; customer service contracts; capital investment contracts; and contracts to design, build and operate new works.
28. The DGWS is seeking views on the appropriate mix, type and number of contracts and their likely length. He would expect any procurement plan to be consistent with the principles set out below.

Timescale and duration

29. The DGWS will be concerned that the procurement process is designed to ensure that the costs revealed by competitive tendering for a substantial proportion and mix of activities are available for the next price review in 2004. In terms of mix, he would expect a number of the large operational and maintenance contracts for water and sewerage works to be put out to early tender such that they were in operation at the time of the next price review.
30. In broad terms longer contracts provide stability and could give contractors time to achieve efficiencies in their service delivery. Shorter contracts foster greater competition in service provision and so respond more quickly but do involve additional procurement and transfer costs. The DGWS believes that there is probably scope for the customer service contracts to be shorter than the asset operation contracts when coming to a judgement regarding optimum contract duration.
31. It is vital that during any transition period as well as in the long term that the mutual ensures continuity of services to customers, maintenance of serviceability and delivery of the quality improvements required by Ministers.

Cost information available at periodic reviews

32. If the cost information provided from such a tendering process is to inform the DGWS's judgements at price reviews as to what is an efficient level of cost, then it would need to be undertaken in an open and transparent way that does not favour any particular party. The existing operator must be able to lose the contract. The Appointee must get sufficient information from the contracting process to be able to compare and contrast bids in order to achieve efficiency.
33. The value of the information also depends on the extent of the development of the markets that supply the services such that they are properly contestable.

New licence condition on procurement

34. In order to formalise the procurement process the DGWS would propose that a new licence condition on procurement should be included in the Appointee's licence. This licence condition would require a procurement plan to be produced and updated on an annual basis. The DGWS would not approve the plan but would have the right to object to the plan or specific aspects of it. The operation of the licence condition would provide evidence that the competitive tendering process had been undertaken in an appropriate manner.
35. The plan should also provide information on the time scale for competitive tendering and also details of contracts consistent with the principles outlined above. It should also set out how the Appointee would ensure that the contracting process does not have a negative impact on the longer-term serviceability of water and sewerage assets. This licence condition would also require the Appointee to ensure that all bona-fide potential service providers have access to the same information during the bidding process. Finally, it would require the Appointee to obtain the regulatory monitoring information, required by the DGWS, from its contractors and to ensure its reliability, together with independent certification from an independent Reporter.

Competition

Comparative information

36. The DGWS attaches considerable importance to his ability to use comparative information from different companies to assist in the regulation of the water companies. Apart from a prospective loss of stock market information (discussed below) the introduction of new ownership structures would not necessarily result in the loss of a comparator for making regulatory judgements. However if a proposal involves the provision of services to one water company by a Group including another UK water company then this might lessen the value of the comparative information provided to the DGWS for both.
37. Alternatively if restructuring drives greater efficiency then such a strategy could enhance comparative competition by creating a new type of comparator.
38. The replacement of equity shareholders with a new ownership structure could lead to a loss of stock market information about the licence holder (or its parent) and therefore reduce the DGWS's ability to form judgements about how the financial markets perceive the company and its operations.

39. To address these concerns the DGWS would expect licence amendments to remedy such a loss of information as follows:
- A condition requiring the Appointee to maintain the listing of a financial instrument (bond or preference shares) on the LSE;
 - A condition requiring the Appointee to publish information about its interim and final results, as is required by the listing rules for a company with ordinary shares listed on the LSE. This condition would also require that the results and the accounts of the company should be subject to public discussion in a manner similar to a conventional Annual General Meeting.

Change in ownership

40. The DGWS has welcomed the competitive pressure on the management of appointed businesses arising from a potential take-over threat by others who feel they could make more efficient use of their assets and business. This has been an important means of incentivising current management to be efficient. The DGWS believes, therefore, that competition in the market for ownership and control of licensed utilities continues to be beneficial.
41. This competitive pressure could be eliminated for a mutual if its Articles and Memorandum of Association did not allow it to change its mutual status.
42. The DGWS would need to be satisfied that the mutual company is a suitable owner for a water company and has the operational and financial capacity to assume this role. The DGWS would be keen to ensure that under any new ownership structure the Appointee remains capable of delivering, in an efficient manner, its improvement programme and fulfilling all of its other licence obligations.

Market competition

43. The DGWS has a duty towards the development of competition between licence holders. The Competition Act 1998 has opened the prospect of increased market competition. In the water industry in particular, this is being developed through shared networks (also known within the industry as “common carriage”). The DGWS believes that the change in company structure would not harm the opportunity for common carriage.
44. There is no single way of introducing market competition. The separation of asset ownership and operation offer an alternative approach to bringing about market competition through the competitive letting of contracts for the activities necessary for the Appointee to deliver its service and licence obligations. The DGWS sees no reason

why common carriage and competitive contracting should not sit alongside each other in delivering market competition.

Constitutional arrangements

45. It has been suggested that an advantage of these new ownership forms is that they could be set up in such a way as to resolve some of the conflict of interest that is inherent in the current relationship between a listed plc and its subsidiary licenced water business. This could be achieved by ensuring that the new owners' responsibilities are restricted to managing the regulated business. The DGWS would expect this to be reflected in the Memorandum and Articles of Association for any company intending to implement these new approaches to ownership.
46. Some proponents of restructuring of the kind discussed in this consultation paper have suggested that ownership of a regulated utility in this form would align the interests of the owners of the regulated businesses with those of its customers and in doing so would minimise political and regulatory risk. They argue that, if achieved, this has a direct impact in lowering the cost of capital for the utility.
47. In order to maintain this focus on the regulated business under mutual ownership the DGWS would expect the following licence modifications to be agreed:
- a condition prohibiting the Appointee in engaging in any activity other than those required to carry out its proper functions under the Water Industry Act or the Licence;
 - a condition requiring the mutual (via a legally enforceable undertaking) to consult the DGWS of any proposed change to the its Articles and Memorandum of Association; and
 - a condition requiring the mutual to provide such information as the DGWS might reasonably require relating to the activities and financing of the Appointee.

Principles of good governance

48. Any new form of ownership, such as a mutual, should be concerned with its customers' interests not political objectives. It must be appropriately staffed, incentivised and accountable for the efficient conduct of its business operations. The owners must be able to replace the managers in a mutual, as in a plc, should they not be acting efficiently. The DGWS would ask any company putting forward restructuring proposals involving new ownership structures, to provide details with regard to its constitutional arrangements in order to assess whether these criteria can be met.

49. Given the importance of proper corporate governance, it is important that a mutual (or other not-for-profit body) carefully considers the process for appointing and replacing its board (and additionally in the case of a mutual its Members.) The appointment of the initial board for the mutual would rightly be the responsibility of the Chairman. The DGWS would need to understand the process by which existing directors once in place could be removed and new directors rejected or approved.
50. If the ownership structure envisaged is a mutual then the DGWS would ask the company to set out a process for how the Board appoints its Members and to consult the DGWS on this process. The aim of the process should be to avoid the appointment of Members with special interests that might divert from the commercial focus required of the Board.
51. Additionally the DGWS would expect to have a right to object to the appointment of individual non-executives to the Board of the Appointee if he considers that they do not have skills and standing for the role.
52. The DGWS could require the licence holder, whilst not being a listed company, to operate in all respects as regards corporate governance, as if it were one. This could be achieved by the Appointee agreeing to a licence modification requiring it to comply with any principles of good governance or code of best practice of the LSE.

The role of CSCs

53. The DGWS believes that the role of the CSC in protecting and promoting customers' interests is an important one in the regulatory regime. This role is more easily understood in relation to shareholder owned water companies but would be less so in relation to the mutual structures. This would be particularly the case where customers actually owned the Appointee (as say in a RCAM type model). The DGWS would like views on how the role of the CSCs would change in a mutual structure and whether this is appropriate.

Finance and risk

54. Proposals to introduce more debt finance into utility businesses could also have implications for the cost of capital for Appointed businesses.
55. Whilst it is unlikely that the risk in providing water and sewerage services would be changed, it has been suggested that restructuring could reduce the overall risk profile of the regulated utility ie the asset-owning licence holder. This is in part by the introduction of a new ownership model, without shareholders or dividends, which will be entirely

focussed on the utility business and also by the transfer of operational risk to third parties providing the services.

56. It is important to recognise that even if the overall risk of running the water business were unchanged, the risk currently borne by shareholders (the “equity buffer”) would be transferred to others. Bondholders, the service providers (contractors) as well as customers will all take on some of this risk. The trade-off for customers is that ultimately they should enjoy the benefits of a lower cost of capital through lower prices.
57. Special administration would be likely to trigger bond covenants and hence a requirement to repay the mutual’s debt, although the Water Industry Act does contain provisions for the protection of lenders in such extreme circumstances. Consequently there may be a risk to customers in the eventuality of special administration because the Director would be required to reset prices for the successor company.