

## OPEN LETTER TO DIRECTOR GENERAL OF WATER SERVICES

Philip Fletcher  
Director General  
OFWAT  
Centre City Tower  
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Birmingham  
B5 4UA

3 November 2000

*Dear Philip,*

I am writing on behalf of the board of directors of Glas Cymru Cyfyngedig. Today, we have announced that Glas has entered into an agreement, subject to contract, with Western Power Distribution ("WPD") to purchase its regulated water and wastewater business, Dŵr Cymru Welsh Water. We believe that completion of this transaction will be in the best interests of Dŵr Cymru's customers.

Glas Cymru is a new and independent company, registered and based in Wales, which was formed earlier this year for the sole purpose of acquiring and owning Dŵr Cymru. It is a company limited by guarantee incorporated under the 1985 Companies Act. Glas Cymru's constitution strictly limits its purpose to that of financing water assets in Welsh Water's area of appointment and letting commercial contracts for the operation of those assets so as to ensure the proper carrying out of Welsh Water's functions in accordance with its licence.

During the course of the summer, Ofwat published a number of papers and statements relating to alternative ownership structures in the water industry, most notably the consultation paper issued on 6 June 2000. We believe our proposals adequately address all the issues raised, and properly meet the potential concerns of customers and regulators.

### **Independence and Board**

Ofwat has stressed the importance of the independence of Glas Cymru. The Board of Directors of the Company at present consists of five directors. There are three non-executive directors, including myself, none of whom have any present or former association with Hyder plc or WPD. I have submitted to your office details of the background and experience of each. The Board intends, in due course, to appoint further non-executive directors with solid commercial track records (and no present or past association with either Hyder or WPD), and I will notify you of these appointments when they are made.

There are two executive directors who have been working independently with me to prepare our offer. No conditions have been imposed by WPD, save that the Glas Cymru team should:

- keep WPD informed of progress, including the appointment of advisers and meetings held with third parties;
- provide and agree an estimate of costs to completion, such costs to be funded by WPD but to be reimbursed by Glas Cymru at completion of the transaction; and
- refrain from making any public statements concerning the transaction without prior approval from WPD.

The two Executive Directors have resigned from Hyder.

In due course, it is expected that one further executive director will be appointed. In accordance with the constitution of Glas Cymru, the Board will maintain a majority of non-executive directors at all times.

The Board of Glas Cymru has taken independent legal and financial advice in the course of the preparation of its offer.

#### **Corporate governance and incentives**

Ofwat has set out clearly its concerns regarding corporate governance, and the importance for the protection of customers of ensuring that incentives are maintained and that directors face the same pressures as they would in an equity investor-owned company.

I believe our proposals can meet these concerns. Glas Cymru is not a "mutual", it is a company limited by guarantee. The directors of Glas Cymru will bring to the company considerable business and commercial experience, both from within the water and wastewater sector in the case of the executive directors, and from the fields of finance, business, and Government in the case of the non-executive directors. We will not be satisfied with mediocre performance.

The Board will be accountable in the first instance to the membership. Members will be put forward by an independent panel, following an extensive consultation and selection process based on "Nolan principles". The panel will consist of one Glas Cymru non-executive director and a number of independent appointees, including the Chairman. It will be guided by a Board statement of policy and procedures governing the selection and refreshment of the membership, which will be published. Together with the provisions in Glas Cymru's constitution, the process will ensure that the membership is immune to "capture" by special interest groups, and that Glas Cymru is protected from "carpet-bagging".

The membership will comprise individuals from across the region covered by Welsh Water, with backgrounds in a variety of sectors including industry, commerce, finance, small business, education, health, the environment, charities, and local government. The panel will consult with a wide range of organisations, including the Ofwat Customer Service Committee, government organisations, the CBI, environmental groups, and health trusts. All members must be prepared to act in accordance with the constitution of the company, and will have a duty to support the primary object of providing high quality water and wastewater services at least cost to the community. They must also be able to play an active role in providing critical oversight of the performance of the Board. They will be assisted in their task by an annual "Members Report" on the performance of the company, and bi-annual members' conferences. In the event of serious under-performance by directors, the Members will have the power to remove them and elect replacements.

It is our intention that the executive directors and employees of the company will be remunerated in accordance with a new performance-dependent remuneration structure. Building on the principles of Cadbury and Greenbury, a significant proportion of maximum pay will be linked to performance, not just in comparison with fixed or historical benchmarks, but also in comparison with the rest of the industry. Significant weight will be given to the company's success in generating financial surpluses to be available to finance reductions in customers' bills. In this way, managers will have a strong direct incentive to run the company as efficiently as possible in a way which benefits customers.

In addition, Glas Cymru will be obliged to act at all times as though its shares were listed on the London Stock Exchange, which will impose additional reporting and other obligations. It will be subject to the Companies Act framework, and will act in accordance with the Principles of Good Governance and Code of Best Practice as required by the listing rules of the London Stock Exchange. This will be reinforced by strict oversight of company performance by the holders of the company's bonds, most of which will be listed.

#### **Acceptability to customers and consultation**

On 25 July Ofwat indicated, in the context of the proposals for Yorkshire Water, that it would require evidence of informed consent on the part of customers to a transfer of ownership to the "Yorkshire mutual".

Under our proposals customers will not take ownership of Dŵr Cymru, nor will they assume responsibility for any of its liabilities. Glas Cymru is not a "mutual", and as such there is no suggestion that ownership of the assets will be "transferred to customers", nor that customers will in any way be responsible for the company's debts. Accordingly, like any other company seeking to purchase Dŵr Cymru, we would not seek formal consent to our proposals from customers by means of a vote or similar exercise.

However, Glas Cymru's primary object, as enshrined in its constitution, is to provide high quality water and wastewater services to customers in Dŵr Cymru's appointed area at the lowest possible cost. We must be, and be seen to be, a "fit and proper" owner of Dŵr Cymru, which can deliver services in the interests of customers.

We also acknowledge that our plans entail the creation of a new structure for the delivery of water and wastewater services, and that customers and others must be given sufficient time and information to give our proposals full consideration.

Over the course of the coming weeks, my colleagues and I will devote much of our time to explaining our plans and purpose to customers and organisations across Wales, including the National Assembly, and to carrying out research on customer opinions. We are publishing our plans for Welsh Water and what our proposals mean. This is available on our website [www.glascymru.com](http://www.glascymru.com).

In addition, we propose to hold meetings, some in public, with a range of organisations across Wales, including the National Assembly, the Ofwat Customer Service Committee, local government, consumer groups, and environment groups. We aim to make ourselves as accessible as possible. We are confident that we can meet the aspirations of all parts of the communities we propose to serve. In due course the informed and considered views of these organisations will no doubt feature prominently in the consultation exercise to be undertaken by your office.

### **Benefits to customers**

Ofwat has stated that any proposals on new ownership structures in the water industry must offer clear and tangible benefits for customers. We agree.

As part of our medium term procurement strategy, we will out-source on a fully competitive basis, and in accordance with a rolling procurement schedule, the day to day operation of assets and delivery of services. Dŵr Cymru already out-sources its capital investment programme, and procurement is a key skill. Our Procurement Plan will increase the proportion of annual cash expenditure carried out by specialist private sector contractors from around 60% currently to just over 80%. We will work hard to obtain the best value for money from the market. Already, Glas Cymru directors have been approached by companies keen to be given an opportunity to compete. Over time, our customers will benefit from the lowest cost service delivery the market can offer, in the form of lower price caps set by your office, and our policy of implementing tariff reductions whenever possible.

In addition, customers will benefit from a lower cost of financing the water and wastewater assets. Glas Cymru will have no ordinary shareholders, and will therefore pay no ordinary dividends. All surplus resources generated by the business after our obligations to bondholders have been duly serviced will be available to finance both price reductions and additional improvements in service demanded by our customers.

I can confirm that, subject to Glas Cymru's financial position not being affected by any major shocks, the Board expects to be able to announce voluntary price reductions before the next regulatory price review in 2005.

To meet the requirements of our investors, the financial structure of Glas Cymru will incorporate a number of reserve arrangements, sufficient to meet Glas Cymru's residual risks, including known possible event risks. This will provide an effective financial cushion. We will build up these reserves prior to implementing customer rebates. These requirements, together with Glas Cymru's obligation to maintain strong investment grade ratings, will promote the financial stability of the company. Operational risks will be substantially borne by our contractors and their shareholders.

Customers will bear no additional risk as a consequence of our proposals. Overall, our proposals will bring about a reduction in risk, in particular by "ring-fencing" the essentially low risk water and wastewater assets from diversification risk.

In short, we believe that the prospect of lower bills due to lower financing costs, coupled with the same regulatory protections as at present, represents a good deal for Welsh Water's customers.

I concur with the view that the "equity model" has delivered very significant benefits to customers in England and Wales since 1989, and will continue to do so. Our proposals are but one way forward which is a natural and logical evolution. They do not eliminate the role of equity, the pressures of which will continue to improve efficiency in the delivery of water and wastewater services as a result of our competitive procurement strategy. Incentives on management to deliver efficient outcomes will be safeguarded by the system of rewards and sanctions referred to earlier. The financing of the essential low-risk assets, however, will in future be separately and exclusively undertaken by issuing bonds with strong investment grade ratings.

### **Continuity of water and wastewater services**

Both Ofwat and the quality regulators have indicated that the continuity of the water and wastewater services, and the maintenance of service quality, are of paramount importance.

The Board will give the highest priority to the continuity and safety of the services. As the owner of a statutory water and sewerage undertaker, we will remain fully accountable for the carrying out of our functions to your office, the Environment Agency, the Chief Drinking Water Inspector, the National Assembly, and the Secretary of State. We understand and accept our liabilities in respect of all our obligations, and will not expect to be treated by the enforcement authorities any differently from the equity shareholder owned undertakers.

Most of Dŵr Cymru's service delivery activities are already carried out at arm's length under detailed service level agreements, following the creation of the core "Licence-co" within Dŵr Cymru in April 1999, and its internal separation of assets from operations. Liaising closely with the Drinking Water Inspectorate and others, Dŵr Cymru achieved ISO9002 accreditation from the BSI for water production (December 1999) and water networks (April 2000) under this out-sourcing structure. The Chief Drinking Water Inspector has welcomed the introduction of quality systems to Dŵr Cymru's water supply activities.

Our procurement strategy has been designed to build on these successes and to ensure that the out-sourcing of service delivery creates no new risks for customers and the quality of service. Glas will ensure that its control over the delivery of its statutory functions will be further reinforced, in line with "Turnbull Report" principles. For example, dedicated committees will be established, each chaired by a Non-executive Director, to oversee all aspects of the delivery of drinking water quality and environmental obligations.

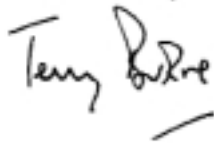
Further, we believe that our procurement strategy has been shaped to deliver excellent and secure service delivery performance. In time, our contracts with new service providers will be designed to procure "best in class" performance. Important features of this strategy will include:

- the establishment of a level playing field for potential bidders, in order that our customers may benefit from the best value the market can offer;
- stringent technical and financial pre-qualification of potential bidders;
- built-in monitoring arrangements, to enable our technical operational staff to be fully informed;
- a requirement on contractors to operate the services in accordance with specified quality assurance standards;
- provisions which will give us no-notice, step-in rights to assume control of service delivery where we believe a significant breach has occurred, or is likely to occur, and similar provisions in favour of a Special Administrator should a Special Administration Order be made under the 1991 Water Industry Act;
- provisions designed to ensure a smooth hand-over from one contractor to another, including an obligation on the out-going contractor to continue in place in the event of delay;
- provisions designed to give each contractor a prima facie obligation to take over responsibility for service delivery in another area at our request;

- unqualified obligations on all contractors to submit information which we require for regulatory purposes in such form and manner as is required by our regulators. Although we will continue to deal directly with regulators ourselves, contractors will also be obliged to grant unrestricted access to information and sites wherever required; and
- a combination of incentives and strong sanctions to ensure that contractors do not put service quality at risk by under-investing in maintenance of the assets.

Finally, I would draw attention to the powerful incentives which will affect how contractors go about discharging their obligations under the service delivery contracts. Firms will be aware of the effect their current performance will have on their future prospects of winning further contracts. Glas Cymru, and potentially other companies as well, will be looking to award future contracts to firms who have an excellent track record.

In summary, the Board of Glas Cymru believes that the requirements set out by Ofwat, for example in connection with the Kelda proposals, are fully addressed in our plans, and that the necessary safeguards can be dealt with through changes to Dŵr Cymru's licence. A number of modifications which would be relevant to our proposals have already been discussed by your office and Dŵr Cymru's current owners, WPD. I can confirm that Glas Cymru would be willing, in principle, to consent to these changes. In addition, your office will wish to consider whether or not further licence amendments can and should be made which would, inter alia, protect the interests of customers. In the meantime I am ready to discuss and respond to any questions you may have regarding our proposals.

Yours sincerely,  


Lord Burns  
Chairman