

Philip Fletcher
Director General
Office of Water Services
Centre City Tower
7 Hill Street
Birmingham B5 4UA

7 March 2001

Dear Philip,

In your announcement on 31 January, you indicated that, provided six conditions were met, Ofwat would not object to Glas Cymru's proposals to buy Dwr Cymru, and that we should be allowed to proceed to try and secure the necessary financing. Those conditions were that Glas:

- agrees to the licence modifications set out in the OFWAT Position Paper;
- gives a public commitment to customer benefits;
- makes public its incentive schemes for executive management;
- provides a public statement on its commitment to limiting its activities to the single purpose of providing water and sewerage services;
- gives a public commitment to appointing the members of Glas on the basis of best practice; and
- confirms that the rights proposed for bondholders to not impede the Director's duties under the Water Industry Act 1991.

The purpose of this letter is to explain how we have met, or are in the progress of meeting, the conditions you set out.

Licence Modifications

I can confirm that we accept the licence modifications you proposed on 31st January and on which you launched a statutory consultation today.

Commitment to delivering customer benefits

I can confirm that we are committed to the delivery of customer benefits, particularly reductions in bills, as soon as it is prudent to do so.

As we have indicated, we will organise and finance Dwr Cymru's business in a way which delivers significant and growing financial surpluses over time. Since we have no shareholders, these surpluses will in all circumstances be for the benefit of Dwr Cymru and its customers, and as such will be available in due course to finance reductions in bills compared with those allowed for under Ofwat's price limits as well as any discretionary service enhancements for which clear support from customers can be demonstrated.

Our short term priority will be to build up the sizeable financial reserves to which we have committed as part of the terms of the new financing arrangements. Thereafter, subject to our commitments to bondholders (we will be prohibited from making voluntary bill reductions if certain minimum conditions relating to the size of reserves and various financial ratios are not met) we will commit the additional surpluses to achieve reductions in customer bills.

The precise timing and amount of bill reductions below the Ofwat price limits will be dependent on a number of currently unknown factors, in particular the final cost of the new bonds which we will be raising in the coming weeks. However, on the basis of our current financial projections we expect to be in a position to deliver bill reductions in two years, ie from 1st April 2003. Thereafter, at a minimum, it will be our objective to increase the value of the benefits in line with inflation (so, for example, if bill reductions are worth £10m in one year, and inflation is running at 10%, it would be our objective to increase the value of the reductions to £11m in the following year).

I intend that the board of Glas Cymru will make a further public policy statement within three months of completion of the acquisition of Dwr Cymru, by which time the final details of the financing arrangements will be known, and we will be in a better position to set a target for the actual value of the benefits we will deliver.

Finally, it is our intention to keep customers and others informed of our policy and plans for reductions in bills and discretionary service enhancements. Each year, as part of the annual reporting cycle, we will make a statement re-iterating the conditions on which reductions in bills can be made, recording what reductions were made for the reporting year, and presenting our updated expectations regarding the following year.

Limiting our activities to water and sewerage services

I can confirm that the Board of Glas has committed to limiting its activities (and those of its subsidiaries) to the provision of water and sewerage services in accordance with the appointment of Dwr Cymru as a water and sewerage undertaker under the 1991 Water Industry Act.

To this end, I can further confirm that:

- our memorandum and articles of association specifically identifies the object of the company as the carrying out of the functions of a water and sewerage undertaker;
- the terms of our financing covenants will prohibit diversification into other activities; and
- we have accepted in principle the proposed licence modification which will prohibit Dwr Cymru or any other subsidiary of Glas from carrying out any activities other than the functions of a water and sewerage undertaker.

Performance incentives for senior and executive management

I can confirm that the Board will publish details of the incentive scheme it plans to put in place for senior and executive management. The remuneration committee of the Board has already set in motion the necessary research and analysis to prepare a detailed remuneration policy for senior management based around the creation of short and long term incentives linked to the performance of the business in creating financial surpluses, meeting customer requirements and delivering other outputs.

We have appointed independent advisers, Hewitt Associates, to advise the remuneration committee (which comprises all the non-executive directors). They are working under the guidance of one of my non-executive colleagues, Alison Carnwath. Their terms of reference require them to recommend a remuneration policy in line with the principles which underpin the Combined Code and which, inter alia, seeks to:

- ensure that the company can attract, retain, and motivate executive managers of the required calibre, but only to the extent that is necessary;

- ensure that a significant proportion of overall remuneration is based on both individual and corporate performance, with targets and criteria that are meaningful, stretching, and which seek to align the interests of the individual with those of the company in the first instance, and ultimately customers. In particular, we have asked Hewitts to take into account the importance of financial performance, output performance, customer service, and contract management.

Hewitts are scheduled to submit recommendations to the remuneration committee by the end of this month. I can confirm that the Board will make a formal statement as soon as the scheme has been approved. Thereafter, in line with best practice, the remuneration policy of the Board, together with remuneration details for the executive directors, will be disclosed in our annual report.

Arrangements for the appointment of Members of Glas Cymru

The Board is finalising its policy statement on the selection of members, which will be published within the next few days. The selection process will be in line with best practice, including an independent Membership Selection Panel. The policy document will set out the process we will put in place to select Members of the right calibre, and to achieve a membership which offers the right balance of stakeholder perspectives. It will also set out the role of Members, and how they will be expected to function. We are also finalising a simpler and more wide-ranging briefing document for prospective Members.

The next step is to convene the independent Membership Selection Panel. I am pleased to inform you that Janet Lewis Jones has agreed to chair the panel. Formerly with the Home Office, Janet is a Commissioner on the Postal Services Commission, and is a Director on the boards of British Waterways and S4C. The second independent member of the panel is Arthur Walford, BUPA's General Counsel and Company Secretary, who brings first hand experience of the policies and procedures for putting in place an effective membership. One of my non-executive colleagues, Geraint Talfan Davies, will be the third panel member.

The panel will be given administrative support by our company secretary. It is expected to be convened for the first time within two weeks.

Nominations for Members will be sought in the coming weeks by placing notices in local newspapers, and by writing to various organisations across Dwr Cymru's area. The primary objective of the membership panel will be to recommend a group of potential members who have the necessary skill and expertise to evaluate and scrutinise the commercial performance of the Board, and who bring a broad and balanced range of stakeholder perspectives.

I will be asking the panel to put forward around 25-35 names initially, for formal appointment by the Board. It is my intention that this process will be complete as soon as possible. All the materials relating to Membership will be published on our web-site.

Bondholder rights and the Director's ability to carry out his functions

We understand and accept that the financing arrangements we put in place must not conflict with or prejudice your ability to regulate Dwr Cymru in accordance with your statutory duties. Work is still ongoing to finalise the terms on which the new bonds will be raised, but I can confirm that nothing in these arrangements will conflict with your requirement. My colleagues will, however, continue to share with you material on the financing arrangements as they are developed, in order that you are kept fully informed of the detail.

Glas Cymru will be an open and transparent organisation. I have made public our commitment to you by publishing this letter on our web-site (www.glascymru.com). I am also copying this letter to Sue Essex, the Minister for Environment at the National Assembly.

*Yours sincerely,
Terry Burke*

Lord Burns
Chairman