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Glas Cymru Cyfyngedig

DŴR CYMRU
WELSH WATER

Presentation to the Environment, Planning and Transport Committee of the National Assembly for Wales

1 May 2002

Background briefing notes

24 April 2002

Introduction

We will be making a presentation to the Environment Committee on 1 May, and this note provides some brief background for Committee Members ahead of the meeting.

The meeting will give Committee Members an opportunity to review and ask questions about the performance of Dŵr Cymru Welsh Water ("DCWW") under Glas Cymru's ownership. Glas Cymru secured ownership of DCWW in May last year following a successful £1.9 billion bond issue. Following this change in ownership, because Glas Cymru has no shareholders and does not pay dividends all financial surpluses generated by DCWW are now retained and reinvested for the benefit of DCWW's customers. Also, because Glas Cymru is a single purpose company DCWW's only concern is its responsibilities as a regulated water and sewerage company. Less than 12 months after completion of the transaction, Glas Cymru's ownership is already delivering tangible benefits for DCWW's customers.

DCWW provides a key public service to much of Wales, and the change of ownership and the successful bond issue that financed it would not have been possible without the support of the National Assembly. Looking ahead, the National Assembly has a key role to play in determining the overall content of DCWW's plans for the period beyond 2005 as well as supporting Glas Cymru and its objectives more generally.

Following an 18 month review starting at the end of this year, Ofwat, the water industry economic regulator, will reset price-caps for all water companies in England and Wales covering the period 2005-2010 ("AMP4"). This "Regulatory Price Review" will include a detailed assessment of what needs to be done in terms of maintaining current standards, tackling high priority service shortfalls (eg risk of sewage flooding), delivering further improvements to water quality and particularly environmental quality, what costs should be allowed to enable efficient water companies to finance their functions, and how these costs should be reflected in the bills customers pay. A key objective must be for DCWW's plans to fully reflect those priorities that matter for Wales, and this is where the National Assembly has a key role to play.

Glas Cymru

Glas Cymru Cyf. was formed in April 2000 for the sole purpose of acquiring DCWW. It is a "company limited by guarantee" ("CLG") registered under the Companies Act 1985. A CLG is the same as any other company except that it has no share capital and has "members" instead of shareholders.

Glas Cymru's constitution strictly limits its purpose to that of financing water assets in DCWW's area of appointment and managing DCWW's business so that water and sewerage services are delivered at least cost to the communities served by DCWW while always ensuring "the proper carrying out of DCWW's functions and responsibilities" in accordance with its Licence and other obligations. Glas Cymru cannot diversify into other commercial activities.

Glas Cymru's constitution requires that the Board at all times has a majority of non-executive directors. Glas Cymru is chaired by Lord Burns and has five further non-executive directors and three executive directors. Short details on each director are set out in Appendix A. The directors of Glas Cymru are also directors of DCWW, its regulated operating subsidiary. In all respects, the Board of Glas Cymru operates in the same way as the board of any other large commercial company, and its constitution and Licence require that it complies with all Stock Exchange regulations and "best practice" codes regarding corporate governance.

Members of a CLG carry out the normal corporate governance duties of shareholders but unlike shareholders they do not receive dividends nor do they have any other financial interest in the company. Members carry out this normal corporate governance role at Annual General Meetings and in doing so they have a "duty to support the Company's primary objective of providing high quality water and sewerage services at least cost to the communities served by DCWW". Glas Cymru has 57 Members who have been appointed in accordance with the Company's published Membership Policy and following recommendation by an independent Membership Selection Panel. Members do not represent any particular constituency, but as a body are intended to be broadly representative of customer and other interests across DCWW's area of appointment.

The Glas Cymru bond issue

In May last year, Glas Cymru completed the largest corporate bond issue ever seen in the UK to finance the change in ownership and to fund DCWW's continuing capital investment programme. The bond issue raised £1.9 billion and despite the size of the issue it was 70% oversubscribed. The bonds are held by institutional investors (pension funds, insurance companies etc). The scale and success of the bond issue, alongside the innovative structure and approach the Glas Cymru "model" represents, attracted 12 different "deal of the year" City awards at the end of 2001 and as such represents a major commercial success for Wales.

The water industry everywhere is capital intensive, and the cost of paying a return on money raised from investors to finance assets is the UK water sector's single biggest cost, absorbing around one third of revenues. With continuing heavy capital investment the proportion of revenues absorbed by financing costs will continue to increase. Over the current five year regulatory period 2000-2005 ("AMP3"), because of the heavy capital investment programme, DCWW (like most other water and sewerage companies) is expected to spend on average £130 for every £100 it receives from customers. The water and sewerage sector in the UK is expected to remain "cash negative" for at least the next 10-15 years.

By funding DCWW's assets with long term, low risk bonds Glas Cymru has cut DCWW's cost of finance by around a quarter. This saving is worth over £50 million every year (or over 10% of annual revenues). In the first instance, these savings are being used to build up Financial Reserves to protect DCWW and its customers from any "shocks", and also to improve credit ratings so that the cost of finance can be reduced still further in the years ahead. Glas Cymru needs to raise around £1 billion of new capital from investors over the next five years, mainly to finance the continuing capital investment programme.

Once Financial Reserves reach a level which secures the lowest possible cost of finance for the long term, a growing proportion of annual savings can be returned to customers in the form of lower bills. While the immediate objective is to maximise Financial Reserves over the course of AMP3, at its first AGM in July last year Glas Cymru announced bill rebates totalling £23 million over two years, and in November announced a reinvestment of targeted savings worth £41 million to accelerate work on a number of high priority areas. The Financial Reserves - which are targeted to reach £400 million by 2005 - are the key measure of value created for customers by the Glas Cymru "model". The £23 million of initial bill rebates and the £41 million reinvestment of targeted savings are early evidence that Glas Cymru's ownership of DCWW is delivering tangible benefits for customers.

The reasons bond investors were willing to support the Glas Cymru transaction and allow Glas Cymru to reduce substantially DCWW's cost of financing included: the single purpose nature of the Glas Cymru "model" and the fact that it revealed and then "locked in the fact that the public service provided by DCWW is fundamentally "low risk"; the absence of equity and the alignment of interests between investors, regulators, management and customers; the strong corporate governance arrangements and clear incentives for executive management and staff; the competitive procurement strategy; the well established and generally supportive regulatory and political environment; and Glas Cymru's commitment to transparency in terms of reporting its financial and operational performance.

Bondholders have invested very substantial sums in Glas Cymru. This is "at risk" capital. If Glas Cymru was ever to get into financial difficulties it would be bond investors not Members or customers who would suffer losses. Bond investors therefore have strong rights and protections, and were Glas Cymru's financial position ever to begin to deteriorate, or were regulators to sanction Glas Cymru's management because of failure to achieve targets or poor performance against industry benchmarks, bondholders can progressively require changes to be made to remedy any shortfall in performance. In extreme circumstances, bondholders can require additional directors to be appointed should this be necessary to protect their investment. In this way Glas Cymru is fully exposed to the same disciplines that apply to any other commercial company.

Investors continue to show strong support for Glas Cymru. Since last May, the Glas Cymru bonds have traded well such that they currently enjoy the best "market" credit rating in the sector. Last month, Glas Cymru raised a further £120 million, on very competitive terms, to finance DCWW's ongoing capital investment programme.

Dŵr Cymru Welsh Water

DCWW is the sixth largest water and sewerage company in the sector. It provides water and sewerage services to over three million people living and working in Wales and some adjoining parts of England. In all, DCWW has 1.2 million household customers and over 110,000 business customers.

DCWW operates 84 impounding reservoirs, 104 water treatment works and supplies an average 900 million litres of water every day through a network of 26,800km of water mains, including 620 pumping stations and 740 service reservoirs. DCWW also collects wastewater (and surface drainage) through a network of 17,600km of sewers, including 1,650 sewage pumping stations and 3,000 combined sewer overflows. This wastewater is cleaned at 850 wastewater treatment works located next to rivers and along the coast of Wales. In all, DCWW employs assets worth over £13 billion, which is more than £10,000 for every one of DCWW's household customers.

DCWW's primary responsibility is to operate, maintain and upgrade this large network of assets, effectively and efficiently, so as to ensure a safe and reliable supply of drinking water and to deal effectively with wastewater so as to protect our natual environment.

Glas Cymru's ownship has secured these essential public service assets for the long term, and the "model" ensures that they are financed efficiently and operated efficiently with the sole aim of giving customers the best possible combination of quality of service and value for money.

Because DCWW employs more assets per customer (and has carried out more investment per customer since privatisation in 1990) its bills are higher than the industry average. Ofwat has recently published details on customer bills and this shows that 1999/2000, the last year of "AMP2" (ie 1995-2000), the average household bill in DCWW's region was £304. This year, because of further cost efficiencies made by DCWW, the average household bill is £28 lower at £276, but this is still £48 higher than the industry average of £228. Continuing capital investment will put upward pressure on customer bills across the industry, but by reducing the cost of financing DCWW's assets Glas Cymru's is aiming to reduce the impact and bring DCWW's bills more into line with the industry average.

Procurement

DCWW has implemented a new competitive procurement policy under which specialist service providers carry out under contract much of the day to day operation of its water and sewerage assets and service delivery. DCWW has also out-sourced customer billing and call centre operations. The contracts for asset operation are "source to tap" so that the integrity of the water supply system is always retained and there is no blurring of responsibilities. Procurement has always been a key capability of DCWW, and the new working arrangements increased the proportion of annual spend carried out in this way from around 60% to over 80%. This way of delivering services is designed to ensure DCWW and its customers benefit from the skills and capabilities of the best operators in the marketplace for each distinct area of activity. It is an effective way of introducing the benefits of competition to a public service like water and sewerage services, and is similar to the "affermage" model established in France and more recently in Australia and the US.

The new working arrangements are working well. The TUPE transfer was completed successfully and United Utilities has agreed a new partnership agreement with Unions which includes a continued commitment to no compulsory redundancy. The level of employment across all of DCWW's business continues to be determined by regulatory targets and the needs of the business.

Regulation

Like all other water companies in England and Wales, DCWW operates under a special regulatory framework prescribed by the Water Industry Act 1991. The Director General of Ofwat, the economic regulator, is responsible for setting limits on the prices that DCWW can charge its customers and for monitoring overall performance. The regulator with responsibility for drinking water quality is the Drinking Water Inspectorate (part of DEFRA), while the Environment Agency oversees DCWW's environmental performance and in particular regulates the way in which we abstract water from rivers and reservoirs and the basis on which we return cleaned wastewater to rivers or the sea.

All aspects of DCWW's water and wastewater operations are subject to extensive performance monitoring against standards and targets set by regulators and by Government. Each year industry regulators produce public reports commenting and comparing the performance of water companies across a wide range of measures, including cost efficiency, customer service, water quality and environmental quality. Each industry regulator (Ofwat, EA, DWI) has strong powers at its disposal which could be used in the event that DCWW's performance were not up to the required standard.

In this context, the National Assembly has a important role to play in determining the overall content of DCWW's future plans, including targets for water quality, environmental quality standards and improvements (within the framework of UK and EU legislation), as well as setting the framework for other public policy matters such as tariff structure, metering and competition.

Every five years Ofwat re-sets limits on the prices DCWW can charge its customers. The last regulatory review of prices, covering the five years to March 2005, (ie "AMP3"), was completed at the end of 1999. This review allowed for continued high levels of investment and included demanding targets for further improvements in cost efficiency. Over the course of AMP3, DCWW is expected to invest a total of £1.2 billion and, notwithstanding very significant improvements in cost efficency over the course of the 1990s, cut day to day operating costs by a further 15% in real terms.

As part of the regulatory review of prices, DCWW agreed with industry regulators targets for water quality, environmental quality and levels of service (as well as investment and cost efficiency) over the course of AMP3. These are summarised in DCWW's "Monitoring Plan", which is a public document available on both Ofwat's and DCWW's websites. Each year, DCWW, like all water companies, produces a comprehensive report (the "June Return") which details DCWW's financial, operational and investment performance against all the targets and other measures of performance monitored by regulators. This June Return is audited by Halcrows, the Company's Reporters (appointed jointly with Ofwat) and PWC, the Company's Auditors.

The fact that "much of what matters is measured" was a key consideration for bond investors, and this combined with Glas Cymru's commitment to regular and full reporting of performance against benchmarks and targets was crucial to the success of the bond issue.

Appendix B sets out a summary of DCWW's performance against key performance indicators for levels of service, water quality and environment for the year ended 31 March 2002. It shows that on most measures DCWW has achieved targets and improved performance compared with the previous year. In some key areas, such as bacteriological water quality, interruptions to supply, sewage flooding incidents (excluding those incidents caused by extreme weather), leakage, "Guideline" water quality at EU designated coastal bathing waters, and customer service response measures, performance is best ever. This is a credit to all the staff who work for DCWW and its partners operating under the new outsourcing arrangements, and is especially commendable given the uncertainties and disruption staff had to deal with during the demise of Hyder.

Appendix A

The Board of Directors

Lord Burns

Appointed Non-executive Chairman of Glas Cymru Cyfyngedig in July 2000, Lord Burns (57), who was made a life peer in 1998, is a former Chief Economic Advisor and Permanent Secretary to HM Treasury. He is currently Chairman of Abbey National plc and a Non-executive Director of Pearson Group plc and British Land plc. Lord Burns is also a former Chairman of the National Lottery Commission.

Mike Brooker

Appointed Managing Director of Glas Cymru Cyfyngedig on 11 May 2001, Dr Brooker (53) has been a Director of Dŵr Cymru Cyfyngedig since the privatisation in 1989 and Managing Director since 1997. Having joined Welsh Water in 1980 Dr Brooker, who is a scientist by qualification, has held a variety of senior roles in Welsh Water including Chief Scientist, Director of Quality and Planning, and Operations Director, South East.

Nigel Annett

Appointed Executive Director in April 2000, Mr Annett (42) was previously a director of Dŵr Cymru Welsh Water (1992 –2000).Prior to joining Welsh Water Mr Annett held various investment banking positions with Schroders, County Natwest and Wasserstein Perella.

Chris Jones

Appointed Finance Director in April 2000, Mr Jones (37) was previously Director of Regulation of Dŵr Cymru Welsh Water and South Wales Electricity PLC. Before joining Welsh Water in 1995, Mr Jones was a Director at National Economic Research Associates and, prior to that, worked for HM Treasury on utility industries and privatisation.

John Bryant

Appointed a Non-executive Director in March 2001, Mr Bryant (57) is a former Chief Executive of British Steel and until December 2000 he was Joint Chief Executive of Corus plc. Mr Bryant, who was born and educated in Wales, is also a Non-executive Director of Costain Group PLC. He was a Non-executive Director of Bank of Wales plc between 1996 and 2001.

Alison Carnwath

Appointed a Non-executive Director in July 2000,Mrs Carnwath (48) is Chairman of Vitec Group plc and a Non-executive Director of Nationwide Building Society, Arcadia Group plc, Friends Ivory and Sime Private Equity Plc, QA plc, Man Group PLC, Routiers plc and QA Group plc. After qualifying as a chartered accountant, Mrs Carnwath spent 20 years working in investment banking during which time she was a Director of Schroders and a Managing Director of Donaldson Lufkin Jenrette.

Geraint Talfan Davies

Appointed a Non-executive Director in July 2000, Mr Talfan Davies (57) is a former journalist whose career spanned both public and private sector broadcasting including Controller of BBC Wales throughout the 1990s. He is currently Chairman of the Institute of Welsh Affairs and of Welsh National Opera, and in March 2001 Mr Talfan Davies was appointed the first Member of the Radio Authority with special responsibility to represent Wales.

Dame Deirdre Hine

Appointed a Non-executive Director in March 2001, Dame Deirdre (63) is President of The Royal Society of Medicine and Chairman of the Commission for Health Improvement. A former Chief Medical Officer for Wales, following her retirement Dame Deirdre was awarded the DBE in 1997 for services to medicine.

Tony Hobson

Appointed a Non-executive Director in February 2001, Mr Hobson (54) is a chartered accountant who was until recently Group Finance Director of Legal and General Group Plc, a position he held since 1987. He was previously with Sperry Corporation, SG Warburg and Arthur Andersen. He is a Non-executive Director of HBOS plc, Jardine Lloyd Thompson Group plc and ESG Re Limited, and was formerly the senior independent Non-executive Director of Thames Water PLC.

Appendix B

Last year's performance at a glance - Customer Service, Water Quality, Environment

Year to 31 March 2002	Actual	Last year	Annual Target	Better/worse than last year	At or above target
Level of Service					
Properties at risk of low pressure (DG2)	0.06%	0.11%	0.14%	✔	✔
Properties experiencing unplanned interruption to supply (DG3)	0.13%	0.31%	0.66%	✔	✔
Properties at risk of sewage flooding (DG5)	0.03%	0.03%	0.03%	✔	✔
Sewer flooding incidents, hydraulic overload *(note)*	60	205	n/a	✔	n/a
Sewer flooding incidents, other causes	132	228	n/a	✔	n/a
Billing contacts answered within 5 days (DG6)	99.9%	99.5%	99.2%	✔	✔
Written complaints answered within 10 days (DG7)	99.1%	99.4%	99.5%	✘	✘
Number of written enquiries and complaints	18,670	12,827	n/a	✘	n/a
Customer meters read within year (DG8)	99.9%	99.9%	99.9%	✔	✔
Telephone contact answered within 30 seconds (DG9)	98.5%	93.7%	94.6%	✔	✔
Water quality					
Overall water quality compliance at customers's taps (Jan to Dec)	99.6%	99.6%	99.6%	✔	✔
Iron compliance at customers's taps (Jan to Dec)	98.8%	98.0%	97.7%	✔	✔
Bacteriological compliance at customers's taps (Jan to Dec)	99.8%	99.7%	n/a	✔	n/a
Environment					
Leakage (m^3/km/d)	[9.2]	10.2	9.2	✔	✔
No. of category 1 and 2 pollution incidents (Jan to Dec)	21	11	<12	✘	✘
Customer's served by compliant waste water treatment works	99.9%	97.2%	>95%	✔	✔
Waste water treatment works complying with regulatory standards	99.1%	98.4%	>99%	✔	✔
Sewage sludge re-cycled satisfactorily	100%	100%	>99%	✔	✔
Compliance with mandatory bathing water quality standard	93.3%	98.7%	>98%	✘	✘
Number of bathing beaches achieving guideline standard	45	32	n/a	✔	n/a

Note: *This measure of performance captures flooding incidents caused by hydraulic overload following storms which have a "return period" of 1 in 10 years or less. In addition, last year there were 771 flooding incidents due to severe storms with a"return period" greater than "1 in 10"; of these 709 were caused by storms with a "return period" of greater than "1 in 30".*