Environment, Food and Rural Affairs Committee Inquiry: Ofwat's Price Review 2009

Submission from Dŵr Cymru Welsh Water

1. Since 2001 Dŵr Cymru Welsh Water ("Welsh Water") has been owned by Glas Cymru – a "not for profit" company (it is a "company limited by guarantee"). It is unique amongst UK utility companies in that it has no shareholders and it reinvests all its financial surpluses for the benefit of Welsh Water's customers.
2. Welsh Water is in effect owned on behalf of its customers. Our only purpose is to deliver – efficiently, reliably and affordably - the essential public service of safe drinking water and reliable sanitation to the three million people who rely on Welsh Water, and to look after – as trustees - the very long term water industry in our region (ie most of Wales and some adjoining parts of England) for future generations.
3. Glas Cymru (and Welsh Water) is chaired by Lord Burns and its Articles require that the Board comprises a majority of non-executive directors (currently, in addition to the Chairman, there are six non-executive directors and three executive directors). In place of shareholders, the Board of Glas Cymru is accountable to currently 72 Members, selected through an independent process to broadly represent stakeholders of Welsh Water and otherwise ensure the proper governance of the Company. The water industry is especially measurable, with water quality, environmental performance and customer service all capable to being benchmarked and judged against what other water companies are able to achieve (ie "comparative competition"). Executive director pay is tied to Welsh Water's performance relative to the rest of the sector on the measures of performance independently captured by regulators which cover most of the things that matter for customers (see attachment 3).
4. Because of its unique ownership structure, Welsh Water has been able to finance its assets more efficiently than assumed by Ofwat, and absent shareholders these efficiency savings in effect "belong" to Welsh Water's customers in the sense that there is no other claim on this "equity". In the 7 years since Glas Cymru secured ownership of Welsh Water, we have built up financial reserves or "customer equity" of some £1 billion - ie some 25% of Welsh Water's £3.5 billion "regulatory asset value" (see attachments 6, 7 and 8). Because of continuing large capital investment programmes, Welsh Water, like the rest of the water industry, is cashflow negative. The higher the level of reserves, the lower the cost of financing this cashflow deficit. Every 1% saving on the cost of finance is equivalent to a 5% savings on customer bills. Welsh Water has placed most emphasis on ensuring that the water industry in Wales is seen as a "safe home" for long term funding by investors. As a result of its ownership, purpose, constitution, governance and performance to date, Welsh Water has been able to achieve long term funding for its capital investment programme at some of the lowest rates of interest ever achieved in the water sector. Welsh Water currently has the highest credit rating in the sector (see attachment 5). One of our biggest concerns is being able to continue to finance efficiently in the years ahead, particularly given the current "credit crunch" and Ofwat's intent on seeing a "break up" of the regulated water and sewerage industry on the grounds of "competition" which will increase risk and uncertainty for long term investors – increasing the cost of finance .

5. As well as building up reserves to reduce the long term cost of financing its assets and continuing investment programme, Welsh Water has distributed to date around a quarter of its annual financing efficiency savings to customers in the form of a growing annual "customer dividend". This year (2009-10) the "customer dividend" is £22 per customer which will bring the total of "customer dividends' paid in recent years by Welsh Water to over £150 million. As a result of the growing customer dividend, Welsh Water's average household bill is falling relative to the rest of the sector (see attachment 2). Given our ownership structure and purpose, the essential nature of the public service Welsh Water is responsible for, and the fact that average household incomes are lower in Wales than elsewhere, affordability is a key consideration in everything Welsh Water does and plans. The "customer dividend" is flat so as to favour customers on low incomes. And when combined with other recently introduced "assistance" tariffs to help customers on low incomes the "customer dividend" can reduce the water and sewerage bill for some of our least well off customers by more than 10%.

6. Welsh Water is the only water company to propose flat bills (in real terms) in the next five year regulatory period 2010-2015. By setting further stretching targets for improvements in efficiency (see attachment 4), Welsh Water can finance an investment programme of some £1.4 billion over the next five years (ie similar in size to the current five year investment programme) without having to increase bills by more than inflation. Independent customer research carried out by Ofwat and others showed a high level of support for this plan – it showed that 93% of customers were happy with the plan, its priorities and cost (see attachment 10).

7. The same research showed that 79% customers believed that Welsh Water provides good value for money and indeed overall Welsh Water was the second highest rated company in the sector for customer service and satisfaction (see attachment 10). In part, we believe, this is due to the fact that customers of Welsh Water - and in particular their representatives in Wales – support the principle that the water industry and the public service it provides should be run and owned on behalf of customers (see attachment 1).

8. Delivering such a large investment programme in the next five years while keeping bills flat in real terms will be challenging and is still subject to a number of major risks, including requirements by the Environment Agency to invest further substantial sums to achieve further environmental improvements, the prospect of a significant increase in local taxes (ie business rates), and the impact of the current severe economic downturn on our revenues and the cost of finance to fund the capital investment programme.

9. Welsh Water is generally content with the conduct of the PR09 review undertaken by Ofwat. For the reasons set out above, we obviously support the fundamental approach of placing customers at the heart of this review and also many of the initiatives included in the Review process. We believe the emphasis on high standards on drinking water quality is vital to reinforce the trust of our customers and ensure that the high standards of service are maintained. We also welcome the increased importance placed on both social considerations. The early indication as to what capital investment programme would be supported by Ofwat in its final determination has been an important and very worthwhile development

allowing companies to plan with more certainty and reduce the disruptive and inefficient "feast-famine" profiles of capital investment expenditure that has characterised previous regulatory price reviews (we will invest over £330 million in the coming financial year).

10. Welsh Water's plan has been carefully developed with the aid of the company's Strategic Investment Planning System, which will enable us to operate a five-year rolling business plan and include a full cost benefit analysis of the programme. Our priorities are based on customer views obtained through extensive customer research and also through stakeholder discussion chaired by the Welsh Assembly Government.

11. We are keen to ensure that a stable regulatory regime exists and continues into the future. Such a regime must be effectively run to ensure that our customers know where they stand in terms of bills and payment, particularly in the current economic environment. Stability is essential for our customers, and is also vital to ensure ongoing investment is maintained.

12. A key feature of Glas Cymru is to de-risk the water industry in Wales so that long term investors continue to provide funds to Welsh Water with confidence. In 2001, £1.9 billion was raised in bonds to enable Glas Cymru to acquire Welsh Water. Since then, a further £1.3 billion has been raised. As indicated above, the key to keeping customer bills affordable while large capital investment programmes to maintain and improve the industry's network of long term assets (Welsh Water employs assets with a replacement value in today's money of £19 billion – ie £15,000 per customer) is to ensure the water industry is seen by investors as low risk and a "safe home" for long term funds. We believe that the arrangements we have put in place in Wales with the support of the Welsh Assembly Government in particular (thereby reducing "political and regulatory risk" for investors) demonstrate what can be achieved with this emphasis.

13. Our biggest concern is the agenda being pursued by Ofwat to "break-up" the water industry in the name of "competition". We believe this will undermine the public service nature of the water and sewerage industry, with significant "cross subsidies" unwound creating large numbers of "winners and losers". It will also increase the cost of financing the water industry, its biggest single cost (the cost of financing investment carried out since privatisation now represents over 30% of the average bill) and where every 1% increase adds 5% to bills. Comparative competition and competition "for the market" (eg Welsh Water currently outsources to "best in class" companies over 80% of its operating and capital costs – see attachment 4) continue to deliver real benefits without undermining the public service nature of our industry and without the risk of undermining investor confidence.

Attachment (1)

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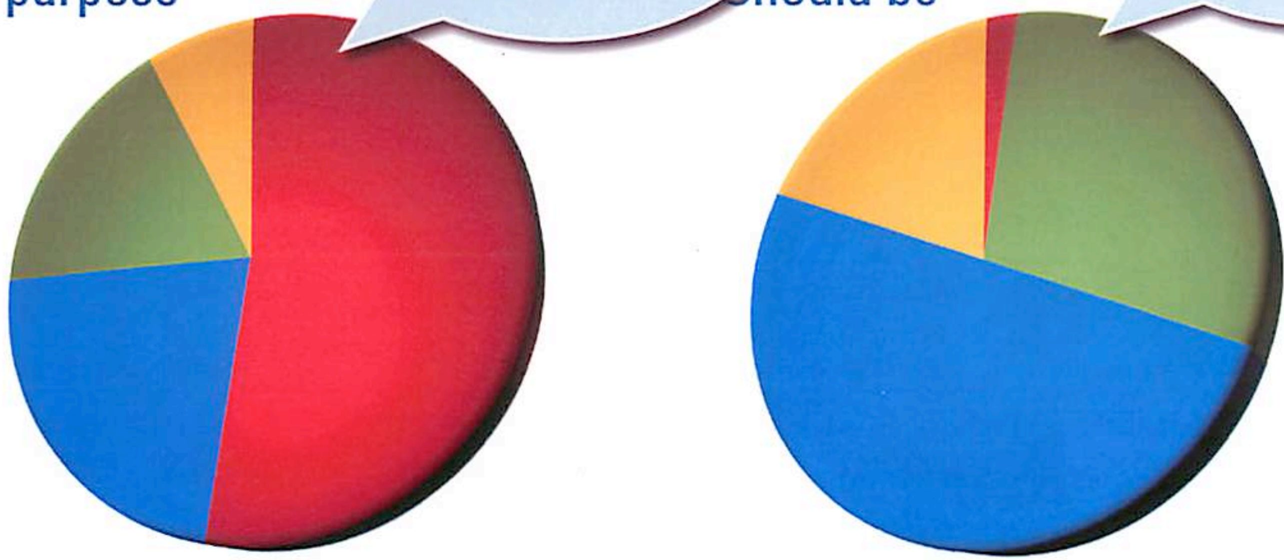
A problem with legitimacy?

This is what customers think companies are actually most concerned about...

This is what customers think companies should be most concerned about...

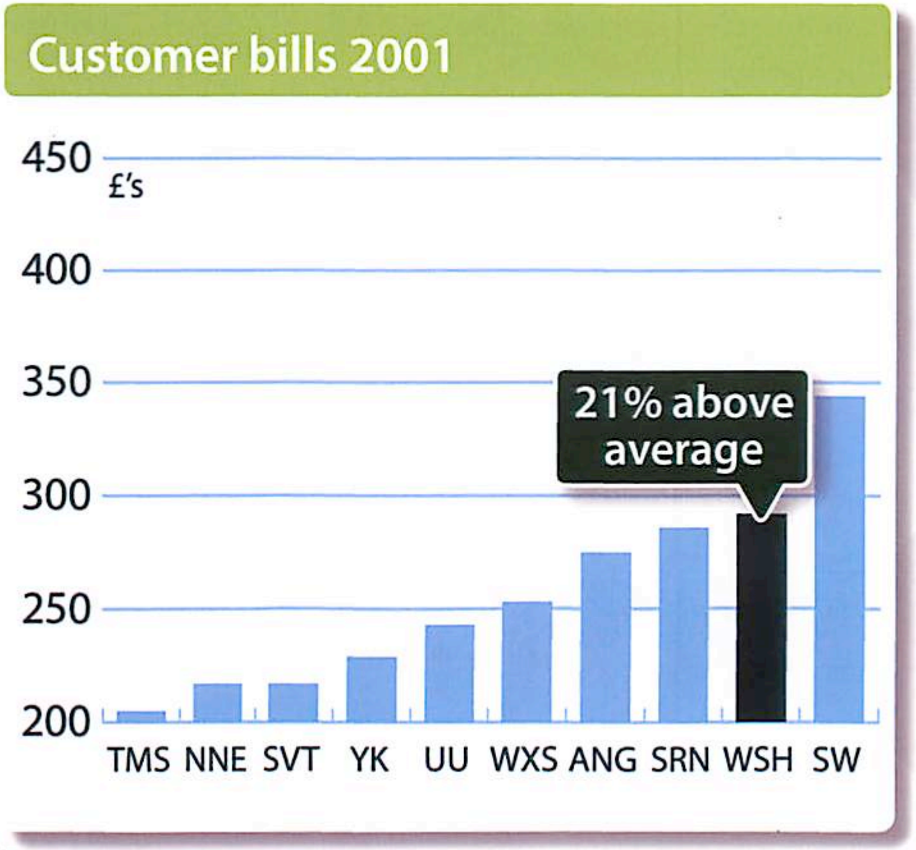
Main purpose

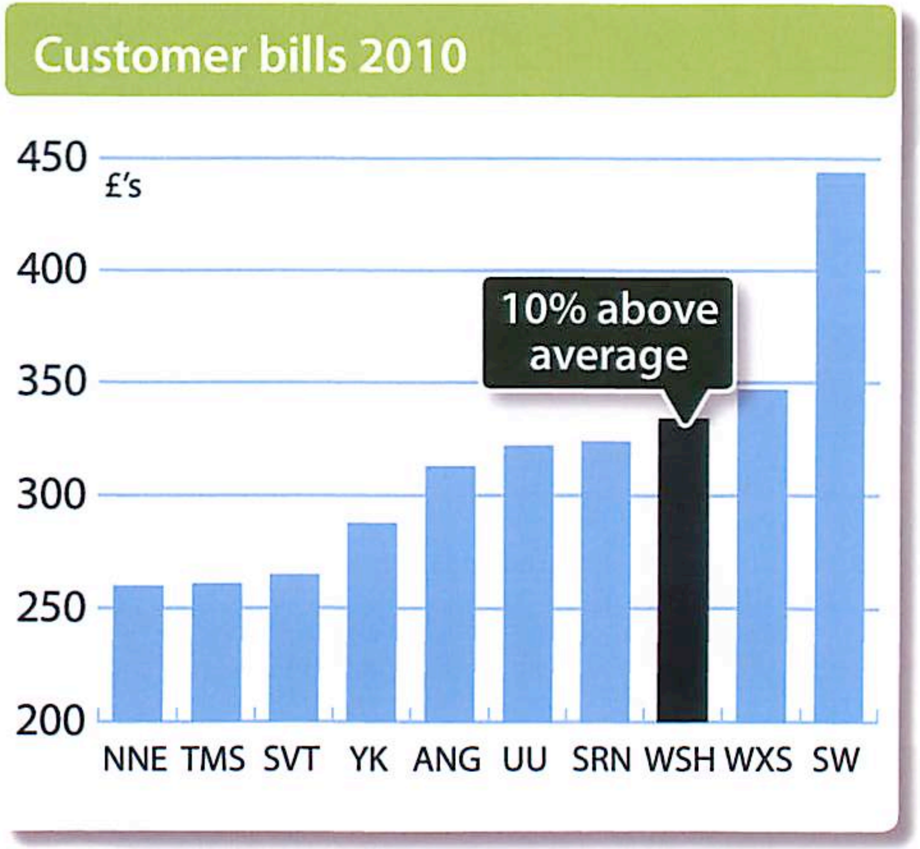
hould be



Attachment 2

Household bills





Attachment 3

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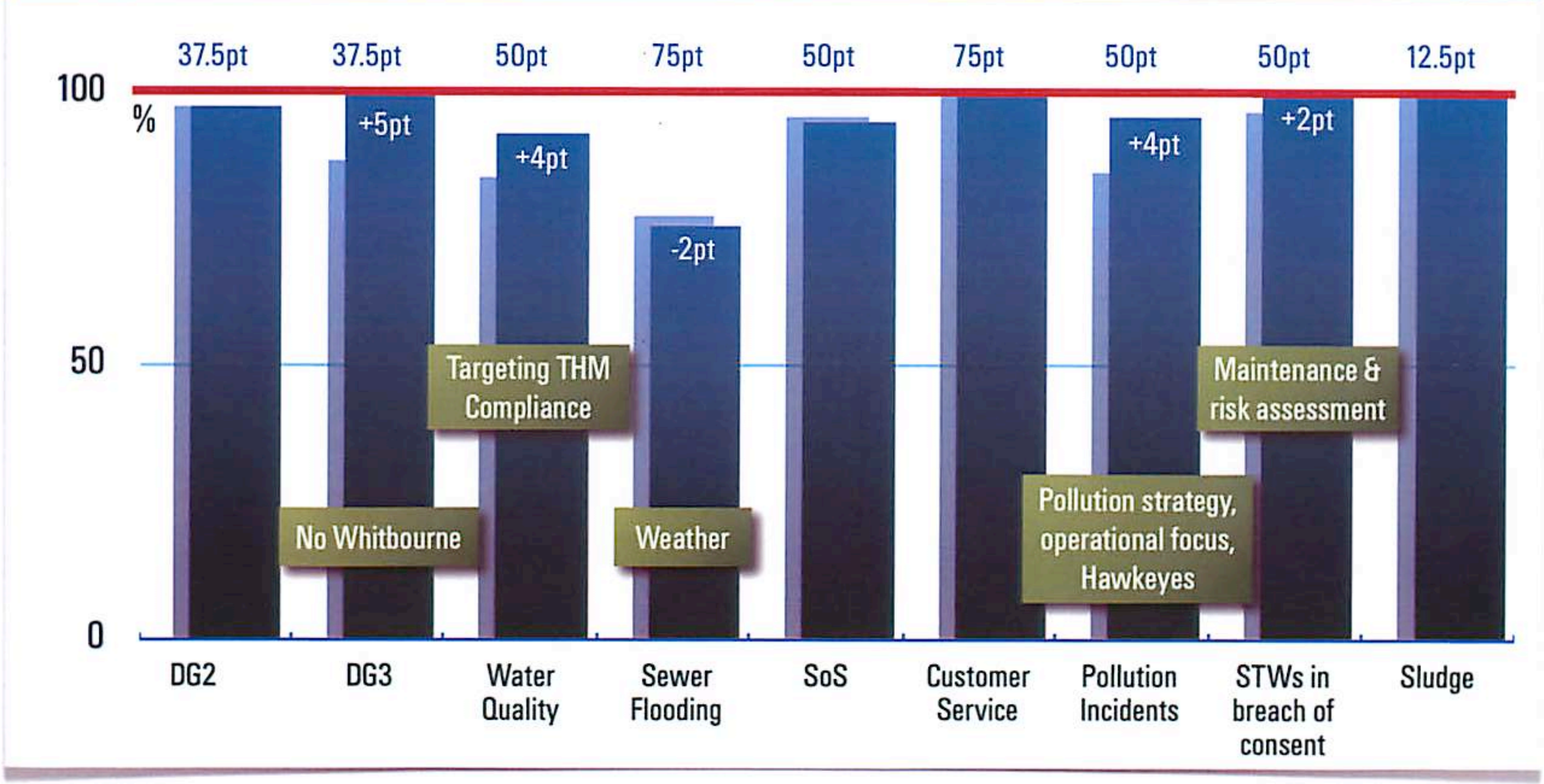
Overall Performance Assessment

Predicted OPA score 2008/09



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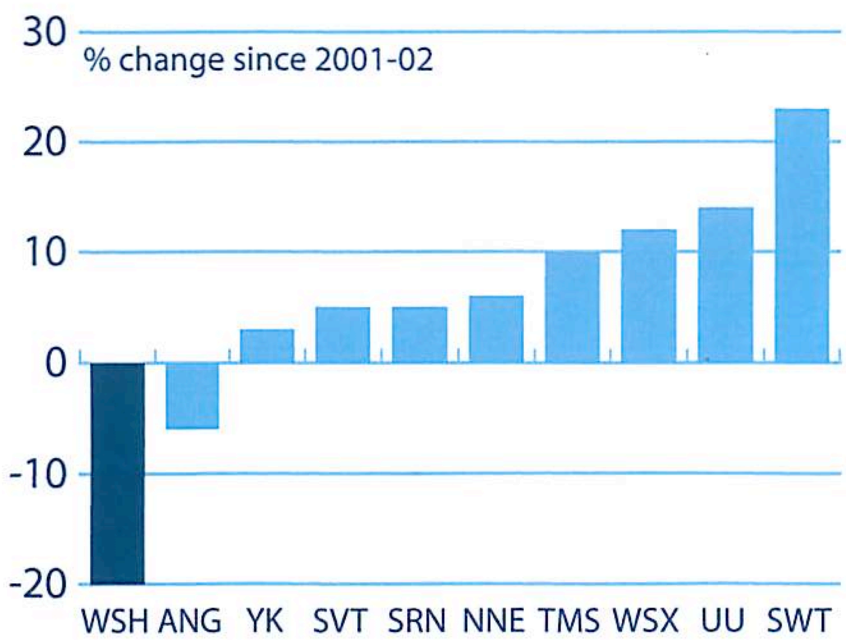
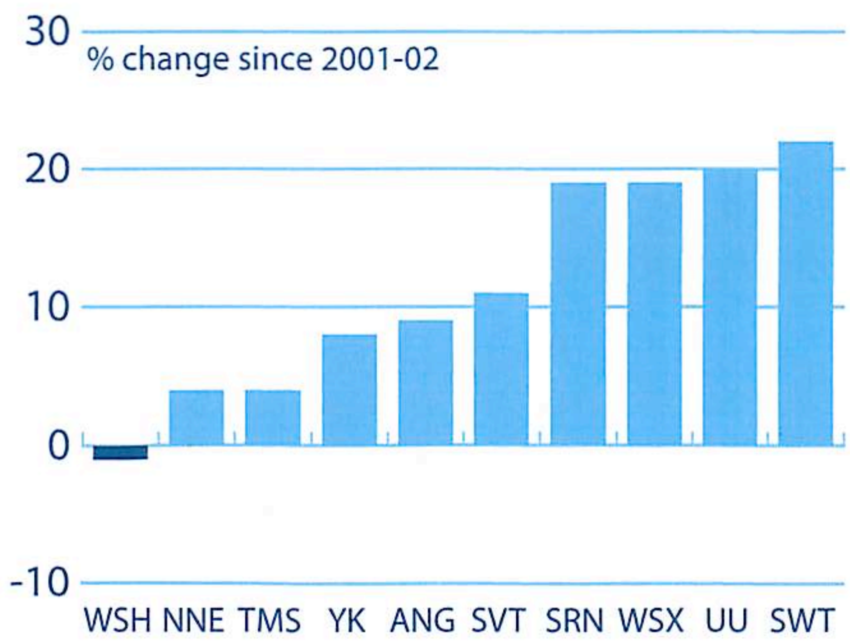
Cost efficiency

Operating expenditure - Water



Operating expenditure - Sewerage



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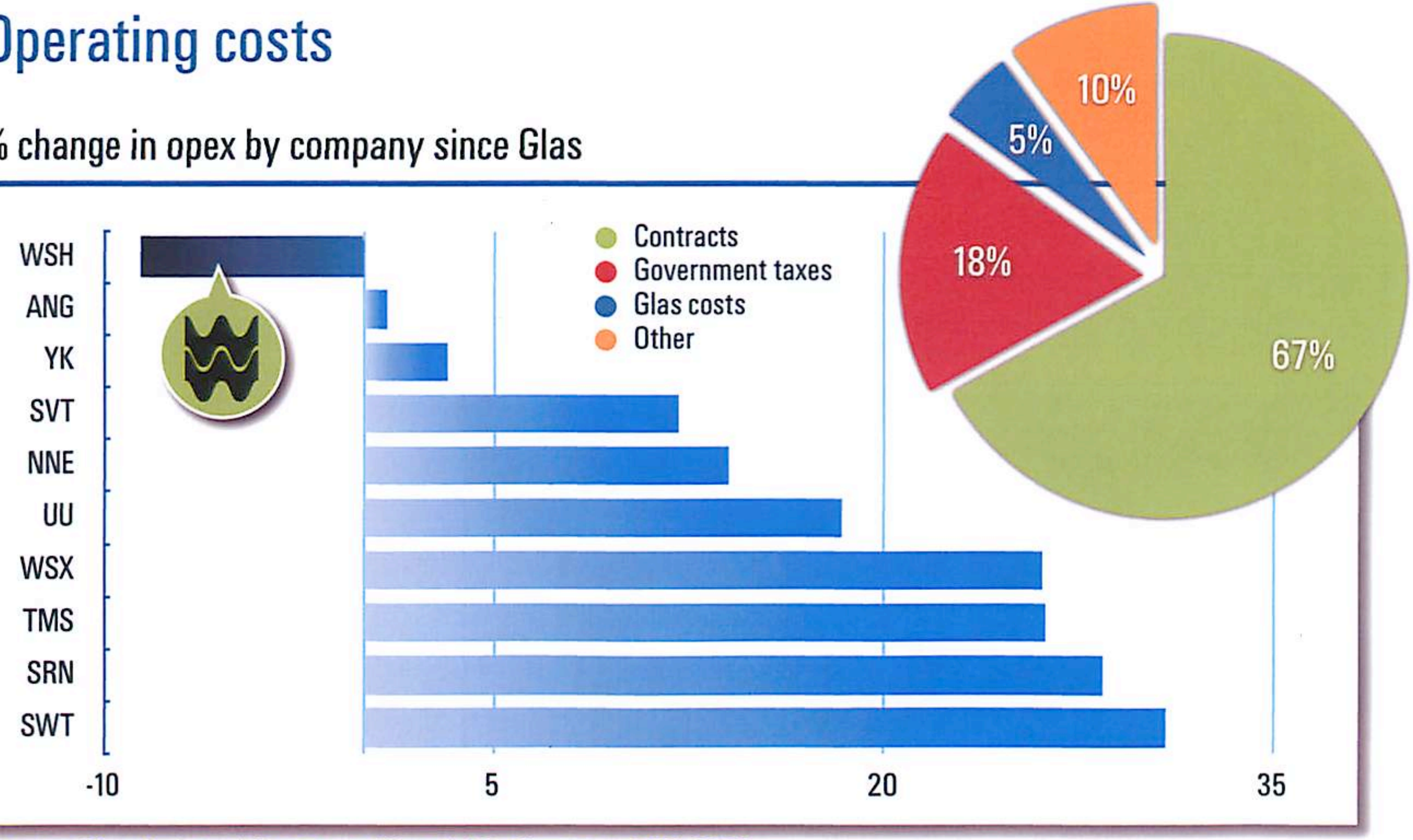
Operating costs

% change in opex by company since Glas



Source: Ofwat's Annual Reports on Financial Performance 2001-2007

In April 2007, Ofwat issued a paper entitled *Outcomes of Ofwat's Internal Review of Market Competition in the Water Sector* as part of its review of competition in England and Wales. Much of the debate arising from this paper has centred on how competition might be increased and whether it can successfully create value for the industry and consumers.

From the perspective of Standard & Poor's ratings service, more competition in the water sector could affect the financial risks of the sector and therefore the ratings of water firms.

The regulator proposes that competition be enhanced through unbundling the value chain, as has already occurred in the former monopolies of telecommunications, gas, and electricity. Consequently, a rated entity's new structure may result in changes to its risk factors, which may in turn lead to a reassessment of credit quality.

Utilities could, for example, withdraw from competitive segments to focus on regulated network activities. All else being equal, this could maintain our view that the sector is exposed to low business risk. However, if expansion into competitive segments were to lead to greater cashflow volatility than that of utilities with purely monopolistic activities, the result could be a greater divergence of ratings within the sector.

Under Ofwat's proposals, contestable markets would be separated from natural monopoly activities in both water and wastewater. In the water and sewerage sector, eight main segments constitute the value chain. The regulator could enhance competition in the contestable segments – both upstream and downstream – while the network segments could remain regulated monopolies.

According to Ofwat, most of the water and sewerage value chains are composed of upstream (such as water resources and treatment) and downstream retailing activities, which have been identified as potentially contestable. In addition, Ofwat has said that several separate markets within the wider water and sewerage industries are or could be contestable, such as resources and abstraction, on-site effluent treatment, and water and sewage treatment.

As a first step, Ofwat proposes that all water-only companies and water and sewerage companies be required to report disaggregated accounts for each element of the value chain from 2010. This will create the cost transparency the regulator needs to set price limits for each segment, which it aims to do on a trial basis during 2010-15. Ofwat suggests that formal price control separation would then be implemented from 2015.

At Standard & Poor's we note that Ofwat views competition as potentially providing cost benefits to consumers while also driving the efficiency and innovation required to tackle long-term challenges such as climate change and security of supply.

Last February, the government appointed Martin Cave of Warwick University to lead an independent review of the costs and benefits of competition in the water and wastewater sector, which should be published in spring 2009. In his initial comments, Cave expressly linked competition with meeting the "challenge of delivering large capital programmes on the basis of sustainable and low-cost finance".

Most water utilities in England and Wales achieve ratings of "A-" or "BBB+", and nearly all have a "stable" outlook. The primary underpinning of these ratings is our view of low business risk in the sector, which is characterised by: a significant share of their profits coming from low-risk regulated activities; established and relatively transparent regulatory processes; strong and stable operating performance; and strategic focus on owning and managing regulated water and sewerage assets.

Nevertheless, at Standard & Poor's we view the sector as having relatively high financial risk. The companies have relatively high financial leverage, large mandatory capital expenditure programmes, generally negative pre-financing cashflow, and significant continuing funding needs.

The relatively low business risk means that for a given rating, a water utility can sustain more leverage than a company in a higher risk sector. To maintain ratings in the A/BBB+ range, we expect rated UK water utilities to maintain funds from operations (FFO) coverage of adjusted debt of about 10-15 per cent.

By contrast, UK-based Scottish and Southern Energy (A/Negative/A-1) – which operates in the unbundled energy market and relies on unregulated, competitively exposed segments for 40 per cent of its profit – requires FFO to adjusted debt of about 20 per cent to sustain such a rating. In the competitively exposed UK telecoms and retail sectors, BT Group (BBB+/Negative/A-2) had an actual FFO to debt ratio of about 36 per cent (for the year ended March 2008).

Therefore it follows that, if business risk for rated water utilities in England and Wales increases (for example, if enhanced competition increases the volatility of revenues from the contestable segments), companies are likely to need to reduce their financial risk in order to mitigate the effect on ratings.

Indeed, in this scenario, if the financial risk were to remain broadly unchanged, the ratings could be lowered, all other things being equal.

The potential future organisational structure of rated water utilities in an unbundled water market remains uncertain, and therefore a statement on the possible direction of ratings is premature. Currently, our ratings take a consolidated approach by assessing the financial and business risks of the consolidated group to determine the corporate credit rating. When assigning a debt rating for a particular entity within a consolidated group, the debt rating is notched up or down, if necessary, from the corporate credit rating depending on the characteristics and seniority of the debt instrument.

In theory, if rated water and wastewater utilities in England and Wales retain ownership of all segments of the value chain, pressure on the corporate credit rating could develop if the contestable segments show greater revenue volatility than those segments of the value chain currently exhibit. However, it is not yet clear whether existing corporate ownership structures would continue. Utilities could withdraw from the contestable segments to focus on regulated monopolistic segments, which could, all else being equal, maintain our view that the sector is exposed to low business risk.

Conversely, if unbundling were to result in sector consolidation, those utilities that expand their presence in contestable segments would be expected to have a greater business risk than those operating only in monopolistic segments. If expansion into contestable segments were to lead to greater cashflow volatility than that of utilities with purely monopolistic activities, the result could be a greater divergence of ratings among utilities in England and Wales.

Ofwat's plans also include the subdivision of water companies' regulated asset value (RAV) between each segment of the value chain. The RAV represents the value of the investment on which the utility earns a return through the payment of water bills. The potential impact on each segment's leverage could affect the ratings. Separating the RAVs and associated cashflows of the contestable segments would increase leverage at the regulated networks unless there was a corresponding separation of debt.

However, the implications of subdividing a utility's RAV may present difficult implications because the debt of contestable segments could lie outside the regulatory ring-fence, which offers a number of advantages including a lower cost of debt. In addition, debt or RAV separation could trigger covenant breaches in loan documentation.

Retaining access to relatively low-cost financing is more important than ever before, especially considering the current difficult market conditions. Indeed, the regulator estimates that total investment by the water sector will increase to about £27 billion in 2010-15, from about £20 billion in 2005-10. Certainly, such access will be more easily facilitated if ratings within the sector remain healthy. ■

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Water company ratings, as of 13 November 2008

Water and sewerage companies	Corporate credit ratings
Kelda Group	A-/Watch Neg/A-2
Northumbrian Water	BBB+/Stable/--
Severn Trent	A/Stable/A-1
South Staffordshire Water	BBB+/Stable/A-2
Sutton and East Surrey Water	BBB+/Stable/--
Three Valleys Water	A-/Stable/--
United Utilities	A-/Stable/A-2
Wessex Water Services	BBB+/Stable/--
Corporate securitisations	**Underlying senior/junior tranche ratings**
Anglian Water Services Financing	A-/BBB
Dwr Cymru (Financing)	A/BBB+
South East Water (Finance)	BBB/--
Southern Water Services (Finance)	A-/BBB
Thames Water Utilities Finance	BBB+/--

Attachment (5)

Attachment 6

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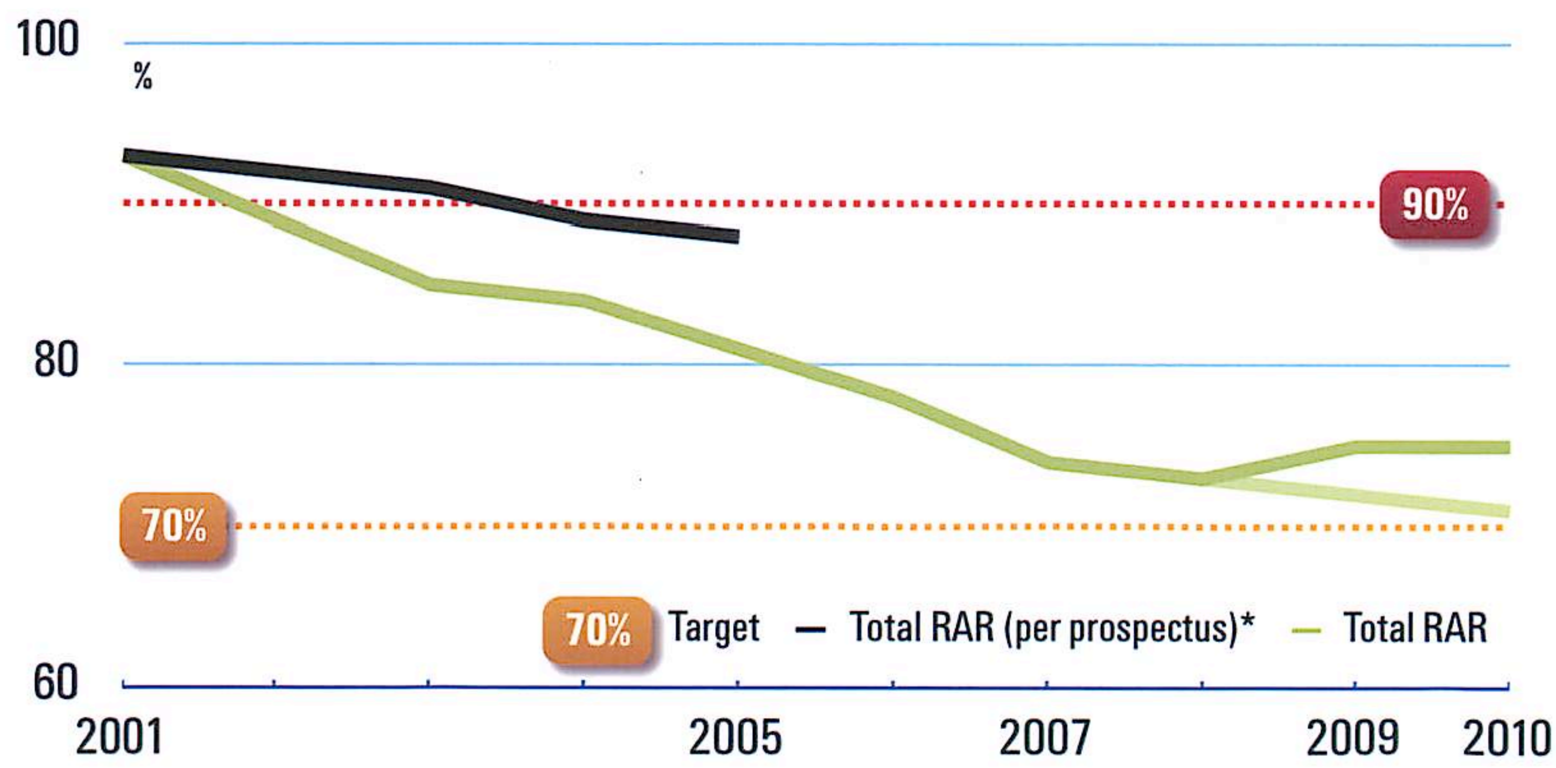
Regulatory gearing - stressed case

Regulatory asset ratio (RAR)



*Prospectus to 2005 only.

Attachment 7

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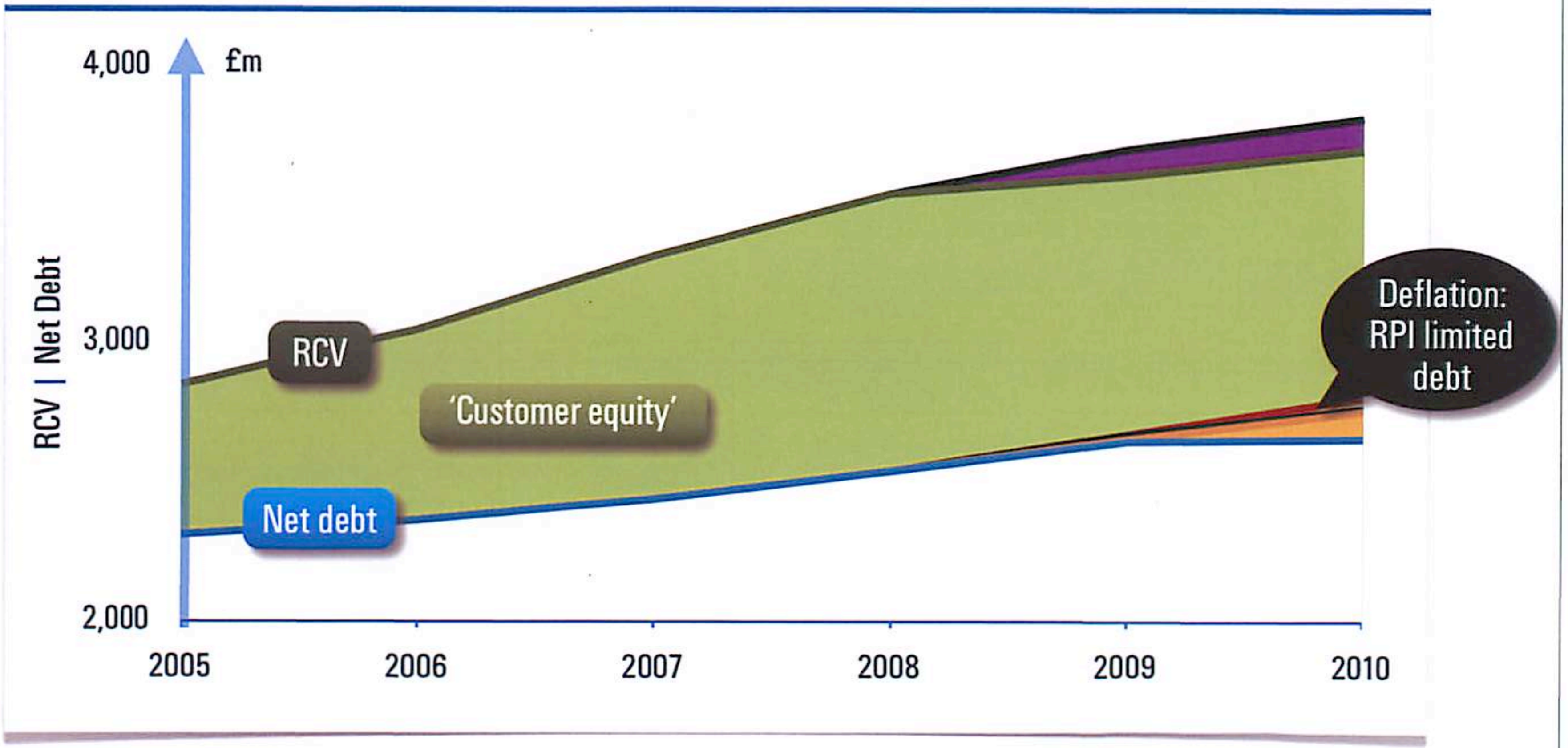
Growth in 'customer equity'



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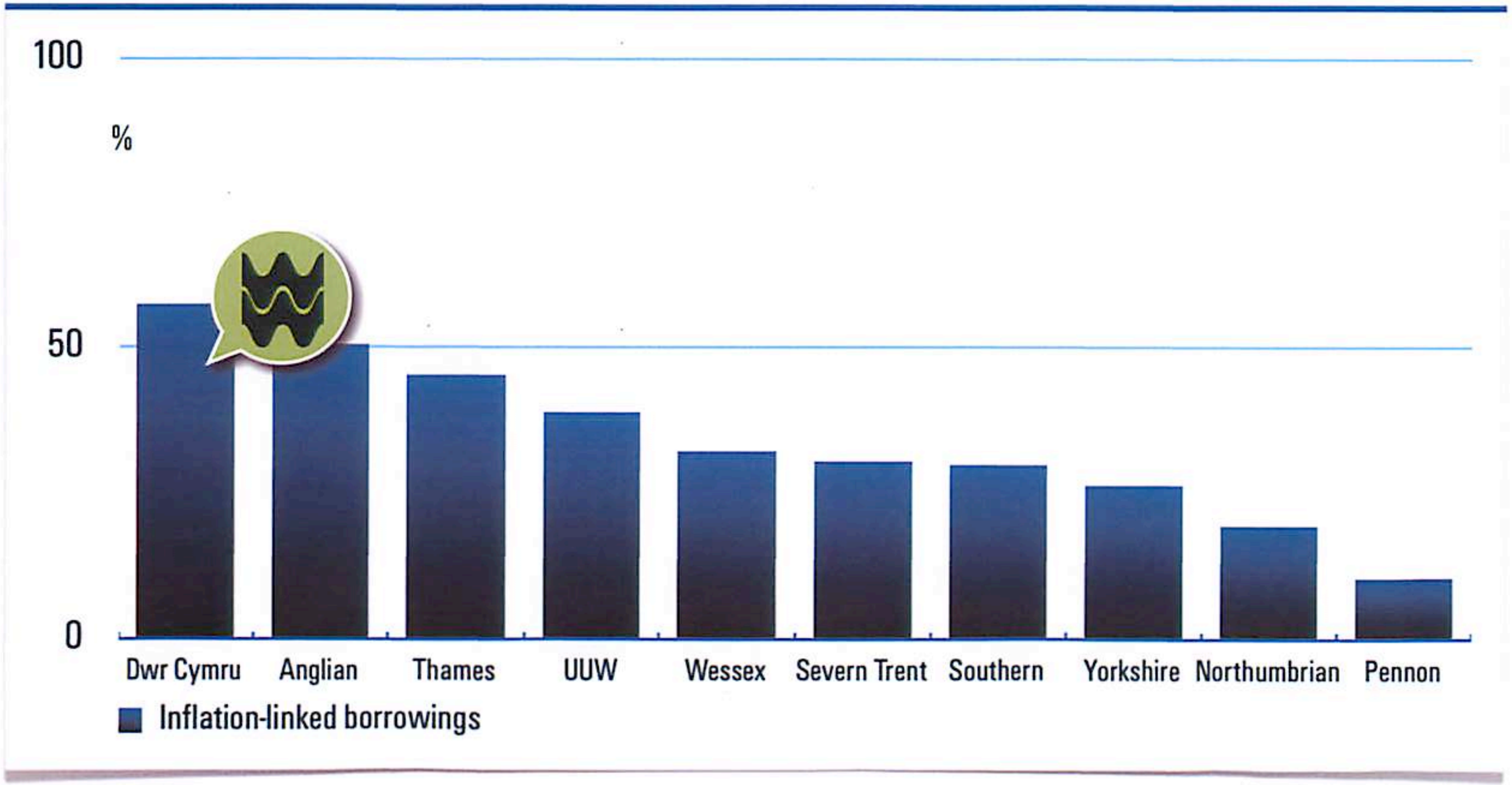
Index linked bonds



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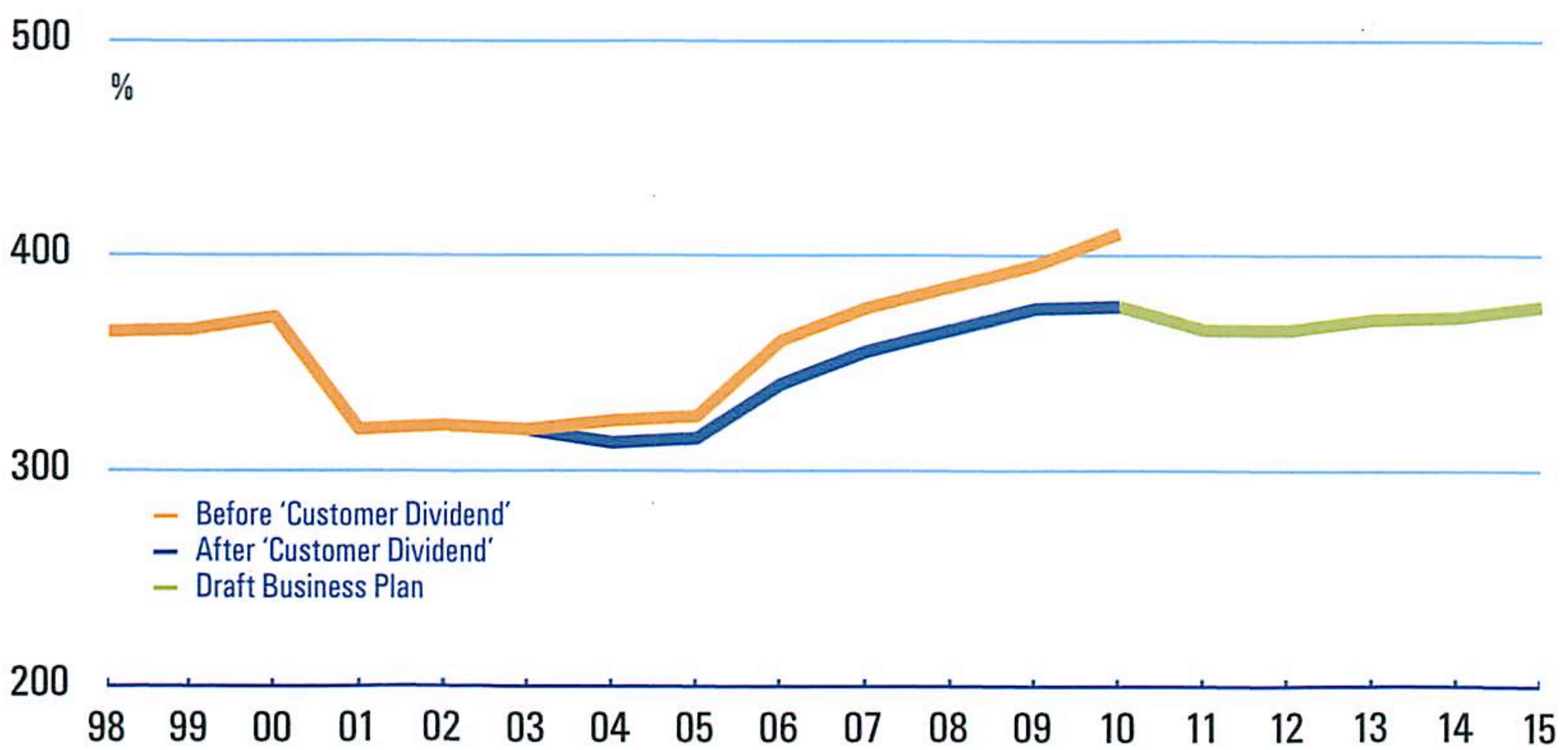
Flat bills proposed in Draft Business Plan

Customer Bill



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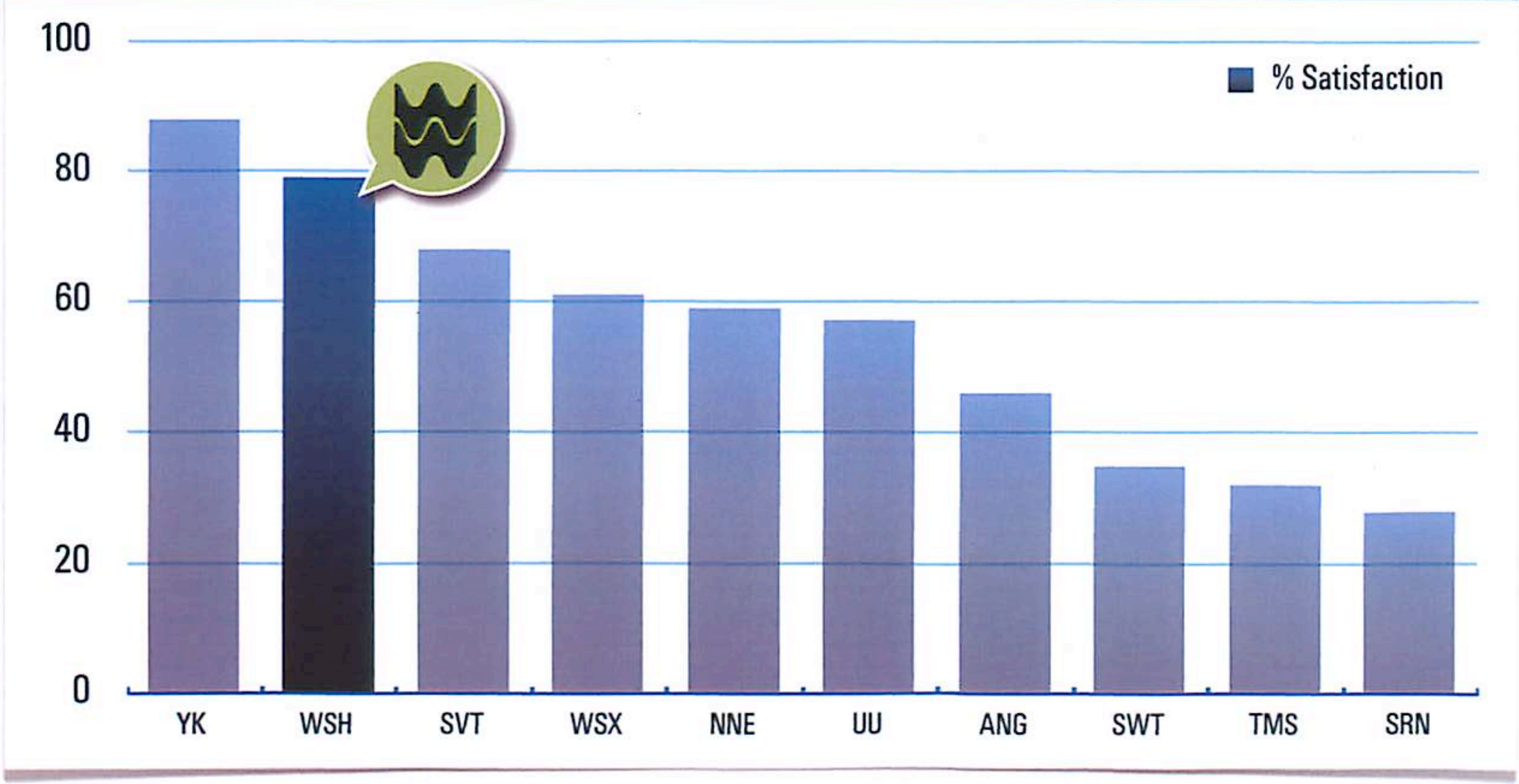
PR09 customer research results

Good value for money for the service delivered



Source. OFWAT – PR09 Quantitative Research into customers' priorities – Overall Report January 2009

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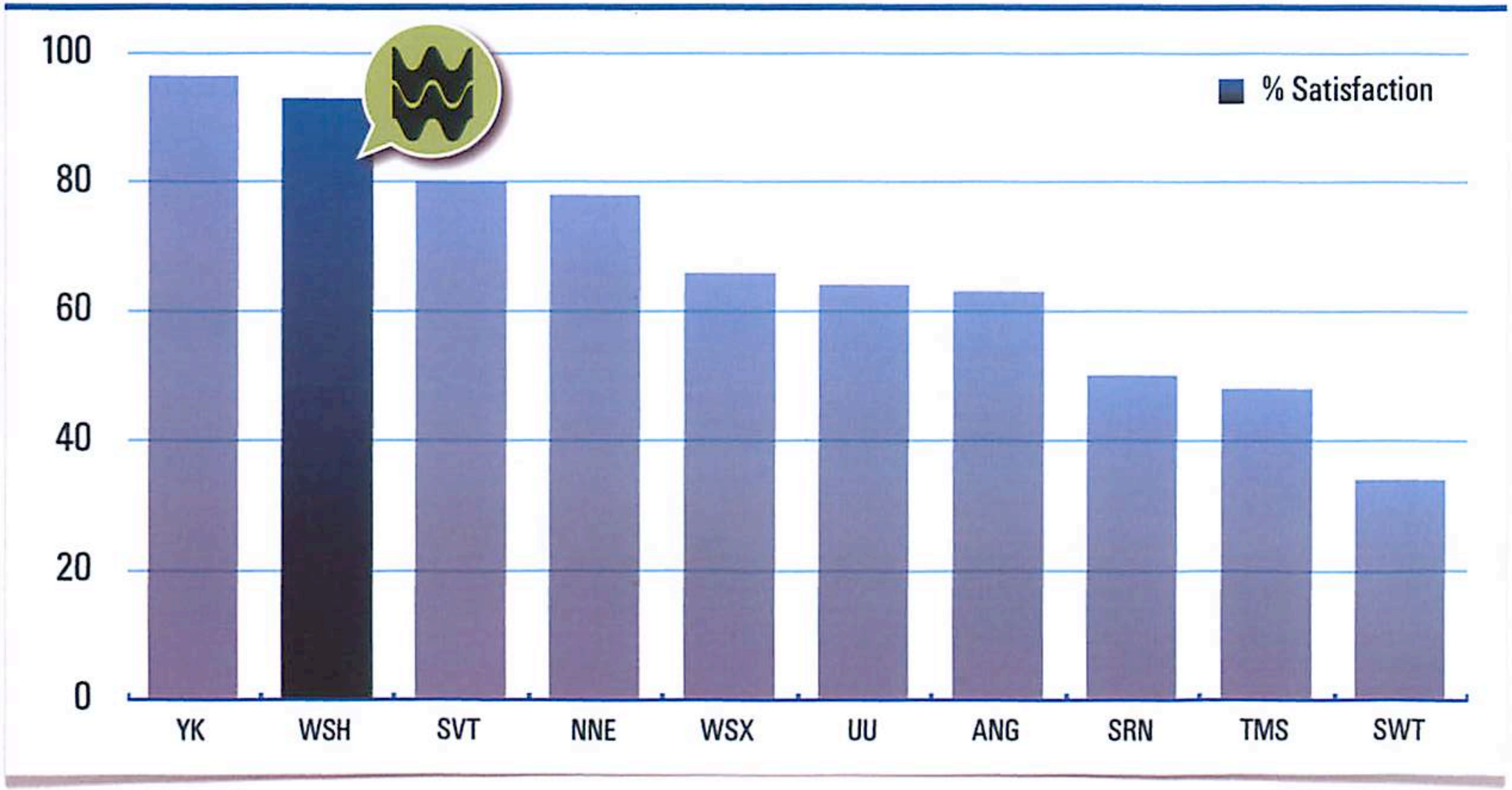
PR09 customer research results

Acceptability of Draft Business Plan as a whole



Source. OFWAT - PR09 Quantitative Research into customers' priorities - Overall Report January 2009