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Cave Review of Competition in Water Markets
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22 August 2008

Martin Cave

I have previously let you have a copy of the "position paper" we prepared last September as part of our response to the first part of Ofwat's consultation on the scope for greater competition in the water industry. That "2007 position paper" was a development of our earlier "2002 position paper", and in response to your call for evidence I enclose a copy of both with this letter.

The main theme in our "2007 position paper" is that any reform of the current structure and regulation of the water industry should be derived from a careful understanding of its fundamental features and on this basis we have concluded that there is a fairly realistic prospect that the possible benefits of competition of the kind envisaged by Ofwat in its two consultation papers would not outweigh the costs. This continues to be our position.

We have contributed to and are, in the main, content with the WaterUK response (14 August) to your call for evidence. My aim in writing this letter is to add emphasis to a number of points that we believe should be especially important considerations in your review.

Raw water rights

In our "2007 position paper" we argued that the most promising area for further analysis appeared to be "upstream" of water undertaker operations, namely the potential creation of markets for water rights. Although this would entail fundamental reform, we stated that:

"Prima facie, on the basis that the opportunity cost of raw water varies significantly from user to user, from one time period to another, and from one place to another, the introduction of markets for water rights in England and Wales theoretically offers significant benefits."

glas
Glas Cymru Cyfyngedig

We welcome correspondence in Welsh and English
Rydym yn croesawu gohebiaeth yn y Gymraeg neu yn Saesneg

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We would now go further and endorse the conclusion of the report published by Professor George Yarrow of the Regulatory Policy Institute in April this year ("the RPI report") that until water markets are put in place and the "value of water" is revealed there are good reasons to avoid premature liberalisation of "downstream" segments, because doing so could actually generate worse outcomes. In other words, if the "retail market", for example, is opened up to competition (along the lines proposed by Ofwat) before anything else, the "market forces" thereby generated may drive outcomes in the "wrong direction", because of the presence of significant but as yet unknown distortions in the upstream segment(s).

This is expressed further in the RPI report discussion of water resource issues (section 6.2):

"The effectiveness of competition at any stage in the vertical supply chain will necessarily be limited for so long as central planning and administrative arrangements dominate the arrangements. For example, the establishment of market competition downstream might simply serve more effectively to translate upstream distortions in price signals, created by inappropriate water abstraction charges, into major downstream pricing distortions."

For us this is a very important conclusion. We have questioned whether so-called "retail competition" along the lines introduced in Scotland and envisaged by Ofwat for England and Wales could be justified on cost-benefit grounds. If anything, the analysis in the RPI report causes us to harden this view: not only are there major questions as to whether "retail" competition can deliver any net benefits by itself (see below), but if introduced in advance of the creation of markets for water rights "upstream" it has the potential to cause damage by encouraging distorted outcomes in the form of "wrong" consumption and investment decisions. It is worth adding here that liberalisation of retail in the energy market followed and (at the outset anyhow) reinforced liberalisation of generation.

We are therefore extremely doubtful that pressing ahead at this time with measures to support competition in the so-called "retail" segment, including accounting and structural separation, would be a good use of resources, as there is a real danger that it would be both costly and counter-productive. Instead, we believe attention should be devoted to the (considerable) challenge of working out whether and how market forces can be brought to bear in the England and Wales context on the way in which raw water is abstracted, stored, and retained in the environment.

Retail competition

Following on from the above, we cannot agree with the Ofwat position that a "competitive retail market" is a useful first step that will "begin to drive competition upstream". We recognise that starting with "retail" might be the easiest, but that does not make it the "right place to start".

We have competitively procured all our customer-facing functions such as meter reading, billing, customer call handling, debt collection and so on. In the last financial year we paid £22 million for these services, or less than 4% of total water and sewerage revenues. This roughly equates to £20 per water and sewerage customer. This is much lower than the figure calculated by Ofwat, namely, that, on the basis of a cost allocation exercise it has carried out, the “retail segment” accounts for around 11% of the water supply “value chain” and even more on the sewerage side. Our evidence suggests that the “retail” segment of the value chain is much smaller than indicated to date by Ofwat.

Cost of capital

The water industry everywhere is capital intensive. And in England and Wales, because, inter alia, its replacement value is around 5 times more than its regulatory capital value, the water industry has been and will continue to be “cashflow negative”. As a result, nearly 20 years on from privatisation, the allowed cost of capital on the regulatory capital value now absorbs more than 30% of revenues and as long as the industry stays “cashflow negative” this percentage will continue to rise. The cost of capital is therefore the most important single cost for the regulated water and sewerage industry in England and Wales; currently a 1% increase in the allowed cost of capital would require a 5% increase in revenues. Yet in its discussion of the costs of breaking up the industry and introducing “in the market” competition, we find it surprising that Ofwat has been more or less silent on the question of the impact of such a reform on the cost of capital. Our experience tells us that this should be one of the most important considerations.

Since the Glas Cymru purchase of Welsh Water in 2001, our sole purpose has been to deliver an essential and high quality public service to the customers in our region at affordable prices. We recognised from the very start that key to achieving this objective was keeping the cost of financing our growing regulatory capital value as low as possible. The Glas Cymru business model is based around the proposition that we could organise matters so as to present to investors a high credit quality offering and as such attract capital into the water industry in our region at low rates of interest. And in so doing we would be able to give our customers a better and more affordable service.

Credit friendly features in our business model include strong corporate governance arrangements (including having a board with a majority of non-executive directors and executive remuneration tied to improving credit quality and sector leading performance); high levels of transparency (including quarterly investor reports with financial projections); and a constitution which, inter alia, rules out diversification away from regulated water and sewerage services in our area of appointment.

In raising substantial sums from investors (and since 2001 we have raised over £3 billion gross) we have also placed considerable importance on the fact that this is an essential industry that cannot be allowed to fail, and that the current and well established and understood regulatory framework in which we operate does provide a number of important creditor protections.

This focus has enabled us to raise long term funds for capital investment at very competitive rates of interest and, given the significance of the cost of capital, in our case this has yielded considerable benefits for our customers. Our financial reserves (or "customer equity") now stand at more than £1 billion, and by the end of the current regulatory period we will have distributed "customer dividends" of more than £150 million. Since 2001, we have secured 4 credit rating upgrades and our "corporate family rating" from Moody's is now A3.

We continue to believe that breaking up the industry along the lines being promoted by Ofwat is likely to increase materially the cost of capital. And given the importance of the cost of capital in the overall cost structure of the industry, we believe this will cause prices and bills to be materially higher than they would have been.

The impact on total costs and therefore bills of a higher cost of capital would be amplified by the 5-fold between regulatory capital value and replacement value mentioned above. Specifically, if to ensure a "level playing field" most of the regulatory capital value were allocated to contestable segments of the value chain with very little (if any) remaining in the natural monopoly segments, then it would not be possible to finance the water industry in our region as we have been able to do to date. In other words, because of the big difference between regulatory capital value and replacement value, the more one seeks to stimulate competition in the contestable segments the more the higher cost of capital required for those segments would push up prices overall.

In our discussions with investors this summer it is clear that they are very aware of Ofwat's proposals to break up the industry and make all but the natural monopoly segments contestable. Indeed, this was the main topic of debate at these meetings. However, the general view from investors is that the sort of proposals included in Ofwat's two consultations are unlikely to be put into practice mainly because breaking up in the industry as proposed would effectively close off its access to low cost finance, as outlined above. That said, we are now beginning to see financing documentation that includes provision for a sort of "competition poison pill" which would trigger early repayment were the industry to be broken up along the lines envisaged by Ofwat.

Cross subsidy and affordability

The drinking water and sewerage service we provide, especially to our household customers, is an essential public service, of critical importance for public health and welfare. This fact informs all we do and indeed all we stand for. Few things are more important than safe drinking water and reliable sanitation.

Always being a trusted and legitimate provider of such an important public service is of fundamental importance for us. In our case this is reinforced by the fact that those who rely on us for this public service have no real choice - on whether or not to use the service, or on whether or not to rely on Welsh Water to provide it.

Doing all that we can to keep this public service affordable – especially for low income households – is therefore a key objective for us if we are to continue to be a trusted and legitimate enterprise. As explained above, keeping the cost of financing our growing regulatory asset value as low as possible has enabled us to slow the allowed rate of increase in bills by growing our customer dividend. Our competitive outsourcing to date has also helped us reduce our running costs (we are the only water and sewerage company to have reduced its running costs in real terms in the period 2001-2008) and these savings have also contributed to the growth in financial reserves which in turn supports efficient financing. The customer dividend is “flat” (ie a fixed amount per customer, regardless of the size of bill) and as such generally favours low income households. This year we have also introduced new tariffs which can give further help those customers on low incomes.

The water industry is riddled with cross subsidies. Some have historical and structural provenance, and many have good and generally accepted public policy origins. One of the most important is charging on the same basis regardless of location and regardless of cost to serve. And this is especially important for us, given the nature and importance of the public service we are responsible for. As the gas and electricity sectors have demonstrated, customers who are less well-off are more expensive to serve than those who are better-off. The difference in a typical energy bill between a direct debit customer and a pre-payment meter customer can be more than £300 per annum currently. The fact that the introduction of market forces will tend to push up prices to the less well-off compared to the better-off is we believe an important matter that must be addressed in looking at the role for greater competition in the water sector. For our part, as argued here, we believe strongly that it would be wrong for the water industry to end up in the same position that we see in the energy markets with poor families paying considerably more for their energy than relatively better-off families.

Competition will always challenge established cross subsidies. And this perhaps matters more in the water industry because of its public service nature and also because of the sheer extent and scope of existing cross subsidies. Only to illustrate what this might mean for the industry and its customers - if it was broken up as envisaged by Ofwat and existing cross subsidies were unwound as a consequence - I enclose as a further contribution to your review a copy of correspondence with both the Welsh Assembly Government and Ofwat on the matter of inset appointments. To date, Ofwat has promoted inset appointments as a useful development of competition in the water industry.

Next steps

We are due to meet on 13th October and we are looking forward to that. If, in the meantime, we can assist you with any further evidence relating to the points set out above, or in what we have enclosed with this letter, please let me know.

I am copying this letter to Matthew Quinn at the Welsh Assembly Government, Diane McCrea at the Consumer Council for Water in Wales, Chris Mills at the Environment Agency in Wales, and Philip Dixon at Ofwat. In addition, this letter will be placed on our website.

Yours ever

Nigel

Nigel Annett
Managing Director