



DŴR CYMRU
WELSH WATER

Pentwyn Road
Nelson
Mid Glamorgan
Treharris CF46 6LY

Tel: +44 (0)1443 452300
Fax: +44 (0)1443 452323
Web site: www.dwrcymru.com

Heol Pentwyn
Nelson
Morgannwg Ganol
Treharris CF46 6LY

Ffôn: +44 (0)1443 452300
Ffacs: +44 (0)1443 452323
Safle gwe: www.dwrcymru.com

Professor Martin Cave OBE
Cave Review of Competition in Water Markets
Defra
2nd Floor, Ergon House
Horseferry Road
London SW1P 2AL

4 February 2009

Thank you again for taking the time to meet with Chris and me the other Friday and to discuss with us what your Final Report might say about Welsh Water and the different circumstances of the water industry in our region.

As you know, our over-riding concern is to ensure that, as far as possible, what you propose in your Final Report does not risk damaging the interests of Welsh Water's customers. We know of course that this is not your intention in any way; but we believe that there is a possibility that what you conclude to be "right" for the regulated water industry in England might turn out to be "wrong" for the regulated water industry in Wales.

We do appreciate that you are very "live" to this apparent dilemma, and one option you are considering is to leave the matter to Ministers in the Welsh Assembly Government to decide. Clearly, we would very much prefer it if you were able to give a more definitive view: from our point of view it would be wrong and unhealthy in all sorts of ways if Welsh Water (and therefore our customers) were to be somehow exempted from the proposals in your Final Report solely on what might be viewed as purely political grounds.

However, having given the matter further thought since our meeting, we do not believe this dilemma really exists, and we think there are strong positive reasons as to why the Final Report *can* recommend a different approach for Welsh Water to that recommended for England.

In a nutshell:

- competition proposals, such as those to be presented in the Final Report, constitute a major industry reform, motivated by the primary objective of re-structuring the industry in a way that it is believed will deliver better outcomes for customers. *Inter alia*, this reform would be expected to address the subsidiary objective of restoring the legitimacy of the delivery of water and wastewater services which was progressively lost as a "side-effect" of privatisation;

glas
Glas Cymru Cyfyngedig

We welcome correspondence in Welsh and English
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- the Government of Wales has already effected a major industry reform, namely the endorsement of the re-creation of Welsh Water as a “not for profit” provider of essential water and wastewater services. That reform was also designed to provide the basis for the delivery of better outcomes for customers in terms of price and quality of service (and environmental outcomes). It also sought to re-establish the legitimacy of service provision in Wales;
- we operate in a very long term sector in which the success of such reforms can only truly be assessed over a period of many years that have seen economic swings, operational emergencies, droughts, and other external challenges. Although the early signs are undoubtedly positive, the arrangements put in place by the 2001 reforms in Wales are still comparatively young. There would be no sense, from a public policy point of view, in replacing an immature but promising set of arrangements for service delivery with an uncertain and very possibly inferior set of arrangements, especially when there is an opportunity to allow the first to continue whilst the second is introduced and can run alongside the first in a parallel jurisdiction;
- clearly, this is a course that can only be recommended for Wales. It offers the benefit of enabling the government to effect reforms implemented in England at a later date with greater confidence, should that turn out to prove a more beneficial set of arrangements. But it also offers benefits for England, because any new competitive regime would have the benchmark of the (different) reforms in Wales against which it could be judged for so long as the two separate models remained in place.

The remainder of this letter elaborates on this view.

The Final Report proposals in historical context

We believe that it is helpful to consider the proposals to extend the role of market forces in the delivery of water and wastewater services in a historical context. Arguably the most significant post-war reform in the water and wastewater sector in England and Wales was the creation of the public “water authorities” in 1973. Crucially, this substantially removed the delivery (and regulation) of water and wastewater matters from municipal control, a distinction from the overwhelming majority of other European countries that remains today.

The next major reform was the creation of the National Rivers Authority by means of the separation of the regulation and the service delivery functions of the water authorities, and the subsequent introduction of private sector equity into the latter by means of privatisation in 1989. These reforms were driven by several considerations, but the paramount importance of delivering best value services to customers at a time when huge quality and environmental investment programmes were in the offing was the leading motivation.

Whilst privatisation, and the system of “arms length” economic regulation that was established as part of those same reforms, delivered huge gains, by the mid 1990s the “new model” was already losing its legitimacy. In essence, for a public service as important as drinking water and sewerage, it became increasingly clear that the combination of monopoly and what is often seen as just “profit maximising” equity would always be problematic. For legitimacy to be restored, either (or both) would have to be changed.

The extension of competition, as advocated by Ofwat and others for implementation over the coming years, would address some aspects of the monopoly issue. The reforms implemented in Wales that established in 2001 the Glas Cymru business model in Wales, however, dealt with the other side of the problem by introducing a new, “not for profit” commercial model.

The Glas Cymru business model and the importance of legitimacy

Glas Cymru secured ownership of Welsh Water back in May 2001 (and thereby stopped it falling into the hands of private equity ownership). The transaction and the business model remains one of the few matters to have been supported by all political parties in Wales. That support continues to this day. One reason is our performance to date (of which more below), another is our clear commitment to the water industry in Wales and the public service it provides, and yet another is our open, transparent and accountable way of working (made all the easier by the absence of shareholders and "price sensitive" worries).

But more generally, as noted above, research shows that people don't like the idea of water companies being "run for profit" given the importance of the public service they are responsible for together with the fact that they are monopolies. This is illustrated by some industry wide research we shared with our Members at last year's AGM (see attachment 1). One way to solve this is to get rid of monopoly by breaking up the industry into competing units (Ofwat's agenda?), another is to remove the "for profit" concern. And this is what we have done – Welsh Water is now owned on behalf of its customers, and we believe we can demonstrate that we are just as disciplined, incentivised, efficient and driven as any other water company (if not more so). This legitimacy is not just "nice to have" – it delivers real benefits for our industry and our customers, including lower "political and regulatory risk" (one of the main concerns of investors) and an ability to "get things done" and save cost (at our meeting we mentioned our experience of getting planning permission in Snowdonia National Park).

The Glas Cymru business model – progress since 2001

It has been repeatedly put to us, by Ofwat but also many others, that the success (or otherwise) of the Glas Cymru business model can only be properly judged over a long period, because of the nature of the industry within which we operate. So far, however, we believe that the model has performed relatively well, that it therefore offers considerable promise for the future, and should not be discarded whilst it is comparatively "young" in favour of an uncertain and potentially inferior alternative. The achievements to date that would not have been realised had the Glas Cymru model not been put in place by the reforms in Wales include the following:

- back in 2001, our average household bill was 21% higher than the industry average, but by 2010 it will be just 10% higher (see attachment 2) despite the fact that we have to achieve the same quality standards as companies in England; by 2010 we will have paid "customer dividends" of over £150 million;
- back in 2001, Welsh Water was next to bottom of Ofwat's "Overall Performance Assessment" league table; by 2005 we had moved to top position, and having slipped back in the last two years, we are confident that we will be at or near top this year (see attachment 3);
- we are the only water company to have reduced its operating costs in real terms according to Ofwat's most recent report (see attachment 4) and while not without its problems our competitive outsourcing model has helped us to achieve a step change in cost efficiency;
- we have had four rating agency upgrades since 2001 and we now have the highest rating in the sector (see attachment 5);
- operating and financing efficiency has enabled us to grow our reserves – ie "customer equity" – to just over £1 billion (after "customer dividends"), or nearly 30% of RCV; this will reverse slightly as a result of the recession, acceleration of AMP5 water quality

schemes and expected deflation (see attachments 6 and 7); the impact of deflation is mitigated by the fact that nearly 60% of our borrowings are index-linked, the highest proportion in the sector (see attachment 8);

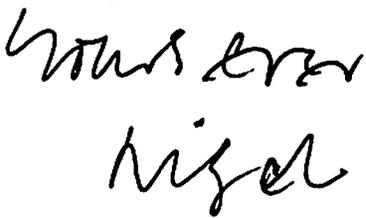
- we were the only water company to propose flat bills (see attachment 9) for the period beyond 2010 and, depending on the outcome of PR09, we would hope that our "customer dividend" policy in the years ahead will bring us closer to our target of getting our bills to below the industry average, notwithstanding the fact that we employ more assets per customer than elsewhere (except for South West Water);
- customer research carried out by Ofwat (and others) for PR09 shows, both in absolute terms and by comparison with other companies, high levels of customer satisfaction for current levels of service and value for money and also for what is being proposed in our business plan for the next five years (see attachment 10).

There is still a lot to do, but we have made and are making, good progress. This prompts the conclusion: "it doesn't appear to be broken and it might be working better than anything else, so why on earth fix it?" The financing efficiency we have been able to secure by putting as much emphasis as we can on credit positives – no diversification, quarterly forward-looking investor reports, strong and transparent governance (majority of NEDs on the board etc), strong incentives, etc – is of enormous importance and has yielded large sums for our customers. Of course we have taken full advantage of what were benign capital markets – but the key point to emphasise is that all the value arising from those conditions has been retained for the benefit of Welsh Water's customers, whereas elsewhere it could be argued that it has been distributed to owners and thereby lost to customers (see attachment 11).

Competition between regimes

Given that the water industry in Wales is very different, primarily because of the unique reforms implemented in 2001 made possible by the devolved government, there is clearly a case for allowing the distinct model in Wales to compete with whatever reforms might be proposed for the industry in England involving business separation and the extension of competition. A key feature of the water industry is that it is very measurable – customer service, water quality, environmental performance, bills, etc – so customers and other stakeholders can see who is doing a "good, bad or middling" job. This fact would allow public policy makers and others to judge which model worked best, and indeed incentivise participants to out-perform. If what is proposed for England turns out to be better on all the things that matter then Ministers here could adopt what is proposed for England when that result becomes clear (and we would not have a problem with that). We believe that this could be the basis for a specific and positive conclusion in your Final Report that would give Welsh Government Ministers a sound basis on which to make their decisions on what course of action to take following the Report.

I hope you find these points helpful. Please let me know if there are any points on which you would like further thoughts. I am copying this letter to Jill Thomas at the Welsh Assembly Government and to Diane McCrea at CCWater Wales.

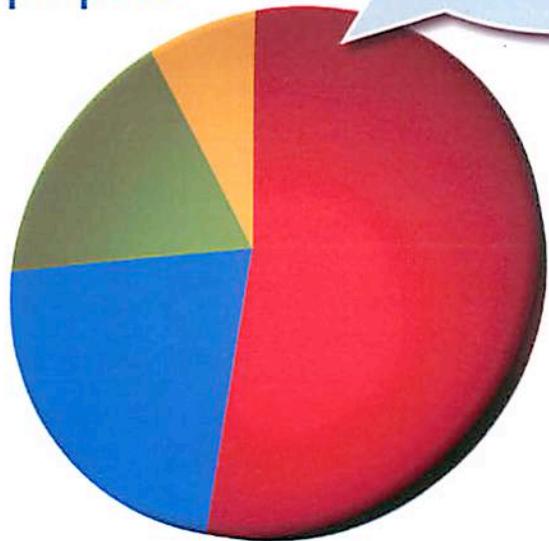


Nigel Annett

A problem with legitimacy?

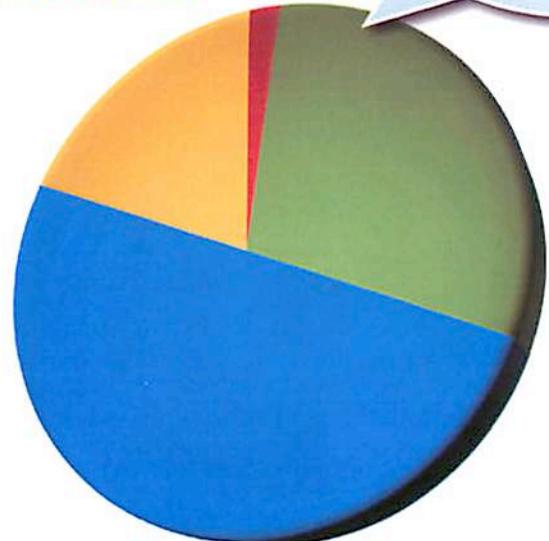
Main purpose

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



Should be

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

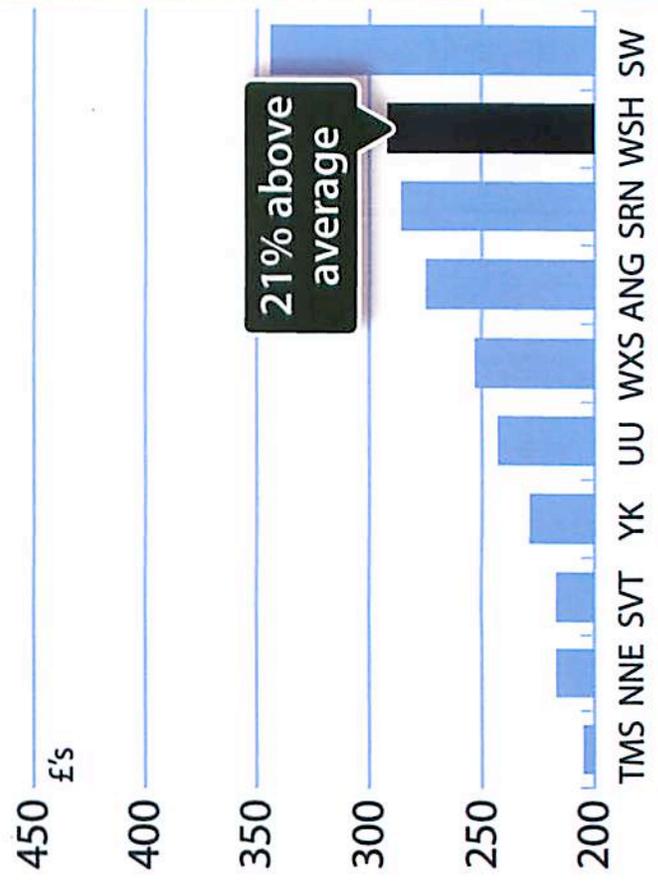


- Making profit
- Basic public service
- Safeguarding public health
- Protecting the environment

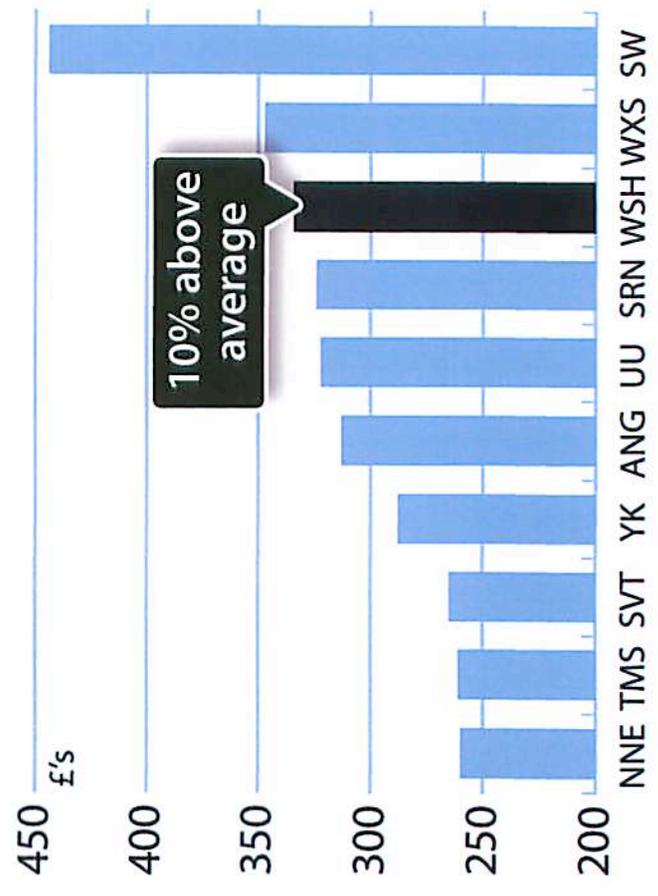
Attachment 2

Household bills

Customer bills 2001



Customer bills 2010



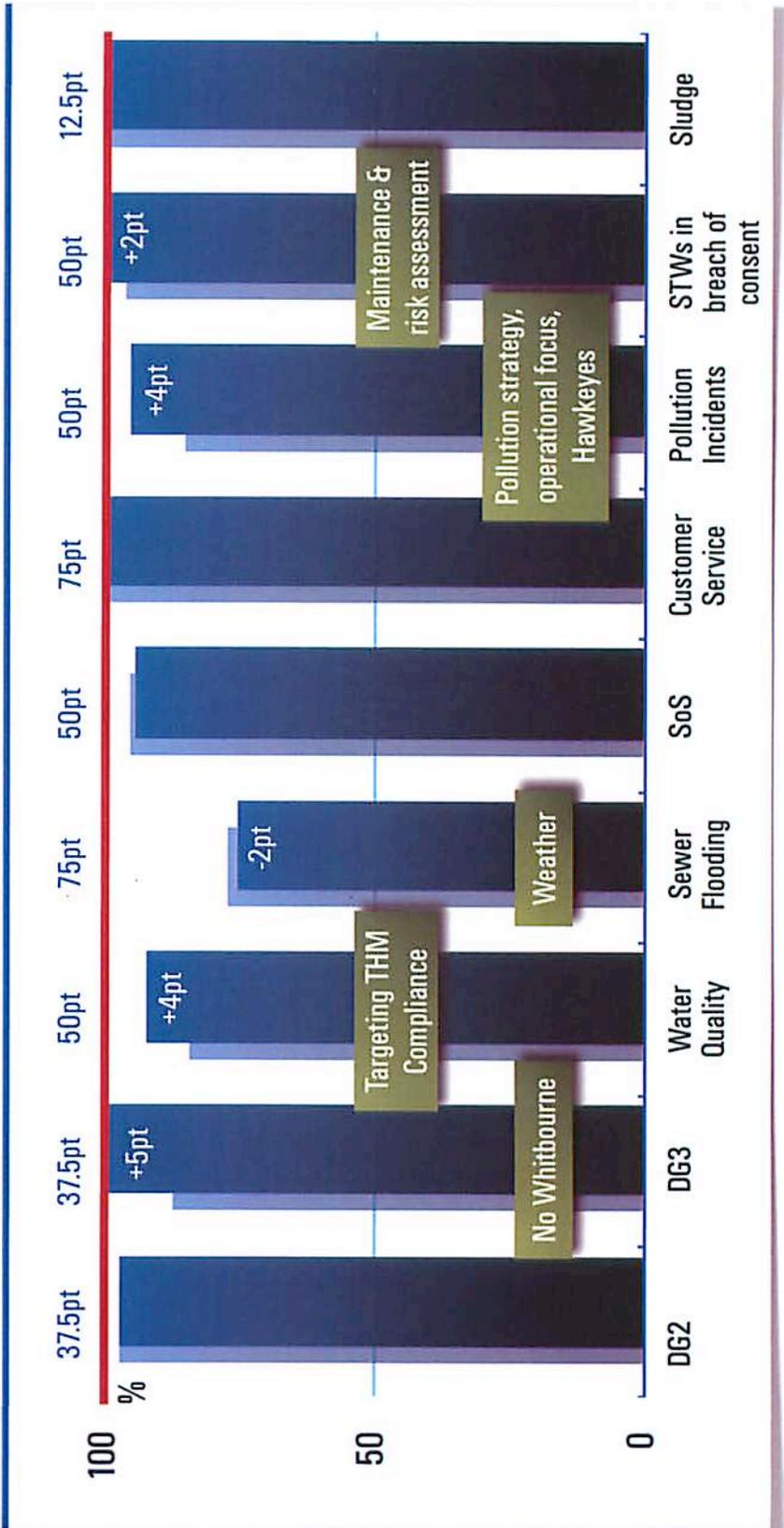
Attachment 3

Members' Meeting | 5 December 2008



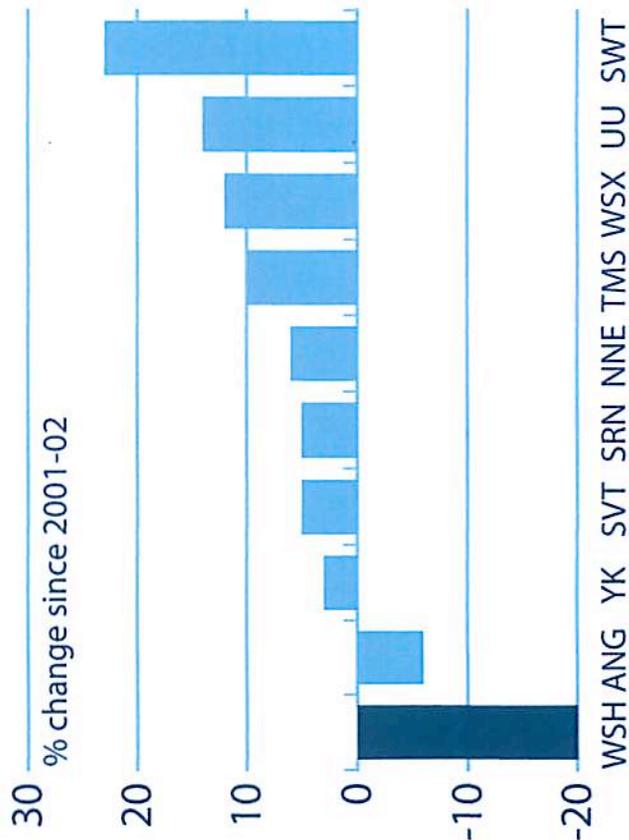
Overall Performance Assessment

Predicted OPA score 2008/09

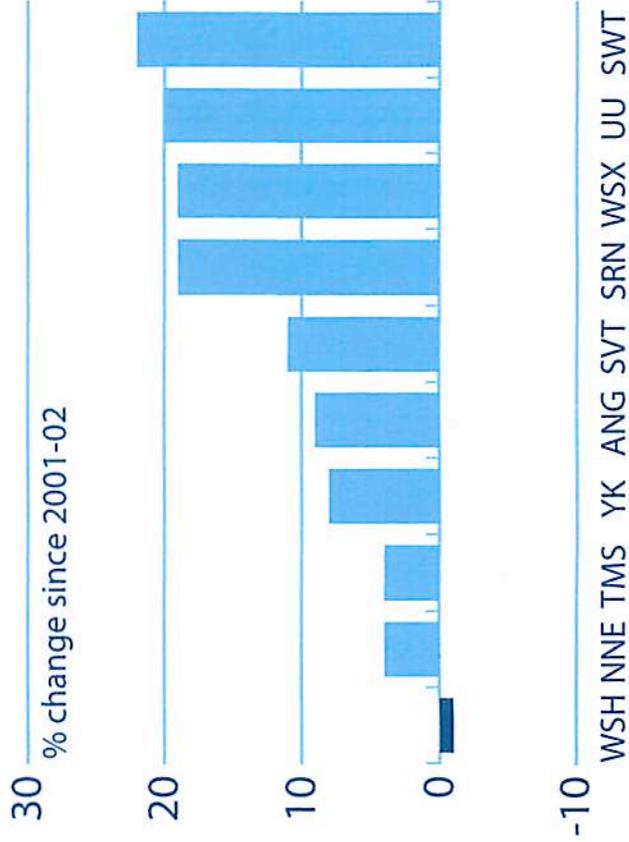


Cost efficiency

Operating expenditure - Water

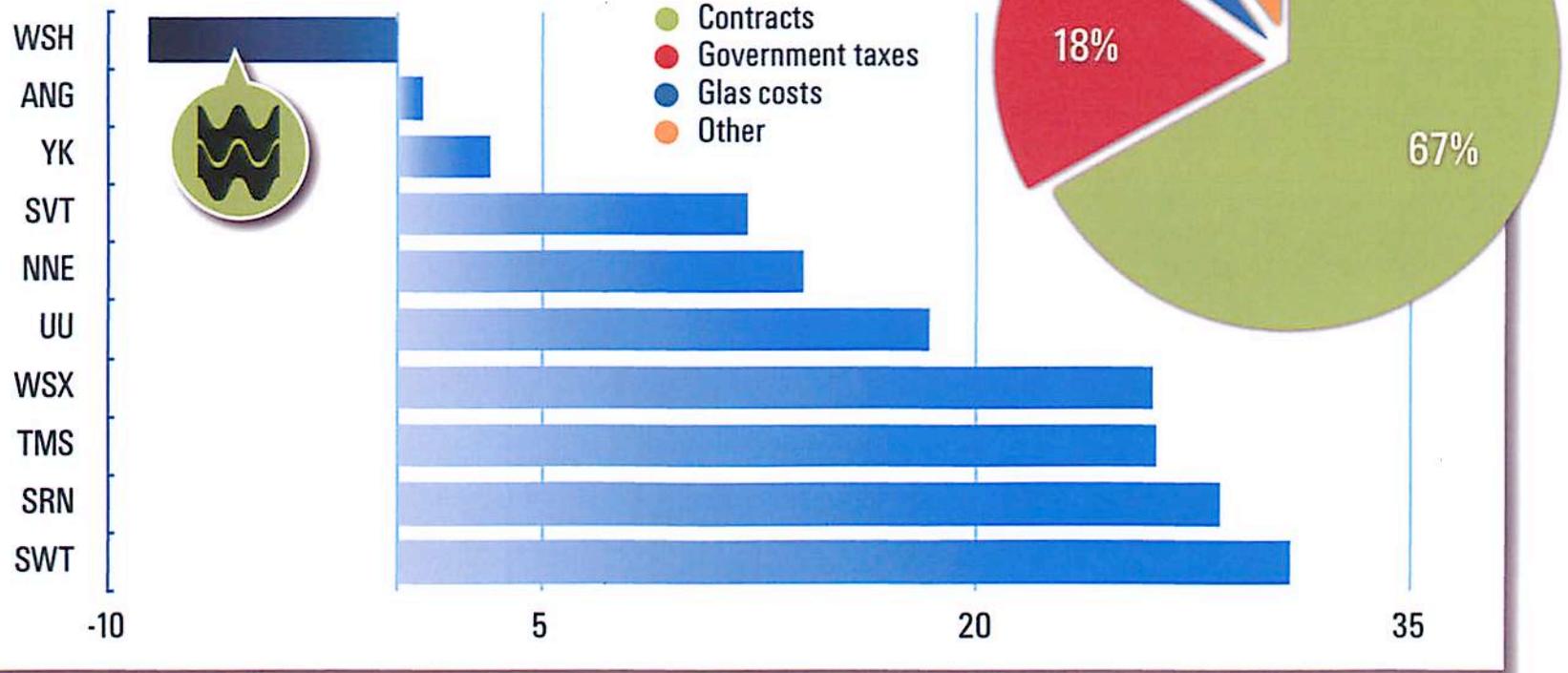


Operating expenditure - Sewerage



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 cor-

porate 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.

Mark Davidson is a director at Standard & Poor's Ratings Services. Email: mark_j_davidson@standardandpoors.com

Water company ratings, as of 13 November 2008

Water and sewerage companies

Kelda Group
 Northumbrian Water
 Severn Trent
 South Staffordshire Water
 Sutton and East Surrey Water
 Three Valleys Water
 United Utilities
 Wessex Water Services
 Corporate securitisations
 Anglian Water Services Financing
 Dwr Cymru (Financing)
 South East Water (Finance)
 Southern Water Services (Finance)
 Thames Water Utilities Finance

Corporate credit ratings

A-/Watch Neg/A-2
 BBB+/Stable/--
 A/Stable/A-1
 BBB+/Stable/A-2
 BBB+/Stable/--
 A-/Stable/--
 A-/Stable/A-2
 BBB+/Stable/--

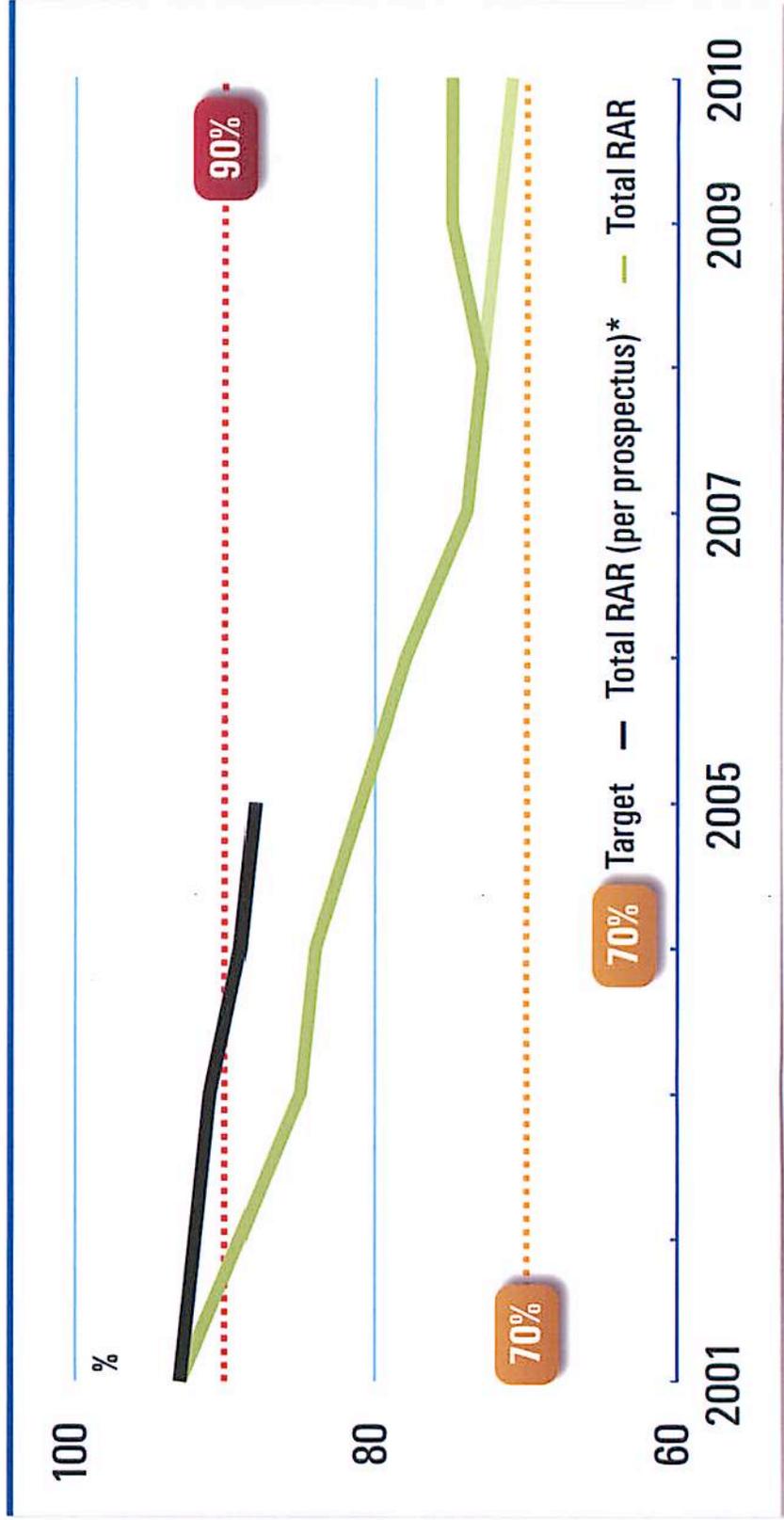
Underlying senior/junior tranche ratings

A-/BBB
 A/BBB+
 BBB/--
 A-/BBB
 BBB+/--

Attach ment (5)

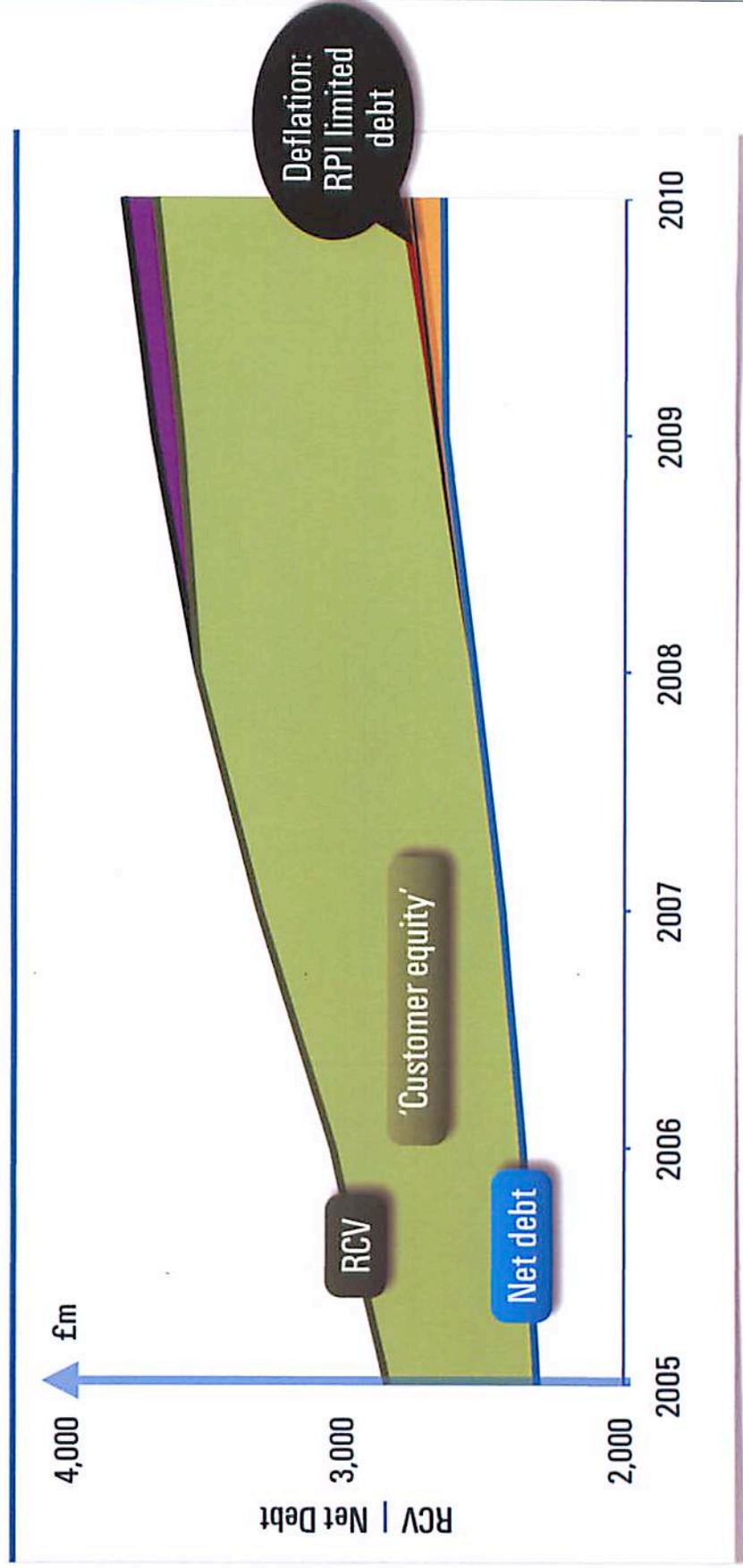
Regulatory gearing - stressed case

Regulatory asset ratio (RAR)

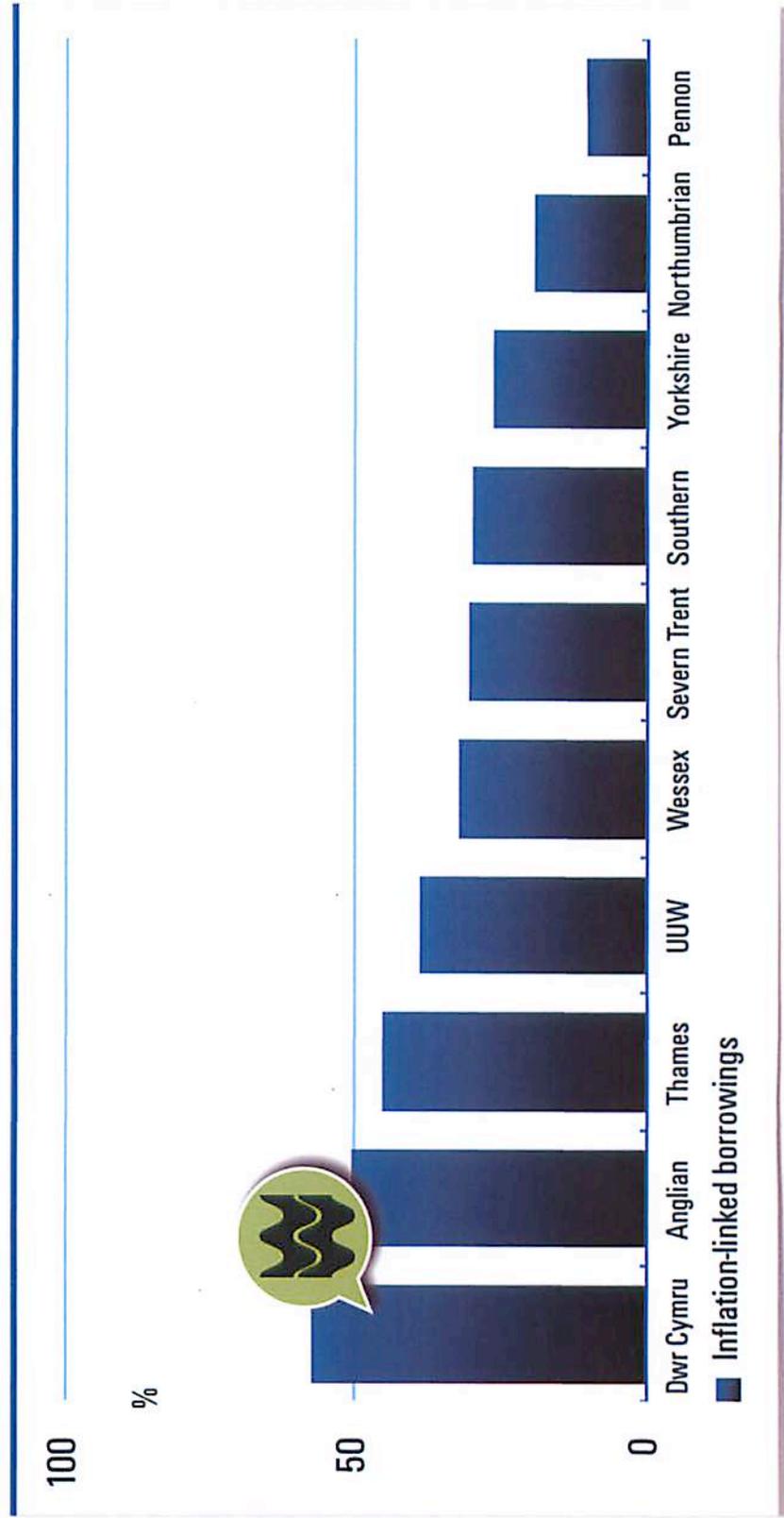


*Prospectus to 2005 only.

Growth in 'customer equity'



Index linked bonds



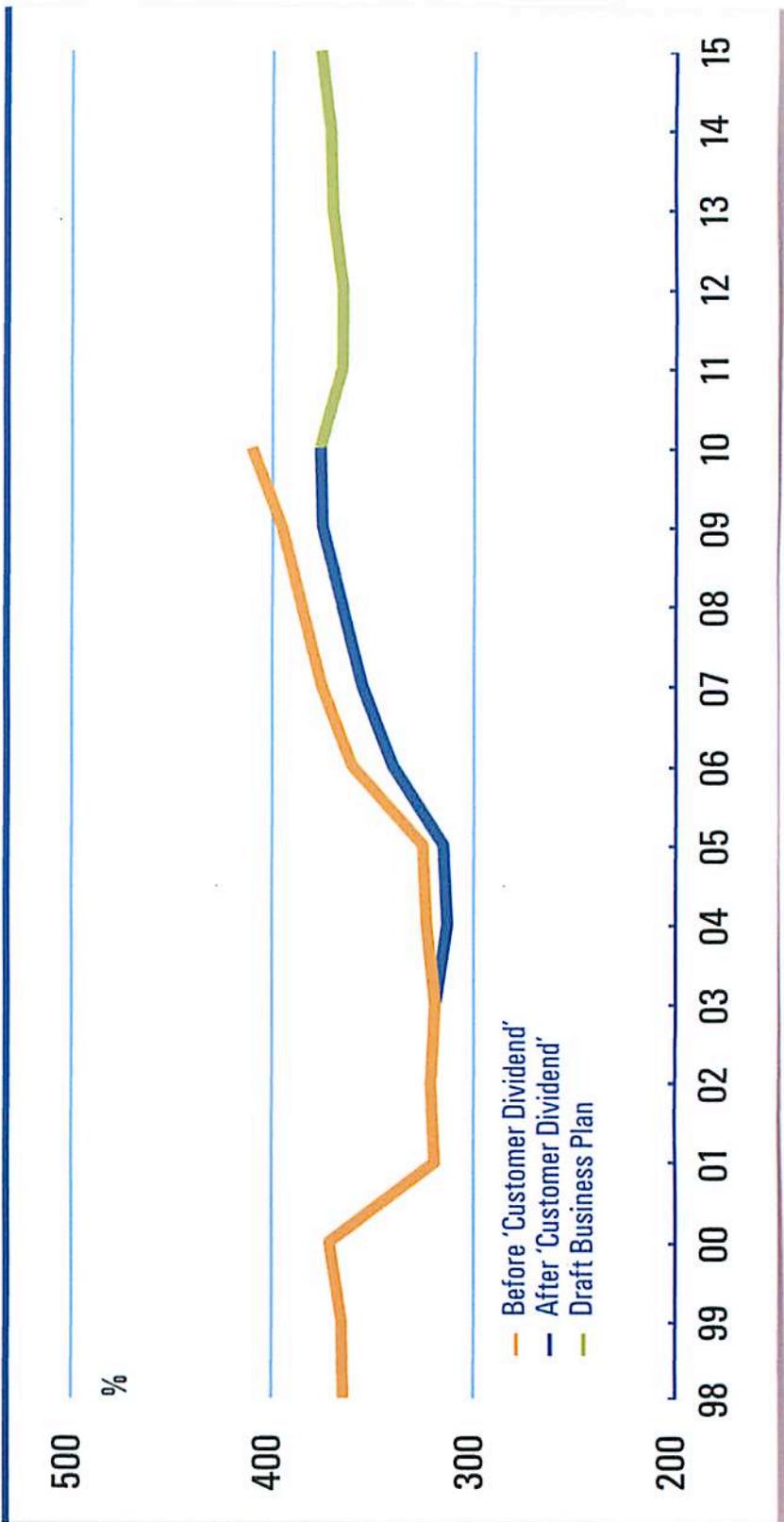
Attachment 9

MD "get together" | January 2009



Flat bills proposed in Draft Business Plan

Customer Bill



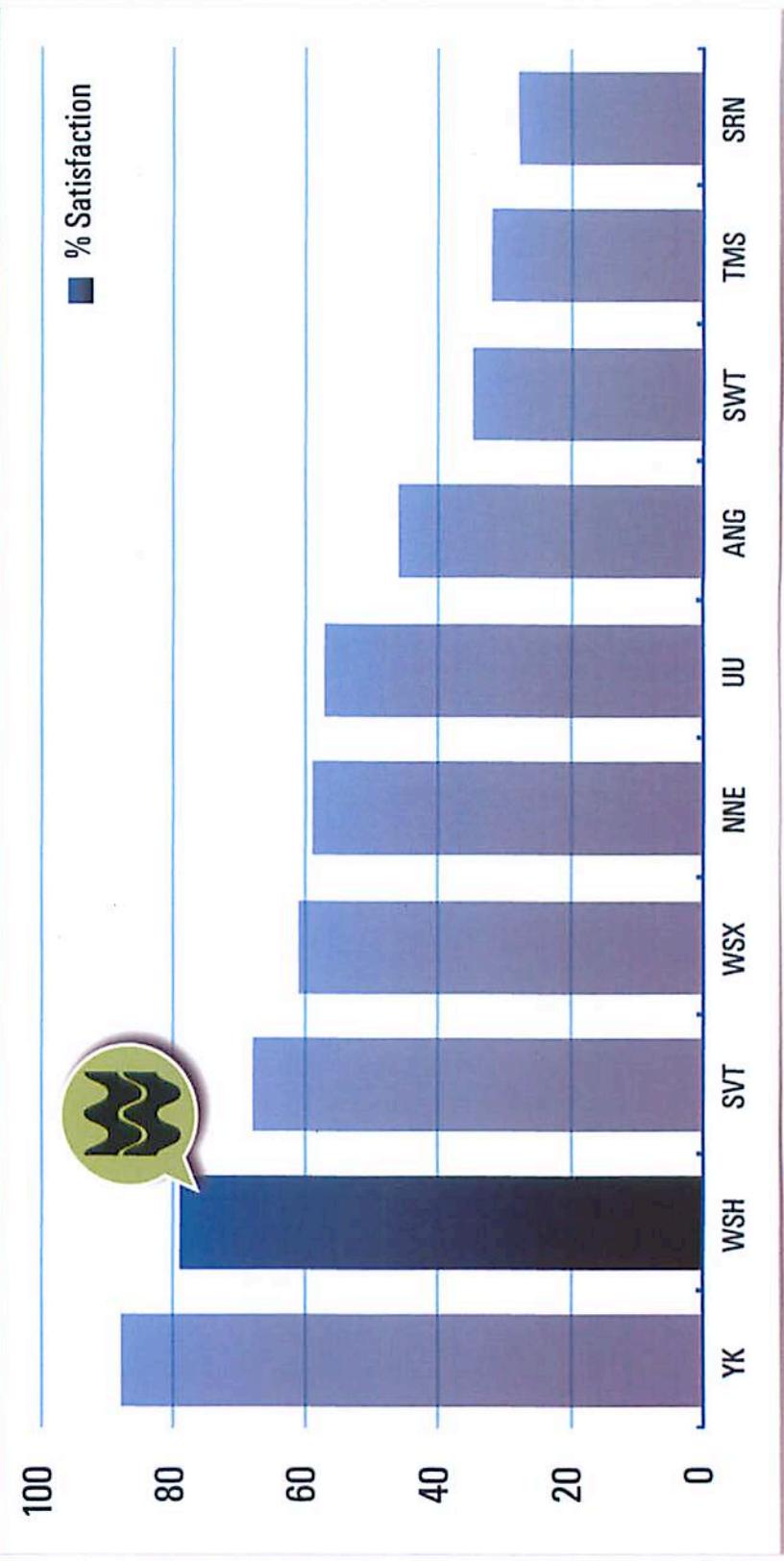
A Gaechman (10)

MD "get together" | January 2009



PR09 customer research results

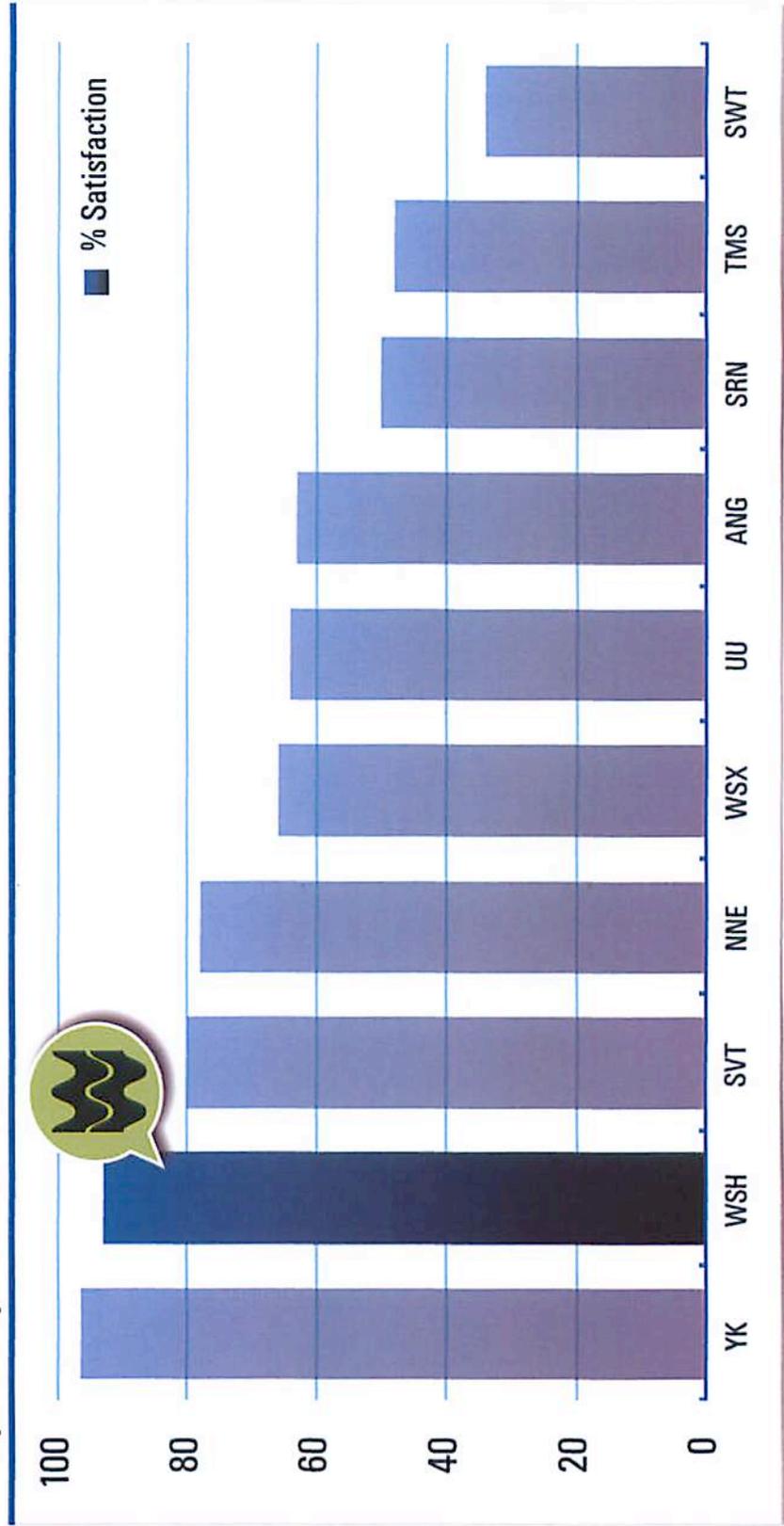
Good value for money for the service delivered



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

PR09 customer research results

Acceptability of Draft Business Plan as a whole



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

Attach ment 11

Takeovers in the water sector

