# The proposed acquisition of Dwr Cymru Cyfyngedig by Glas Cymru Cyfyngedig

A consultation paper by Ofwat

# November 2000

## CONTENTS

## 1. SUMMARY

### Introduction

1. This paper sets out the issues raised by the proposed acquisition of the regulated water utility, Dwr Cymru Cyfyngedig (Dwr Cymru) by Glas Cymru Cyfyngedig (Glas). This was announced on Friday 3 November. The proposals involve restructuring Dwr Cymru and such proposals require regulatory clearance. Ofwat invites views of all interested parties on these proposals and particularly seeks comments on whether the Licence modifications set out in this paper are adequate to protect customers' interests.
2. Section 2 of this paper sets out Ofwat's overall framework for considering proposals, such as those made by Glas, to restructure the water companies in England and Wales. This section also considers related merger issues involving water companies. Section 3 sets out the Glas proposal in detail. Section 4 considers the regulatory issues raised by it.

### The duties of the Director General of Water Services

3. When considering the issues raised by the proposals, the Director General of Water Services (the Director) must have regard to his duties as set out in the Water Industry Act 1991 (the Water Act). He must ensure that companies properly carry out their functions and that they can finance the proper provision of those services. He also has a duty to protect customers. He has further duties to promote efficiency and economy by the regulated business; to ensure that companies promote the efficient use of water by customers and certain environmental duties. The Director also has duties to facilitate competition in the provision of water and sewerage services and in minimising anti-competitive behaviour in the water industry. These powers have been strengthened recently by the Competition Act (1998).

## Background

4. Substantial efficiency gains have been made in the water industry under the current investor owned equity financed model put in place at privatisation. This provides incentives on management from shareholder pressure. Good reasons would need to be offered to justify alternatives to this model. Nevertheless, new structures may hold potential for further gains. In parallel with work to develop price competition in the industry, companies and others are considering new structural forms that might be implemented within the existing legislative and regulatory regime. Such initiatives include unbundling of the activities necessary to run a water business, for example splitting asset ownership from service delivery, and introducing new ownership structures. Advocates of these initiatives claim that unbundling these activities will enable companies to identify and control costs better and to expose them where practicable to direct competitive pressures. It is also claimed that new organisational structures will enable better use of resources and give access to a wider range of financing options.

5. Ofwat welcomes innovation directed at improving the efficiency and effectiveness of the water companies. It holds no particular view of the forms or structures that might be adopted. However, Ofwat must be satisfied that the interests of customers are protected and that its ability to carry out its duties is not harmed.

6. Earlier this year Ofwat issued a consultation document, *New ownership structures in the Water Industry* (6 June 2000). This examined, in a generic way, the constitutional and regulatory issues arising from the separation of the ownership of assets (including the licence) from operations together with the impact of new ownership structures, including a company limited by guarantee. A number of these issues were relevant to the acquisition of Hyder plc by Western Power Distribution Ltd ('WPD'); specifically the issues relating to the separation of the ownership of Dwr Cymru's assets from operations and the proposed arrangements for service provision. These were set out in Ofwat's consultation paper on WPD's bid for Hyder plc, *The proposed take-over of Hyder plc by Western Power Distribution* (6 June 2000).
7. Recently Ofwat consulted on the restructuring proposals put forward by the Kelda Group ('Kelda') in *The proposed restructuring of the Kelda Group* (20 June 2000). The proposal included plans to separate the assets of Yorkshire Water Services Ltd from operations and the creation of a customer-owned body to acquire these assets. This customer-owned body would have been 100% debt financed.
8. Following consultation, Ofwat issued a preliminary assessment of the Kelda proposals, *The proposed restructuring of the Kelda Group – a preliminary assessment by the Director General of Water Services* (25 July 2000), which also drew on responses to the issues raised in earlier consultations. This paper set out the regulatory requirements and concerns that would have to be addressed before consent for any revised restructuring proposal could be considered. These remain the relevant criteria for assessing similar proposals such as those from Glas.
9. The Glas proposals are different in some important respects to Kelda's proposals. In particular, Ofwat recognises that customers would not become owners under these proposals since the

vehicle of ownership proposed is a company limited by guarantee not a mutual body. However the Director must be satisfied that the relevant criteria are met.

10. Glas has set out how it believes its proposals address these requirements in an open letter to the Director. This was published at the same time as the announcement of its intention to acquire Dwr Cymru (available on the Glas Cymru website – www.glascymru.com)

## Issues for consideration

11. The proposed Glas transaction raises important considerations for customers and regulatory issues for Ofwat. As noted above, many of these issues are similar to those raised in the Kelda case. The issues for Ofwat and customers, and on which Ofwat is seeking views, are set out in sections 3 and 4 of this consultation paper. For convenience the issues are summarised here:

a. **Do the Glas proposals meet the regulatory requirements for restructuring proposals set out by Ofwat following its consultation on the proposed restructuring of the Kelda Group? In particular:**

i. **In the absence of pressure from shareholders, are incentives for efficiency maintained under these proposals? Does the proposed structure ensure that Glas will be sufficiently commercially focussed to drive performance in the regulated business?**
ii. **Are there risks and benefits to customers from the Glas proposals which are not present in the current shareholder model? Under the Glas proposals are customers adequately protected from taking on additional risks? In particular, are the reserves proposed by Glas sufficient to cover any significant cost shocks associated with the functions of a water company?**
iii. **As Glas proposes to outsource the operation of Dwr Cymru's assets and the provision of customer services, will the management of Dwr Cymru retain adequate control to meet its statutory obligations, in particular to ensure that the quality of drinking water and the environment is not put at risk?**
iv. **Will the ability of the Drinking Water Inspectorate (DWI) and the Environment Agency (EA) to prosecute for failures to meet water quality and environmental standards be compromised under the proposals?**
v. **Are Glas' proposals for customer consultation adequate given that it proposes to introduce a new type of ownership for the regulated business?**
vi. **Is Glas fully independent of Hyder plc and WPD?**

a. **Is the process set out by Glas for the appointment of members to Glas robust enough to prevent the 'capture' of the membership by any particular interest group? Will the members of Glas have sufficient incentives to hold the Board of Dwr Cymru to account?**
b. **As with any other merger or acquisition, the Director needs to be satisfied that prospective**

**owners have the probity and operational and financial capacity to assume that role and therefore requests views on whether Glas is a fit and proper owner of Dwr Cymru.**

c. **Is the package of licence modifications proposed by the Director sufficient to protect customers' interests? Should further licence modifications be sought?**
d. **Should the Director consent to the further licence modifications sought by Glas?**

### Ofwat's preliminary analysis of the Glas proposals

1. The Director has set out a framework for assessing proposals for restructuring of water companies. Each case will be assessed on its merits against this framework. Each is likely to be different and no one case should be viewed as a template for others. The Director has held productive discussions with Glas. He considers that Glas has sought to address his concerns within the constraints of the debt-financed model of a company limited by guarantee.
2. The critical questions are whether customers' interests are prejudiced by moving from the current investor owned equity financed model and whether there are any compensating benefits for customers. On the positive side, subject to Glas being able to finance its proposals, there is the potential for lower financing costs derived from a lower cost of capital which would lead, all other things being equal, to lower bills. Also, Glas point to the advantages of an owner concerned solely with the business of providing water and sewerage services. Against this is the concern that in the absence of shareholder pressure, incentives for efficiency may be weaker. Ultimately the performance of Dwr Cymru under Glas' ownership would be the test of this.
3. Without an equity buffer, the risk of unanticipated adverse events will need to be offset by substantial and well-structured reserves. The financing plan underpinning Glas' proposals is therefore crucial and to a large extent depends upon the credit quality assessment made by the credit rating agencies on the borrowings to be undertaken by Glas. These borrowings will be to finance both the initial purchase of Dwr Cymru and its ongoing capital programme. It will be a matter for the financial markets, having regard to the views of the credit rating agencies among other factors, whether, and on what terms, to provide the financial support required to implement Glas' proposals. Ofwat proposes to modify Dwr Cymru's licence to require it to maintain an investment grade corporate credit rating.
4. The views of respondents on the issues raised are critical and will inform the Director's final assessment in due course. At this stage, his preliminary assessment is that Glas' proposals do not, on balance, give rise to any insurmountable issues provided that the package of licence modifications can be fully implemented and the appropriate investment grade rating secured.

**Ofwat would welcome the views of interested parties on this preliminary analysis.**

## 2. FRAMEWORK FOR MERGERS AND NEW STRUCTURAL ARRANGEMENTS IN THE WATER INDUSTRY

### New initiatives

1. An important objective of incentive-based regulation is to encourage innovation in the pursuit of greater efficiency. Substantial efficiency gains have been realised under the industry structure that has prevailed since privatisation. Good reasons would be required to support alternative models. Nevertheless, new structures may hold potential for further gains. The Government has recently consulted on a number of possible reforms to introduce a greater degree of competition in the provision of water supply and sewerage services. Work on these is being taken forward. At the same time, water companies and others are considering new structural forms that might be implemented within the existing legislative and regulatory regime. This, in part, reflects pressures imposed by the 1999 revisions to price limits.

2. Such initiatives include further unbundling of the activities comprised in water and sewerage undertakings and the introduction of new ownership structures. The advocates claim that these initiatives will enable them to identify and control costs better and to expose them where practicable to direct competitive pressures. They say that the new organisational and legal structures will facilitate more effective use of resources and access to a wider range of financing options.
3. Ofwat welcomes innovation directed at improving the efficiency and effectiveness of the water companies. Ofwat holds no preconceived or prescriptive views of the forms or structures that might be adopted. However, Ofwat must be satisfied that the interests of customers are not prejudiced and that its ability to carry out its functions is not adversely affected. In the interests of regulatory transparency, it seems appropriate to set out the general principles that will inform Ofwat's response to any restructuring proposals requiring its clearance, or in respect of which its advice is sought by other Government departments or regulatory agencies.
4. In Ofwat's preliminary assessment of the Kelda proposals (25 July 2000), Sir Ian Byatt, the then Director, set out the principles that should be addressed by any proposals involving the transfer of regulated water and sewerage assets to a not-for-profit entity and the contracting out of the operation of these assets to third party service providers. The current Director considers that these principles should apply to any similar proposals advanced by water companies. In essence, the medium term incentive based regulatory framework will continue. All water companies, irrespective of their structures will be subject to RPI-X regulation and comparative competition.
5. In relation to new ownership structures, the Director is particularly concerned to ensure that there is no blunting of incentives to efficiency, through the loss of shareholder pressure (including the threat of take-over) or the acquisition of undue influence by sectional interests. As discussed in this paper, Ofwat will have to decide, following this consultation, whether the present proposals from Glas comply with these requirements.

6. In relation to proposals that retain the shareholder model, but similarly involve the separation of operation from the ownership of the assets, Ofwat will be seeking to ensure that the licence holder's ability to exercise effective control over its assets is not compromised. Ofwat will be seeking to ensure that there is no loss of access to information and no harm to its ability to take effective enforcement action. Ofwat will need to be satisfied that appropriate contractual relationships are established and that these are exposed to competitive pressures. In addition, the contractual arrangements must not compromise the ability of the relevant quality regulators, the

DWI and the EA to prosecute in relation to incidents of water quality and environmental pollution. There can be no presumption that all costs arising under such contracts would be passed through to customers following the next review of price limits since the comparative and incentive based regime will remain in force. These criteria will apply equally to proposals involving separation under common ownership and separation involving a change of ownership.

7. Some restructuring proposals may have the objective of reducing the water companies' cost of capital, through utilisation of increased levels of borrowings and other financing techniques. Ofwat will be concerned to ensure that such structures are reasonably stable and do not threaten the water company's ability to finance its functions. Nor must they increase risk for customers without at least commensurate benefits. Ofwat considers that water companies should be required to maintain investment grade credit ratings and should be prohibited from entering into arrangements containing cross-default provisions. Ofwat's duties to ensure that companies can finance their functions do not imply a need to have direct regard to the interests of lenders. Lenders are expected to obtain for themselves whatever protections they consider necessary. However these must not inhibit a water company's ability to carry out its functions, including making the new investment required to meet environmental standards or to maintain or improve quality of supply and service.

### Mergers involving water companies

8. In cases involving proposed combinations between businesses of two or more water companies, or between a water company and an entity providing significant services to one or more other water companies, Ofwat will take a cautious view about the potential for loss of comparative information. Clearly, these cases may be referred for investigation by the Competition Commission, in accordance with the requirements of Section 32 of the Water Industry Act 1991. Ofwat will continue to consider that whole-company mergers between water companies would be detrimental to the regulatory framework where this would result in a material loss of comparative information. In other cases Ofwat will wish to be satisfied that there is significant potential for benefits to accrue to customers.

9. In cases involving the combination of the regulated business of a water company and an entity not involved in the water sector, Ofwat does not normally consider that a significant loss of comparative information would arise. Such cases would be considered under general merger law under the Fair Trading Act 1973.

## 3. THE GLAS TRANSACTION

## The proposed transaction

10. On 3 November 2000 the boards of Glas and WPD announced that they had reached agreement, subject to contract, on terms for Glas to acquire Dwr Cymru from WPD. The transaction values Dwr Cymru at £1.8bn (including debt). This is approximately 95% of Dwr Cymru's regulatory capital value. The acquisition will be almost wholly debt financed. The offer envisages that there will be an amount of deferred consideration expected to be paid to WPD no later than 31 March 2005. No dividend would be payable on this deferred consideration, however the amount paid would be dependant on the performance of Dwr Cymru in the period up to 2005.
11. WPD recently became the new owners of Hyder plc, a multi-utility group which includes both Dwr Cymru and South Wales Electricity plc (a Public Electricity Supplier). Dwr Cymru is a licensed water and sewerage undertaker regulated by the Director.
12. In conjunction with its announcement, Glas has issued a number of documents setting out details of its proposals. These include a public document setting out Glas' plans for Dwr Cymru and an open letter to the Director which sets out how Glas proposes to address the regulatory concerns raised earlier by Ofwat in the context of other restructuring proposals. Whilst obviously expressing the views of Glas, these documents provide useful additional background to the proposals.
13. Under the proposals, Glas would implement a strategy which separates ownership of Dwr Cymru's assets (together with responsibilities under the Licence) from its operations. Subject to Glas acquiring Dwr Cymru, it is proposed that Glas will implement a procurement strategy whereby Dwr Cymru will continue to outsource the operation of its assets and the provision of customer services to third party specialist service providers under competitive commercial contracts of differing terms, mix, duration and type. Ofwat understands that the majority of this re-tendering will be completed before the next periodic review.
14. In the intervening period Ofwat understands that whilst WPD remain owners of Dwr Cymru, WPD in agreement with Glas intends to put in place two or three competitively procured large contracts for the provision of these services to Dwr Cymru.
15. Ownership by Glas represents a new form of corporate structure for the regulated water business. It introduces a financing structure directed at reducing the cost of capital for that business - under the Glas proposals the regulated assets of Dwr Cymru would be entirely financed by debt. Glas, having no shareholders, will not have to pay any dividends.
16. The new debt to be issued by Dwr Cymru on behalf of Glas will largely be in the form of bonds. Ofwat understands that in order for Glas to achieve the lower cost of capital that underpins its financial plans, then a high quality credit rating (of the order of 'A' category) is required for these bonds. The credit rating will be assessed by the credit rating agencies who take account of both the financial and business risks of companies.
17. Glas is a new company formed in March 2000 for the sole purpose of acquiring and owning Dwr Cymru. Glas is a company limited by guarantee incorporated under the Companies Act 1985. The constitution of such a company allows for a body of members to whom the board of Glas will be accountable to in the first instance. Further details on the constitution of Glas are set out in Section 4 under the heading 'constitutional arrangements'.
18. The restructuring proposals set out by Glas raise a number of important issues. The existing

investor-owned, equity financed model has brought big gains to customers and to the environment and has led to the greater efficiency of water companies. As a result of the 1999 Final Determinations, prices have been reduced while allowing the continuation of a large environmental improvement programme.

19. Ofwat will want to understand what the benefits to customers are under Glas' proposals and whether, in the absence of equity shareholder ownership, they are adequately protected from taking on additional risk. Ofwat will also want to be sure, in the light of the proposals for contracting out its operations, that Dwr Cymru will retain adequate control over service delivery. Dwr Cymru must remain capable of meeting all its statutory and licence obligations including its responsibility for drinking water quality and environmental standards.
20. The proposals would need regulatory clearance before they could proceed. This would involve Ofwat being confident that the regulatory requirements established following consideration of the Kelda proposals had been satisfied.
21. In addition to responding to this consultation paper the public will also have the opportunity to express their views at public hearings to be chaired by the Chairman of the Customer Service Committee for Wales. Representatives from Glas will contribute to these meetings.

## Proposed licence modifications

22. The Director considers that, if these proposals go forward, then licence modifications will be necessary to ensure customers' interests are protected and so that he can carry out his statutory duties. These proposed modifications are discussed further in section 4 of this paper and summarised in Appendix A. A number of the proposed modifications have already been agreed by WPD when it purchased Hyder and remain relevant to the purchase of Dwr Cymru by Glas. These have not yet been formally incorporated in the Licence. Ofwat will be seeking a number of additional modifications as a result of the specific nature of the Glas transaction, in particular issues arising from the constitution of Glas as a company limited by guarantee.

23. In addition Glas are seeking a number of licence modifications in respect of the mechanisms for changing price limits between periodic reviews set out in the Licence. They are similar to licence conditions for some other water companies. Glas believes that this would emphasise to potential lenders the low risk nature of Dwr Cymru's business and enable it to finance Dwr Cymru's assets with strong investment grade bonds. The licence modifications are set out in Section 4 under the heading 'Additional licence modifications sought by Glas'.
24. Glas has given agreement in principle to the full list of amendments required by Ofwat.

**Ofwat would welcome views on the package of licence modifications proposed and on whether these modifications are considered sufficient to protect customers' interests.**

**Ofwat would welcome views on the additional licence modifications sought by Glas.**

## 4. KEY ISSUES FOR CONSIDERATION

25. The Glas proposals present significant issues for the industry. The approach taken to these proposals will be made against the framework set out for assessing restructuring proposals. Each case will be assessed on its merits and no one case should be considered as a template for others. Indeed, in this case, there are a number of aspects of the Glas proposals which are specific to the situation in Wales.

### Benefits and risks for customers

26. Ofwat needs to be satisfied that the proposals are in the best interests of Dwr Cymru's customers.

27. In terms of benefits to customers, Glas has stated that it believes it will be in a position to offer reductions in water bills before the next price review over and above the reductions set out by Ofwat in the Final Determination of price limits. Glas believes that these reductions will be possible because it will be able to finance the water and waste water assets at lower cost. It will also not have to pay any dividends to shareholders. Glas propose to finance Dwr Cymru's assets with long maturity, high credit quality investment grade bonds on attractive terms. In addition it believes that customers may benefit from efficiency savings achieved through implementation of its competitive outsourcing strategy.

28. Against this proposed benefit, Ofwat wishes to understand the extent to which (if at all) customers are being asked to take on additional risks compared to the shareholder model under Glas' proposals. This question arises from the fact that there will be no equity ownership of Glas and hence there is no shareholder capital to act as a `buffer' between adverse events suffered by the company and their impact on customers.

29. The level of Glas' reserves, and hence its ability to cover 'cost shocks' will be crucial in determining whether customers face additional risks. If Glas can fund unexpected costs (eg drought costs) through reserves then customers are not being asked to bear this risk – the reserves form the buffer that previously was provided by shareholders. The requirement for reserves should be a formal part of the constitution of Glas and incorporated in its Articles of Association. Glas states that it will not pass savings onto customers until it is prudent to do so. This must mean that it has sufficient reserves to deal with unexpected costs. Glas intends to build up reserves to a

level of £300m by 2005.

30. Ofwat understands from the credit rating agencies that where individual reserves can be ‘ring-fenced’ and only used for specified purposes (eg to pay interest or to cover increased costs) then this provides a greater level of comfort to debt providers than a general pool of reserves.
31. The price paid by Glas for Dwr Cymru and the cost at which it can finance the acquisition and any future investment requirements (which for an entirely debt financed company is essentially determined by its credit rating) could also have implications for the risk faced by customers under these proposals. A small part of the purchase price is deferred consideration and this will assist in the accumulation of reserves.
32. As part of Ofwat’s assessment of the Glas proposals it will be meeting with the credit rating agencies to hear their views. In particular Ofwat will want to consider the sensitivity of Glas’s financial position to variations in key assumptions and the potential impact of any significant downgrading of its credit rating in the future.

**Ofwat would welcome views on whether there are additional risks to customers under the Glas proposals. In particular are the reserves proposed by Glas sufficient to cover any significant cost shocks associated with the functions of a water company (and hence provide an adequate protection for customers from taking on additional risk)?**

## Customer consultation

33. Ofwat has carefully considered the degree and nature of consultation with customers that it expects Glas to undertake on these proposals.

34. The proposal involves significant changes to the current investor owned equity financed model. We believe that there is a case for a fuller consultation by Glas of customers than would be undertaken, for example, when there is a proposed change in the ownership of a water company to a new equity financed company (such as the proposed take-over of Thames Water plc by RWE). For any restructuring proposal, the degree and nature of the consultation required will depend on the specifics of the transaction and in particular on the extent to which customers are being asked to take on additional risks. Ultimately the consultation process might require customers to vote on the proposals (or express their views in a comparable procedure) to establish whether they have the support of the majority. Ofwat concluded that this was required in relation to the Kelda proposals where it was proposed that customers would become direct owners of the appointed business.
35. In case of the Glas proposals, Ofwat does not envisage that a formal vote is required because customers would not become owners of the business with the increase in responsibilities and risks that this would entail. However the proposal that Glas would finance the assets of Dwr Cymru almost entirely by debt potentially has consequences for the risks faced by customers and the extent of consultation undertaken must recognise this.
36. Over the coming weeks Glas intends to explain its plans to customers and organisations across Wales and England, including the National Assembly for Wales. It intends to hold at least two

public hearings at different locations in Dwr Cymru's operating area where customers will be able to express their views. It also intends to carry out research on customer opinions – Ofwat will be fully involved in this research.

**Ofwat would welcome views on whether Glas' proposals for consultation are satisfactory.**

## Change of ownership

37. Where there is a change of ownership, Ofwat, as in other cases, must be satisfied that the potential new owner is a suitable prospective owner of the appointed business. Glas must be properly staffed and have the operational and financial capacity to assume this role. Glas is a new company with no interests other than owning Dwr Cymru. Ofwat will closely examine the financing plan underpinning the proposals from Glas to assess its financial capacity to be the owner of a water company which has significant capital investment commitments.

38. In mergers involving change of ownership, Ofwat has sought licence modifications to strengthen the ring-fencing provisions in companies' licences. These are conditions designed to enable Ofwat to regulate effectively the water utility within a wider group and to provide re-assurance that it remains able to finance its regulated activities. Although Dwr Cymru would not be part of an extended group under Glas' proposals, its proposed financing structure poses analogous potential threats to its financial position. Ofwat will, therefore, expect Dwr Cymru to agree to licence modifications prohibiting the raising of any finance for the regulated business on terms which include cross default covenants and to agree that it will at all times maintain an investment grade corporate credit rating.

**Ofwat would welcome views as to whether Glas is a fit and proper owner for Dwr Cymru.**

## Incentives for efficiency

39. The water companies have become more efficient following privatisation in consequence of the combined pressure from shareholders and the system of incentive-based regulation under which they operate. Under this incentive-based framework, Ofwat has set price limits which allow companies to cover the cost of efficient provision of operations and maintenance and allow a reasonable return on capital. Ofwat does not control profits or dividends. Companies have the scope to increase efficiency, and hence profitability, and share these rewards with shareholders and customers. Ofwat must be satisfied that the incentives for efficiency are not harmed by the absence of shareholder pressure.

40. Dwr Cymru under Glas' ownership must stand comparison with other water companies regardless of ownership structure. It will continue to operate under a price cap and be subject to periodic reviews alongside investor-owned equity financed water companies. Ofwat will not treat restructured businesses differently and will expect Glas to strive for outperformance no less than

investor owned water companies.

41. Ofwat must consider whether the board of Glas remains driven by commercial principles. In a company limited by guarantee, the role of members in shaping board policy is an important consideration. It would not be appropriate for the particular interests of any group of members to shape the policy or direction of the regulated business.
42. Ofwat must consider what the incentives on the directors and managers of Glas to deliver performance of the regulated business would be.
43. Glas would have no recourse to the equity markets but would be reliant on the debt market to finance the initial purchase and, on a continuing basis, the approximately £1bn improvement programme allowed for in price limits for the period 2000 to 2005. Ofwat recognises that the debt markets do provide incentives for companies to act efficiently and adopt good management practices but believes that these may not be as strong as those provided by shareholders. Lenders are concerned to ensure that their investment and interest is secure but are not necessarily concerned to press management to seek further efficiencies over and above this. Thus lenders would provide pressure to improve in a deteriorating situation but not necessarily in a neutral one and would be unlikely to drive company performance in the manner of equity shareholders.
44. Ofwat believes that the Glas board and managers would be put under pressure to perform by making an explicit public statement with regard to its policy on customer rebates, in the same way in which directors of shareholder-owned companies make an explicit statement of their dividend policy. Such a statement should allow customers to form a reasonable expectation regarding the timing, level and growth of future rebates. In the same way as for investor owned companies, such a policy should not jeopardise either the financing of the business or the viability of its future capital programme.

Other incentive mechanisms

45. Glas also intend to incentivise executive directors and employees of Dwr Cymru through an incentive based pay scheme. They will be remunerated in accordance with a new performance dependant remuneration structure whereby pay will be linked to service performance indicators as well as to financial indicators. Ofwat agrees that Glas and Dwr Cymru should maintain an incentive scheme designed to attract and retain a high calibre management team and to strongly incentivise them to deliver efficiency in business operations. This should be publicly available and formalised in the Articles of Association of Glas.
46. As previously mentioned part of the purchase price for Dwr Cymru is deferred consideration. The final amount payable to WPD will be dependant on the performance of Glas and Dwr Cymru up to 2005. Therefore, to some extent WPD has an interest in the performance of the Glas management team.
47. Glas would also be committed to ensuring that Dwr Cymru undergo a regular programme of competition in the market for operations directed at realising cost savings in asset operations and customer service delivery. Details of this programme are set out in the section on procurement below.

**Ofwat would welcome views on whether the Glas proposals would maintain incentives for**

**efficiency.**

## Constitutional arrangements

Summary of the Glas structure

48. Glas, which would own the regulated water utility, is incorporated under the Companies Act 1985. Its Memorandum and Articles of Association limit its purpose to the provision of water and waste water services in England and Wales. Glas suggest that this has the advantage of resolving some of the conflict of interest between a listed plc and its regulated water business subsidiary. However, Glas would be entirely debt financed and servicing the substantial debt burden would be the first call on Glas Cymru's income. Dwr Cymru would become a wholly owned subsidiary of Glas.

49. Glas envisages the appointment of four to six non-executive and three executive directors, initially to be appointed by the Chairman. As a company limited by guarantee Glas is owned by its members instead of by its shareholders. Members carry out some of the responsibilities of shareholders to the extent that they have duties to appraise the performance of the Glas board and hold it to account. In addition members have powers to appoint and remove directors. All members will be bound to further the objects of Glas Cymru as set out in the company's Memorandum and Articles of Association. However, they have no financial interest in Glas and do not receive dividends. To this extent members might exert less pressure on directors and managers to perform than shareholders.
50. Glas envisages a maximum of 200 members. These will be appointed by the board of Glas following nomination by an independent panel. Glas has stated that this panel will undertake a selection process based on 'Nolan principles'. These principles, which arose from the Nolan Committee's *First Report of the Committee on Standards in Public Life* (May 1995), set out the standards that should be applied to appointments to public bodies. Broadly, these state that appointments should be made based on the following principles; appointment by merit; independent scrutiny; equal opportunities; probity of members; openness and transparency of the appointment process; and proportionality of process to the responsibilities involved.

Issues

51. Ofwat is concerned that the board of Dwr Cymru must be of high calibre and is motivated to achieve and to be accountable for the efficient conduct of its business operations.
52. The boards of both Glas and Dwr Cymru must be capable of being replaced in the event of poor performance. It is also important for Glas to be and be seen to be fully independent from Dwr Cymru and WPD from the outset of negotiation with WPD over the offer price for Dwr Cymru.
53. It would not be appropriate for the interests of any group of members to shape the policy or

direction of the regulated business. Glas has set out a process whereby members will undergo a pre-selection process undertaken by an independent panel before being nominated to the Glas board for appointment. Ofwat will consider whether this process is sufficiently robust to prevent the capture of the membership by special interest groups over time. In addition it will consider just how much this body of members might be able to influence in practice the policies of Glas (and hence Dwr Cymru). Dwr Cymru has an existing licence condition requiring the board to act independently of its parent at all times and in its own interests.

54. As a minimum, to maintain focus on the regulated business and to formalise principles of good governance Ofwat seeks modifications to Dwr Cymru's Licence requiring:

- the board of Dwr Cymru to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the requirements for listed companies of the UK Listing Authority;
- Glas (via a legally enforceable undertaking) to consult Ofwat on any proposed changes to its Memorandum and Articles of Association;
- Glas (via a legally enforceable undertaking) to provide such information as the Director may reasonably require relating to its activities and financing;
- Glas (via a legally enforceable undertaking) to provide necessary information to Dwr Cymru to allow it to comply with its Licence;
- Glas (via a legally enforceable undertaking) to refrain from any action that would make Dwr Cymru breach its Licence;
- the board of Dwr Cymru to have a majority of non-executive directors.

1. In addition Ofwat considers a licence amendment prohibiting Dwr Cymru from carrying out activities other than those required of a water and sewerage undertaker is appropriate.

**Ofwat would welcome comments on the governance arrangements that have been proposed by Glas and particularly views on whether these will ensure that Glas will be commercially focussed in order to drive performance in the regulated business.**

**On the role of members, Ofwat would welcome views on whether members have sufficient incentives to hold the Board of Dwr Cymru to account and whether the membership selection process is robust enough to prevent capture by special interests.**

## Procurement of services

2. Under the Glas proposals, the ownership of Dwr Cymru's assets will be separated from the operation of those assets. Over a period of time Glas will implement a procurement strategy whereby it will retender the day to day operation of its assets and service delivery under a series of competitive contracts.

3. Ofwat is concerned that under such a strategy Dwr Cymru must be in a position to discharge its obligations. In addition the tendering process must be undertaken in a manner which ensures a level playing field at all times. The DWI, in the context of the Kelda proposals, expressed concerns associated with such a strategy including a concern that its ability to prosecute failures in water quality by Glas must not be compromised when outsourcing is undertaken to the scale and extent as proposed. Ofwat has been working in conjunction with the DWI and the EA to develop licence condition on procurement aimed at addressing both Ofwat's and the quality regulators' concerns.

4. Under the Glas proposals, Ofwat considers that it would be appropriate for Dwr Cymru to agree to a new licence condition on procurement, requiring it to submit a Procurement Plan to the Director. This Procurement Plan should include:

- An explanation of how Dwr Cymru intends to retain proper and effective control over the prospective contractor's operations, in particular in relation to its regulatory requirements relating to the quality of drinking water and the protection of the environment.
- An explanation of how assets will be properly maintained in light of the procurement strategy proposed.
- An assessment of the current contestability of the markets associated with each of the regulated activities in Dwr Cymru's area of supply and regions within it and how the contract mix put out for tendering relates to this assessment.
- Dwr Cymru's timetable to undertake this tendering.

1. Additionally Ofwat considers that it is appropriate to seek agreement to a new condition prohibiting Dwr Cymru from delegating responsibility for the proper performance of its statutory functions to any other party. This condition could also prevent Dwr Cymru, should it be prosecuted under the Water Industry Act (or regulations made under it), from raising a defence of due diligence, other than when that defence would have been available to it in the absence of any contracting arrangements.
2. Ofwat, in the context of WPD's proposals to implement competitive outsourcing for the provision of services to Dwr Cymru, is developing guidance on the minimum internal controls that need to be in place and in use in a water company to ensure and demonstrate that it meets its legal obligations and can carry out its functions. In light of Glas' similar proposals which involve a significantly greater degree of outsourcing than currently undertaken by water companies, Ofwat believes it would continue to be appropriate for Dwr Cymru to comply with these guidelines.
3. In light of the importance of Dwr Cymru having control over its functions, Ofwat considers that it is appropriate to strengthen the existing licence condition requiring water companies to have adequate financial and management resources and formally certify this to Ofwat. This would require Dwr Cymru to ensure that as well as having adequate financial and management resources it has adequate systems of planning and control to carry out its regulated activities.

**Ofwat would welcome views on whether, taken as a package, these licence modifications**

**provide sufficient measures to ensure the quality of drinking water and the environment is not put at risk under the Glas proposals and that the DWI's and EA's ability to prosecute undertakers in relation to water quality incidents is not compromised.**

### Comparative information

4. Ofwat attaches considerable importance to its ability to use comparative information to assist in the regulation of the water industry. The proposal would create a new type of comparator for making regulatory judgements. However in order to maintain the information available for comparative assessments, Ofwat would expect Dwr Cymru to agree to licence conditions requiring it:

- to publish periodically information relating to its financial and trading position, and the results of its operations, in line with the Listing Rules for a company with ordinary shares listed on the London Stock Exchange or a major recognised stock exchange;
- to maintain a listing of a Dwr Cymru financial instrument (bond or preference share) on the London Stock Exchange or a major recognised stock exchange.

## Additional licence modifications sought by Glas

1. Glas are seeking a number of licence modifications to the mechanisms for resetting price limits between periodic reviews set out in the Licence of Dwr Cymru so that it is consistent with that of certain other water companies. These are directed at widening the circumstances under which Dwr Cymru can ask for an interim determination of price limits and modification of the interest cover test used in interim determinations to reflect the fact that Dwr Cymru would be entirely financed by debt. Glas believes that this would emphasise to potential lenders the low risk nature of Dwr Cymru's business and enable it to finance Dwr Cymru's assets with strong investment grade bonds. The modifications requested are:

- Reinsertion of a relevant change in circumstances for capital price inflation. This would allow Dwr Cymru to ask for an interim determination in the event that capital price inflation results in an increase in costs which breaches the materiality threshold;
- Reinsertion of a the "shipwreck clause". This clause would allow Dwr Cymru to ask for an interim determination in any circumstance which has or could have a substantial adverse effect on its regulated business and which could not have been avoided by prudent management ; and
- Modification of the interest cover test used in interim determinations to reflect the fact that Dwr Cymru's assets will be entirely financed by debt.

1. The relevant change in circumstance for capital price inflation and the `shipwreck' clause are, however, symmetrical and allow customers to benefit from favorable effects also.

## 5. NEXT STEPS

2. The Director will take full account of responses to this consultation paper in deciding whether, in his opinion, the proposals described in this paper ought to receive regulatory clearance, with or without modification. He will take into consideration that Glas has indicated its acceptance to the modifications of Dwr Cymru's licence which are described above. The Director's decisions will be published and a copy sent to all those who responded to the consultation.
3. He will then, if necessary, advise the Director General of Fair Trading (DGFT). If, following advice from the DGFT, the Secretary of State for Trade and Industry were to conclude that this proposed acquisition is a merger situation under the provisions of the Fair Trading Act 1973, it would be open to him to refer it to the Competition Commission.
4. If the acquisition proceeds, the Director will follow the statutory procedure for amending Dwr Cyrmu's Licence to include the modifications set out in this paper as amended following consultation. In previous cases, he has obtained from the bidder assurances that, if its bid is successful, the target utility (in this case Dwr Cymru) will, pending the making of those modifications, conduct itself as if they were already in force.

Comments on the issues raised in this paper are welcomed and should be sent to:

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Fax: 0121 625 3609

**Comments should be received at Ofwat by 5:00pm on 18 December 2000**

This document is also available on the Ofwat website:

http://www.ofwat.gov.uk

Respondents should state clearly who they are and what organisations they represent. All responses will, at the end of the consultation, be placed in the Ofwat library unless clearly marked confidential.

A copy of this document will also be available in Welsh.

# APPENDIX A

## The proposed purchase of Dwr by Glas Cymru - Summary of the proposed licence modifications (and other requirements)

### Procurement of services

- A new licence condition on procurement requiring Dwr Cymru to submit a Procurement Plan to the Director.
- A new condition prohibiting Dwr Cymru from delegating responsibility for the proper performance of its statutory functions to any other party. This condition would also prevent Dwr Cymru, should it prosecuted under the Water Industry Act (or regulations made under it), from raising a defence of due diligence, other than when that defence would have been available to it in the absence of any contracting arrangements.

- Strengthen existing licence condition F6 requiring water companies to have adequate financial and management resources and formally certify this to Ofwat. Amend to require Dwr Cymru to ensure that as well as having adequate financial and management resources it has adequate systems of planning and control to carry out its regulated activities.

- Guidance on internal controls. The Director will expect Dwr Cymru to follow the guidance he will issue, setting down the minimum internal controls that need to be in place and in use in a water and sewerage undertaker to ensure and demonstrate that it meets its legal obligations and can carry out its functions.

### Strengthening of ring-fencing provisions

- Licence condition prohibiting the raising of any finance for the regulated business on terms which include cross default covenants.
- Licence condition that all loan facilities made available to it should secure investment grade rating.

## Corporate governance

- Licence condition requiring the board of Dwr Cymru to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the Listing Rules of the UK Listing Authority.
- Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will consult Ofwat on any proposed changes to its Memorandum and Articles of Association.
- Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will provide such information as the Director may reasonably require relating to the activities and financing of Glas Cymru.
- Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will provide it with the necessary information to allow Dwr Cymru to comply with its Licence.
- Dwr Cymru to obtain a legally enforceable undertaking from Glas that Glas will refrain from any action that would make the water company breach its Licence.
- Licence condition requiring the board of Dwr Cymru to have majority of non-executive directors.
- Licence condition prohibiting Dwr Cymru from carrying out activities other than those required of a water and sewerage undertaker.

## Availability of market and other information

- Licence condition requiring Dwr Cymru to publish information relating to its financial and trading position and the results of its operations in line with Listing Rules for a company with ordinary shares listed on the London Stock Exchange.
- Licence condition requiring Dwr Cymru to maintain the listing of a Dwr Cymru financial instrument (either bond with coupon related to rating, or preference share).

## Price limits

- Glas are seeking modifications to the mechanisms for setting price limits between periodic reviews in its Licence:
- reinsertion of a symmetrical relevant change in circumstance for capital price inflation (former RCC6);
- reinsertion of a symmetrical "shipwreck clause" (B.14.3);
- modification of the interest cover test (B14.2.9 (b)) for interim determinations to reflect 100% debt financing of Dwr Cymru’s assets.

## Requirements of Glas’ constitution to be reflected in its Articles of Association

- The requirement for reserves should be a formal part of the constitution of Glas and incorporated in its Articles of Association;
- Glas and Dwr Cymru should maintain an incentive scheme designed to attract and retain a high

calibre management team and to strongly incentivise them to deliver efficiency in business operations. This should be publicly available and formalised in the Articles of Association of Glas.