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Lord Dafydd Elis Thomas AM

Chair, Environment and Sustainability Committee

National Assembly for Wales

Cardiff Bay

Cardiff CF99 1NA

8 March 2013

Dear Lord Elis Thomas

Inquiry into water policy in Wales

Further to your letter of 22 January and your Committee's short inquiry into water policy in Wales – particularly the implications for Wales of the Draft Water Bill – I am pleased to have this opportunity to set out some of our views on what is being considered by policy makers, both here in Wales and in England. I will be happy to expand on any of the points I cover in this submission - or indeed address any other matters of interest or of concern to your Committee - when I give evidence later this month.

Dŵr Cymru

Dŵr Cymru is the sixth largest of the ten regulated water and sewerage companies in England and Wales. We serve much of Wales, Herefordshire and Deeside, providing water and sewerage services to 1.3 million household and over 100,000 business customers, looking after - on their behalf and for future generations - a long term industry employing essential infrastructure with a replacement value of around £25 billion (or around £20,000 per customer). Our revenues are £700 million and we are currently investing around £320 million each year in maintaining and improving our extensive network of infrastructure.

We operate 70 water treatment works and 850 sewage treatment works across our region and we supply drinking water and collect wastewater through a network of 27,000km of water mains and over 30,000km of sewers (now nearly doubled in size following the transfer of private sewers in October 2011). We now employ directly just under 2,500 staff having ended in 2010 the out-sourcing that was necessary for the original bond issue.

Our average household bill for the coming year is £434 - £181 for water and £253 for sewerage. This is a £7 increase on this year's average household bill and is once again the lowest increase in the industry (and this is the fourth year in which our average household bill has risen by less than inflation). Our bills cover our operating costs, our infrastructure maintenance costs and a return (ie for interest and/or dividends) on the sums for investment funded by investors since privatisation in 1989. For Dŵr Cymru, this sum now stands at £4 billion – this is our "regulated asset value", a key financial metric for the regulated utilities.

The water industry

The water industry provides an essential public service (focusing on public health, and protecting our environment from pollution) that households, communities, industry and indeed modern society as a whole depends on. For households, water and sewerage services are different from other utility services like energy (water is more than just a commodity); in particular, tap water is consumed and its quality and safety has always to be of paramount importance.

This is a capital intensive industry and the cost of financing investment comprises a large proportion of the total cost of providing water and sewerage services. Twenty four years on from privatisation - during which time the water industry in England and Wales has invested some £100 billion – the regulatory allowance for interest and dividends now absorbs a third of the average household bill. With continuing investment, this proportion will rise. It follows that small changes in the allowance for interest and dividends (which in turn reflects investors' assessment of the risk of investing in the regulated water sector) will have a large impact on the total cost. A 1% increase in the overall cost of capital would increase customer bills by 5% (and vice versa of course).

It is a long term industry where decisions taken today impact future generations (just as we rely on the good decisions made by our predecessors and have to live with the bad ones). In addition, most capital invested is "sunk" and cannot be re-allocated (hence the worry about "stranded assets" and also household customers paying more if say some large customers manage to use "competition" to pay lower prices which cover only marginal costs"[1]). Capital turnover is low and the likelihood of a "technological revolution" (as in telecoms for example) that would fundamentally change the nature of the water industry is unlikely. This makes the water industry – potentially – stable, predictable and low risk from an investor's point of view compared with other sectors.

The public service nature of the industry (certainly for households) means that the public interest is served by the cost being recovered fairly; there is no single "right price" for providing a water and sewerage service and the legitimate cross-subsidies resulting from any basis (volume, location, investment, ability to pay etc) that might be used to calculate a "fair price" are significant.

It follows that there are good reasons why the water industry in most parts of the developed world is integrated ("source to tap" and "bath to bay") and holds a monopoly position with only one provider of network infrastructure (but meaning that customers cannot choose between competing water and sewerage enterprises); it allows the public interest to be served, water quality and public health to be the first priority, and low cost long term funding for investment to be secured.

The Glas Cymru model

The ten water and sewerage companies privatised in 1989 remain integrated monopoly suppliers of water and sewerage services. Ownership has changed hands a number of times since then and much of the industry is now owned privately with just three companies still having their shares listed on the London Stock Exchange (see attachment 1).

Privatisation of the water industry has delivered very big improvements in cost efficiency and has enabled record levels of investment without government subsidy (to date) which has transformed water and environmental quality standards; customer bills have risen but by considerably less than would have been the case had the industry remained in the public sector (Ofwat put this saving at £100 per household customer). Research shows however that customers do not recognise this good outcome because (when asked for an opinion) they generally do not like the idea of their local monopoly water supplier being "owned and run for profit"; legitimacy suffers and costs are higher

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[1] This is one of the key points made by Professor Dieter Helm in his critique of the Draft Water Bill – see http://www.dieterhelm.co.uk/node/1342

as a result. It is perhaps worth adding here that "competition" in the energy sector has not solved this problem with legitimacy.

The Glas Cymru model is based on the premise that the advantages that came with privatisation could be retained – access to capital, a focus on performance, commercial drive, cost efficiency and so on - while legitimacy with customers could be restored by adopting a "not for profit" ownership model. A regulated monopoly has the important advantage of providing long term bond investors with more certainty and this translates into a lower cost which in turn is the key to keeping the total cost – and therefore customer bills - as low as possible. Under the Glas Cymru ownership model, this financing efficiency remains with Dŵr Cymru for the benefit of our customers – either through lower bills and social tariffs or through additional investment.

Using the financing efficiency that could be secured by the Glas Cymru model to make customer bills more affordable while not cutting back on essential investment and standards was at the heart of the original transaction in 2001. Research tells us that around 30% of our customers spend 3% of disposable income on their water and sewerage bill while around 14% spend more than 5%. Keeping our bills affordable must remain the priority and the key to doing so in this capital intensive industry is continued access to long term efficient financing of investment.

With the Glas Cymru form of ownership, the interests of investors and customers are aligned. Bond investors want improving credit ratings which in turn lead to lower interest costs when new funds are raised for investment - then these lower funding costs are in turn key to keeping total costs down and customer bills affordable. Affordable bills and high standards improve legitimacy and reduce regulatory and political risk which in turn supports credit ratings. We refer to this as the "Glas Cymru virtuous circle" (see attachment 2).

Dŵr Cymru under Glas Cymru's ownership

Glas Cymru (a company limited by guarantee) acquired Dŵr Cymru for £1.9 billion in May 2001. We funded the purchase with an issue of bonds (with a range of maturities and ratings) which were bought by pension fund and other long term UK investors. The initial bond issue was nearly two times over-subscribed and remains the largest ever non-government backed bond issue completed in the UK. Since 2001, we have raised a further £1 billion in bond (or equivalent fixed interest) finance to fund investment or to re-finance earlier funding.

Gearing (ie the ratio of total debt to regulatory asset value) has fallen from 93% at the time of the acquisition in 2001 to below 65% now; our financial reserves or "customer equity" (ie the difference between the regulatory asset value of £4 billion and our total debt today of £2.5 billion) is now £1.5 billion (or around £1,000 per customer). Because of this steadily improving financial position, Dŵr Cymru has had six credit rating upgrades since 2001 and our rating is now the highest in the entire utilities sector (see attachment 3).

One worry that was expressed at the time of the Glas Cymru acquisition was that as a result of its governance structure and lack of shareholders driving returns, Dŵr Cymru would not be as driven to improve operating cost efficiency. Our track record since 2001 suggests otherwise; Ofwat's latest report shows that Dŵr Cymru has been the only company to have reduced its operating costs since 2000 (see attachment 4).

The financing and operating cost efficiency savings stay with Dŵr Cymru for the benefit of our customers. Customer bills in 2015 will be lower in real terms (ie after adjusting for RPI inflation) than they were in the year before Dŵr Cymru became "not for profit" (see attachment 5); in the past we have paid "customer dividends" of £150 million. We also fund help for nearly 50,000 household customers who are really struggling to make ends meet with a range of social tariffs and other assistance; this is more help than that offered by any other water company and is now supported by recently published Welsh Government Social Tariff Guidance which we welcome. In addition, while keeping bill increases to below the rate of inflation we have accelerated investment - to deliver high value improvements to our infrastructure for the benefit of our customers and our environment - and we will now invest a total of £1.5 billion in the current five year period 2010-2015 (see attachment 6); we estimate that we are employing currently more than 10% of the entire construction sector in Wales.

When we set up Glas Cymru, I think we underestimated the importance of the ownership model for the culture of our organisation. Being owned on behalf of our customers has had a real impact on day to day customer service as well on the way in which our teams across the business behave and deal with all the issues and challenges we face every day. Household customer satisfaction is currently running at over 90% (see attachment 7) while our own tracking research shows that business customer satisfaction is just short of 90%. I now think it looks likely that the number of written thank you letters and emails we get may well exceed the number of written complaints this year.

This is all down to a lot of hard work, a host of customer service improvement initiatives backed by investment in systems and training, but I judge that the most important ingredient in what is now a sector leading performance for customer service is the culture that we have in Dŵr Cymru which puts our customers first. We have recently carried out a Staff Engagement Survey and 83% of our colleagues are "proud to work for Welsh Water" while 80% agree with the statement that "Welsh Water puts its customers first" (see attachment 8).

The water industry is particularly measureable and we (and others) are able to compare and judge our performance on many of the things that matter most for our customers and for protecting our environment. To help us focus on what matters we have a "Performance Scorecard" (see attachment 9) which includes a sub-set of the key measures of performance; this Scorecard is updated every month and reviewed by the Board (alongside other performance reports) and shared with staff across the business. The "target" level of performance on the Scorecard is what the leading companies in the sector are able to achieve. The Scorecard is used to calculate half of variable pay for all staff, the other half being cost efficiency; in this way we are able to say to our colleagues that if our customers have had a good deal then we should share in that good outcome (rather like the John Lewis Partnership).

Overall, for the current year, we judge that our performance overall ranks us close to top of the industry league table on the basket of measures that matter for our customers and for our environment - whilst again having the lowest bill increase in the sector .

Proper and effective governance has been a feature of Glas Cymru's ownership of Dŵr Cymru since the start. As well as being tightly regulated, we have a constitution that requires a majority of the Board to be independent of executive management; currently the Board, chaired by Bob Ayling, comprises seven non-executive directors of high standing plus the three executive directors. In addition, we have 60 Members from all walks of life who hold the Board to account for the performance of Dŵr Cymru and all other corporate governance matters; we meet with our Members at least twice every year (including our Annual General Meeting each July) and keep them informed on matters of interest or concern between meetings. Jonson Cox, the recently appointed Chair of Ofwat, has this week published[2] a note setting out his concerns about the industry, the governance of the "highly leveraged" companies in particular; these concerns do not apply to Dŵr Cymru.

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[2] www.ofwat.gov.uk/mediacentre/speeches/prs_spe20130305jcrae.pdf

Draft Water Bill

If one accepts that "public service plus monopoly plus for profit" is a mix that will always suffer from a lack of legitimacy, then one way to look at the Draft Water Bill is that it aims to deal with the fundamental problem by bringing more competition into the water sector and diminishing, where possible, the "monopoly" nature of the industry. By contrast Glas Cymru has sought to restore legitimacy by removing "for profit" from the mix.

The Draft Water Bill sets out to allow and encourage new entrants - licenced by Ofwat - to compete with incumbent water companies at either end of the "source to tap" and "bath to bay" supply chain. In the first instance, all non-household customers (in England for now) will be able to choose between competing water "retailers" (as in the energy sector) and the incumbent water company will sell water at a wholesale price to the retailer. Looking further ahead (2019?) and under proposals for "upstream competition", an existing water company might be required to take treated water from a new entrant and transport that water – mixed with other drinking water already in the water mains network – to another new entrant's large retail customer.

This sort of major re-shaping of the water industry has not been tried anywhere else. The thinking behind it is that as well as improving legitimacy, a disaggregated and competitive water industry will be more innovative, more customer focused, more cost efficient and better equipped to deal with the challenge of climate change and growing populations.

What is our position?

First of all, we start from a different position having put ownership of the water industry in the region served by Dŵr Cymru into a "not for profit" structure with all the advantages for our customers that this has delivered to date.

Second, we are very concerned about the risks that come with undermining "source to tap" responsibility for the quality of drinking water at the tap; as an integrated industry, we are equipped and able to deal with water quality incidents quickly without having to argue with anyone else as to who might be responsible. Drinking water in not like energy where one supplier's gas or electricity is no different from another supplier's; drinking water is consumed and its quality and indeed safety can be compromised in all sorts of ways.

Third, there are good public policy reasons why the cost of water and sewerage should be averaged so that expensive-to-serve customers (because of location or ability to pay for example) should not pay more than cheap-to-serve customers; experience elsewhere tells us that with competition (and "cherry picking") legitimate and important cross-subsidies are unwound (poor customers on prepayment meters paying more than direct debit customers in energy for example). This worry about "de-averaging" was one of the key conclusions from the recent Efra Committee pre-legislative scrutiny of the Draft Water Bill.[3]

Fourth, recent experience suggests that the "level playing field" may well be tilted to encourage new entrants at the expense of our customers; we have recently responded to a consultation by Ofwat on its proposal to grant an "inset" to serve a new development at Coed Darcy the effect of which would be to increase our customer bills so that the new entrant could secure an additional profit of £600k annually (see attachment 10). Related to this, the water industry regulator for Scotland has shown how "upstream competition" could lead logically to stranded assets and higher total costs.[4]

Fifth and crucially, the prospect of a disaggregated industry with more competition would increase uncertainty for long term investors and increase the cost of funding continuing high levels of investment. More than ever, the key to delivering a high quality and resilient service for customers in the years ahead at an affordable cost - including dealing with the challenge of climate change – is continued access to long term funds at low rates of interest. This is what the Glas Cymru model achieves.

Remaining a regulated and integrated monopoly is not without risks of course, the main ones being complacency, inefficiency, caution, self interest and so on. These risks are real but I think can be mitigated to a large degree by regulation, by benchmark "comparative competition" – with the Drinking Water Inspectorate, the Environment Agency (and soon to be Natural Resources Wales) and Ofwat published league tables showing what "good, middling and bad" looks like – by good governance (the Board of Dŵr Cymru will change executive management if performance falls short) and by a good customer focused culture, top to bottom.

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3 www.publications.parliament.uk/pa/cm201213/cmselect/cmenvfru/674/67402.htm

4 www.watercommission.co.uk/UserFiles/Documents/TechnicalNote2.pdf

This is not to say that we have closed our minds to the sort of change envisaged by the Draft Water Bill and the agenda being promoted by Ofwat. But we think it is important that the changes being mooted do – demonstrably - improve on the current model [5]we have adopted for the water industry in the area served by Dŵr Cymru.

As you know, the Welsh Government has taken a more cautious approach to the changes being put forward in the Draft Water Bill and water policy in Wales is a mostly devolved matter. There may well be a case for allowing the "not for profit" regime in Wales to compete with the "for profit" regime in England, in whatever way that evolves. For our part, we would relish taking on that challenge to prove that "not for profit" ownerships of the water industry not only chimes with the instincts of customers but also delivers better outcomes for both today's customers and future generations.

Yours sincerely

Nigel Annett

Nigel Annett

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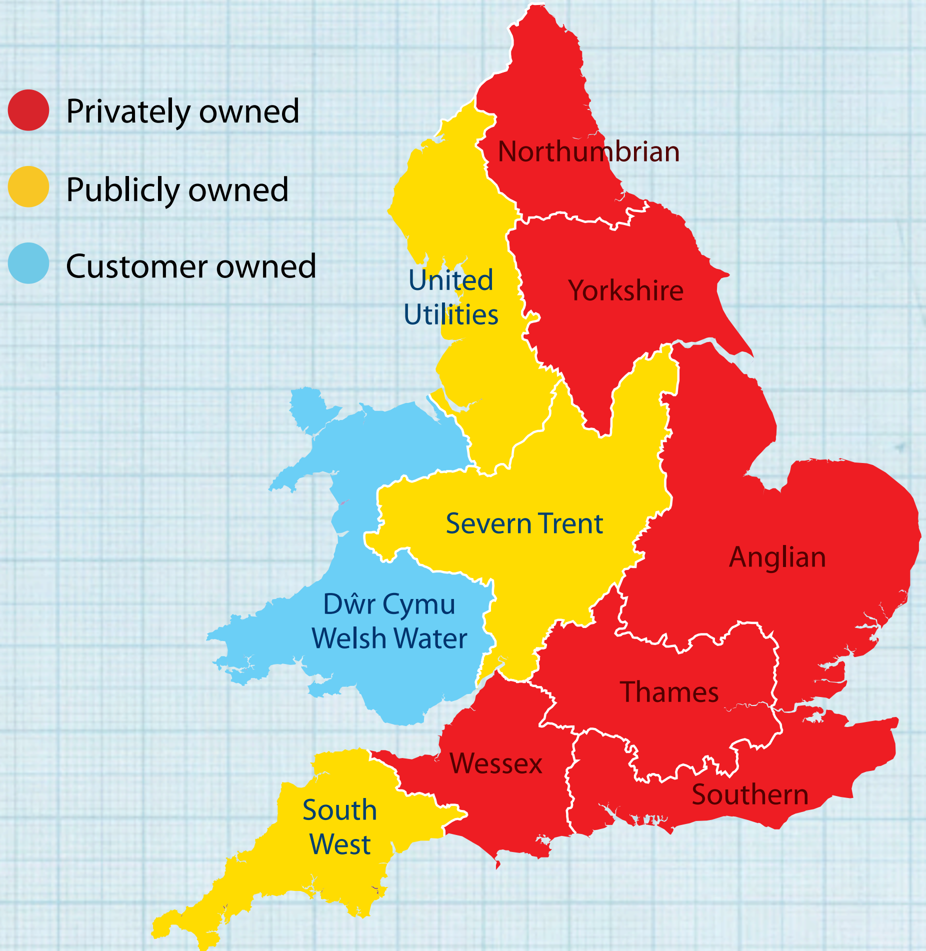
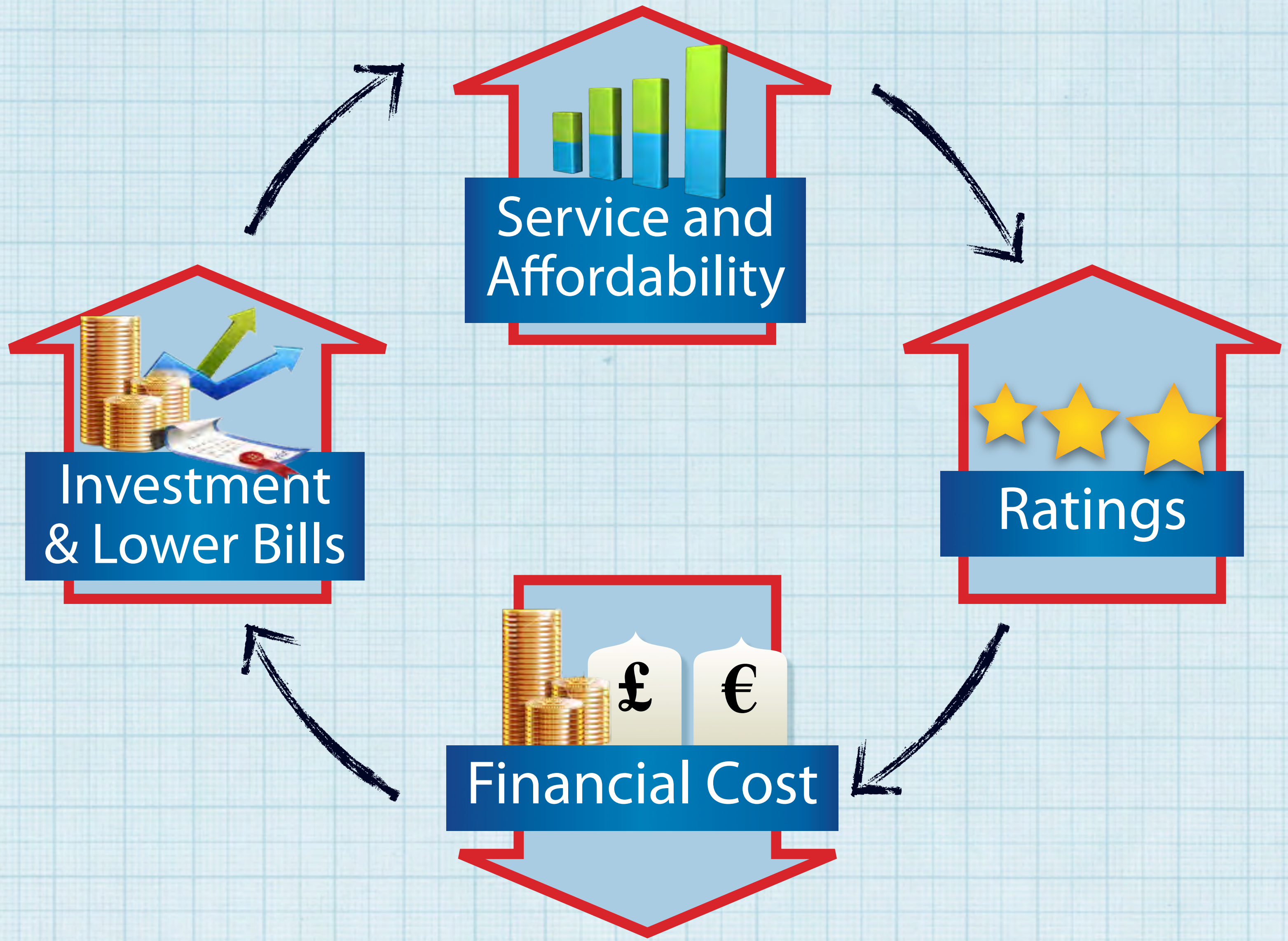
The regulated water industry in England and Wales



- Privatised in 1989 - doubling of investment and rising customer bills
- RCV of water sector now £40bn - less than £10bn at privatisation
- MEA valuation now over £300bn
- Sector remains cash-flow negative (though assets still getting older)
- Financing accounts for third of bill
- Bills 40% higher than 1989
- Three quarters of sector privately owned - up to 30% premia paid

The Glas Cymru "virtuous circle"...



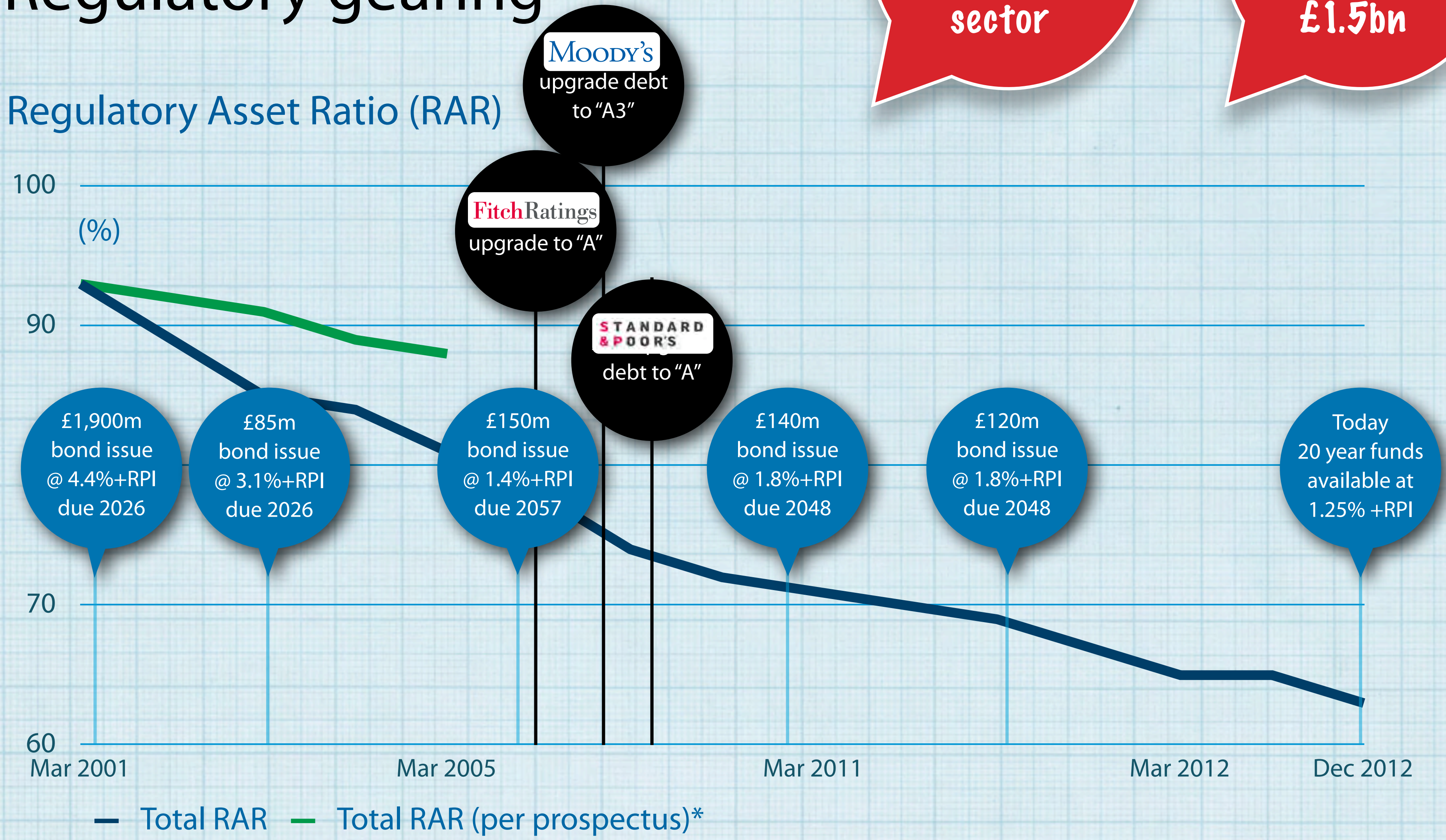
glas

Glas Cymru Cyfyngedig

Highest credit rating in the utilities sector

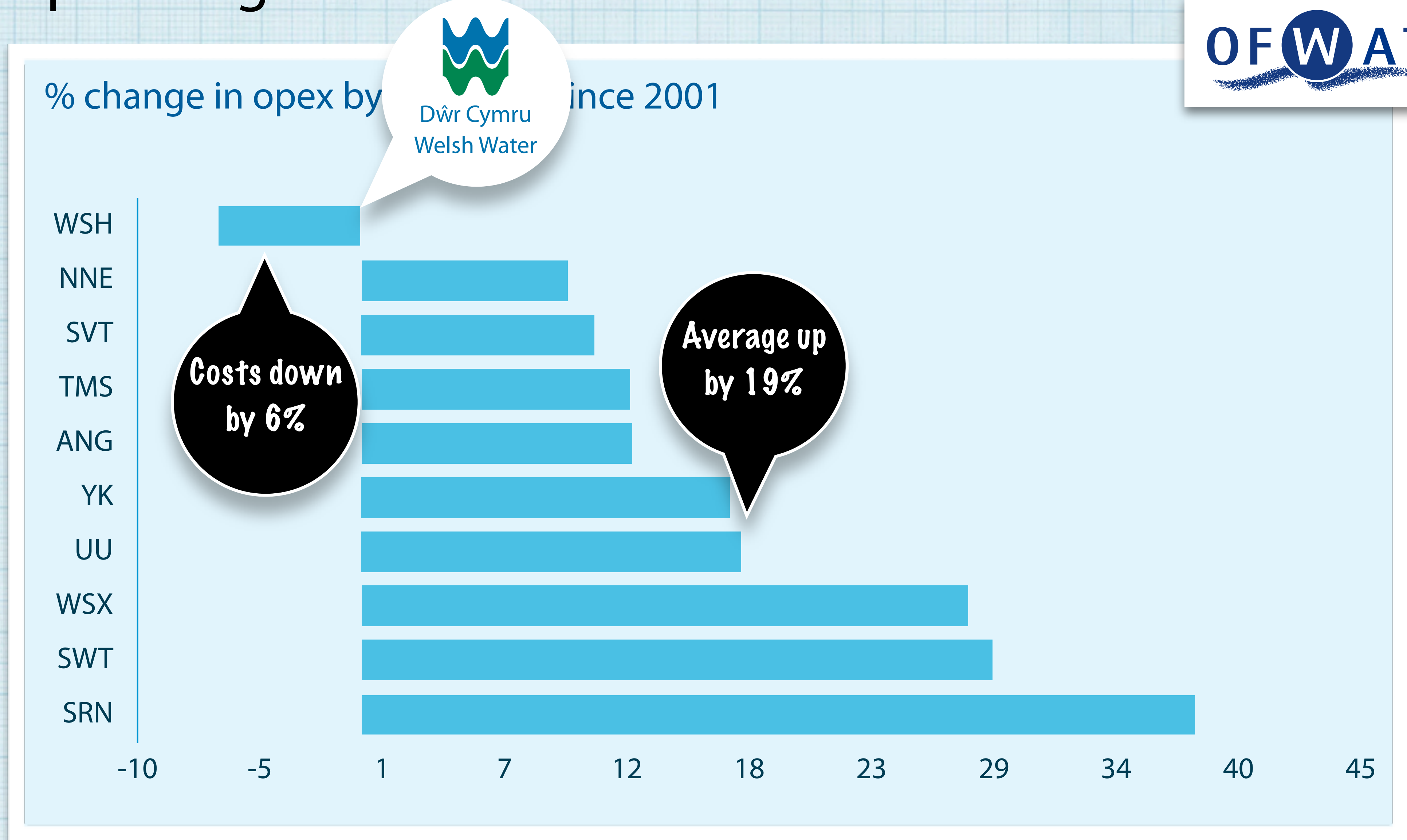
Customer equity now stands at £1.5bn

Regulatory gearing

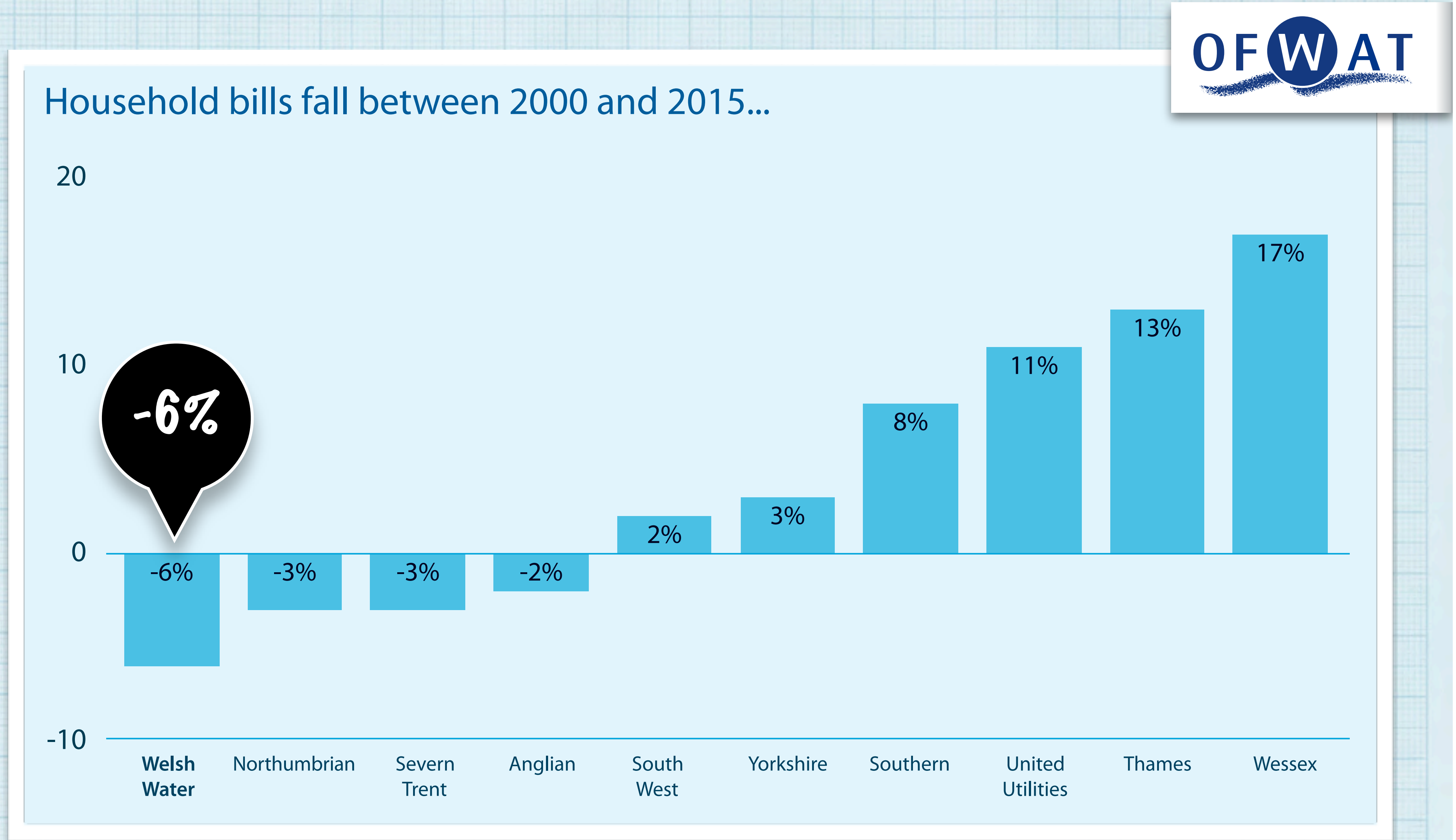


*Prospectus to 2005 only

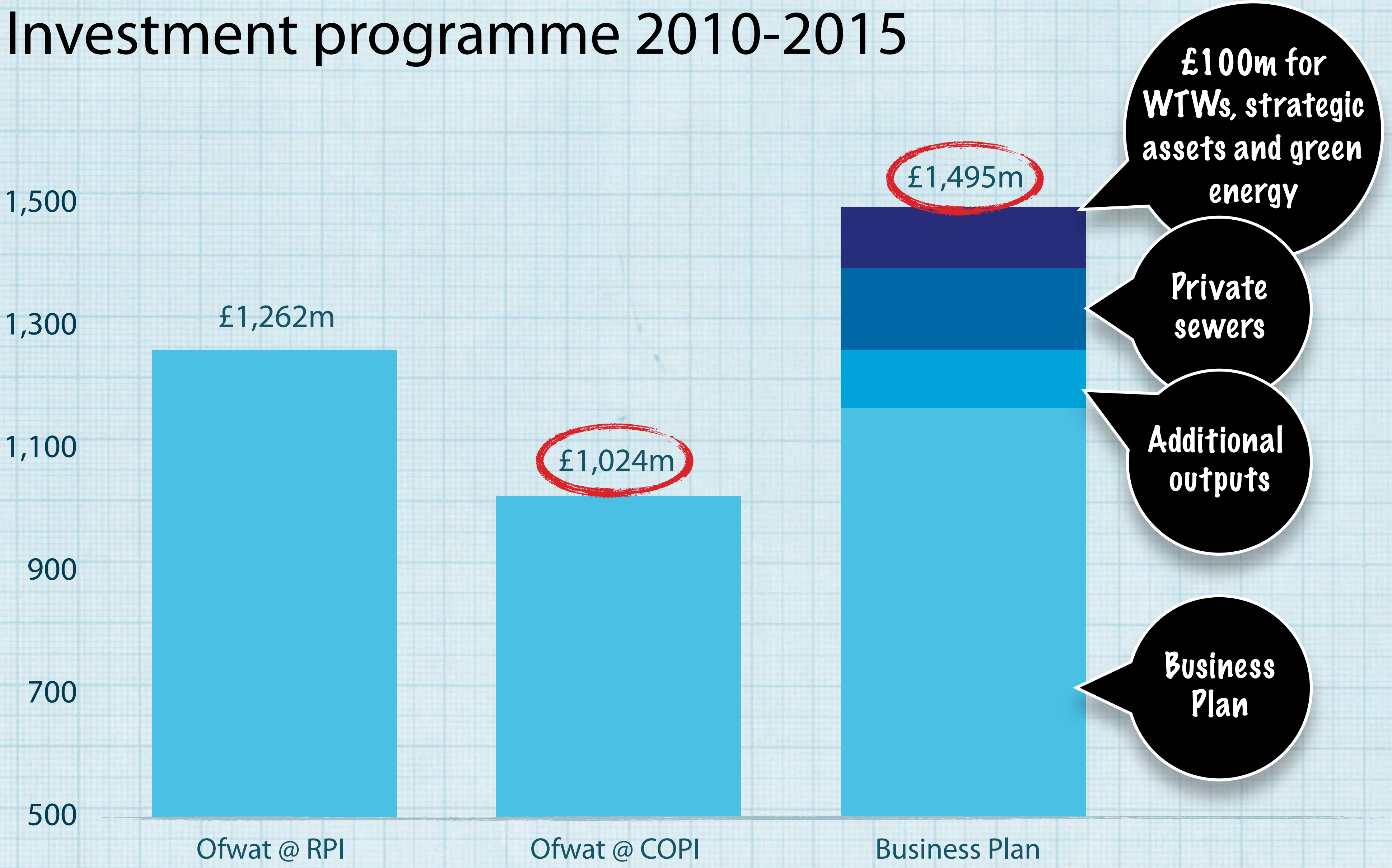
Operating costs since 2001



Customer bills...



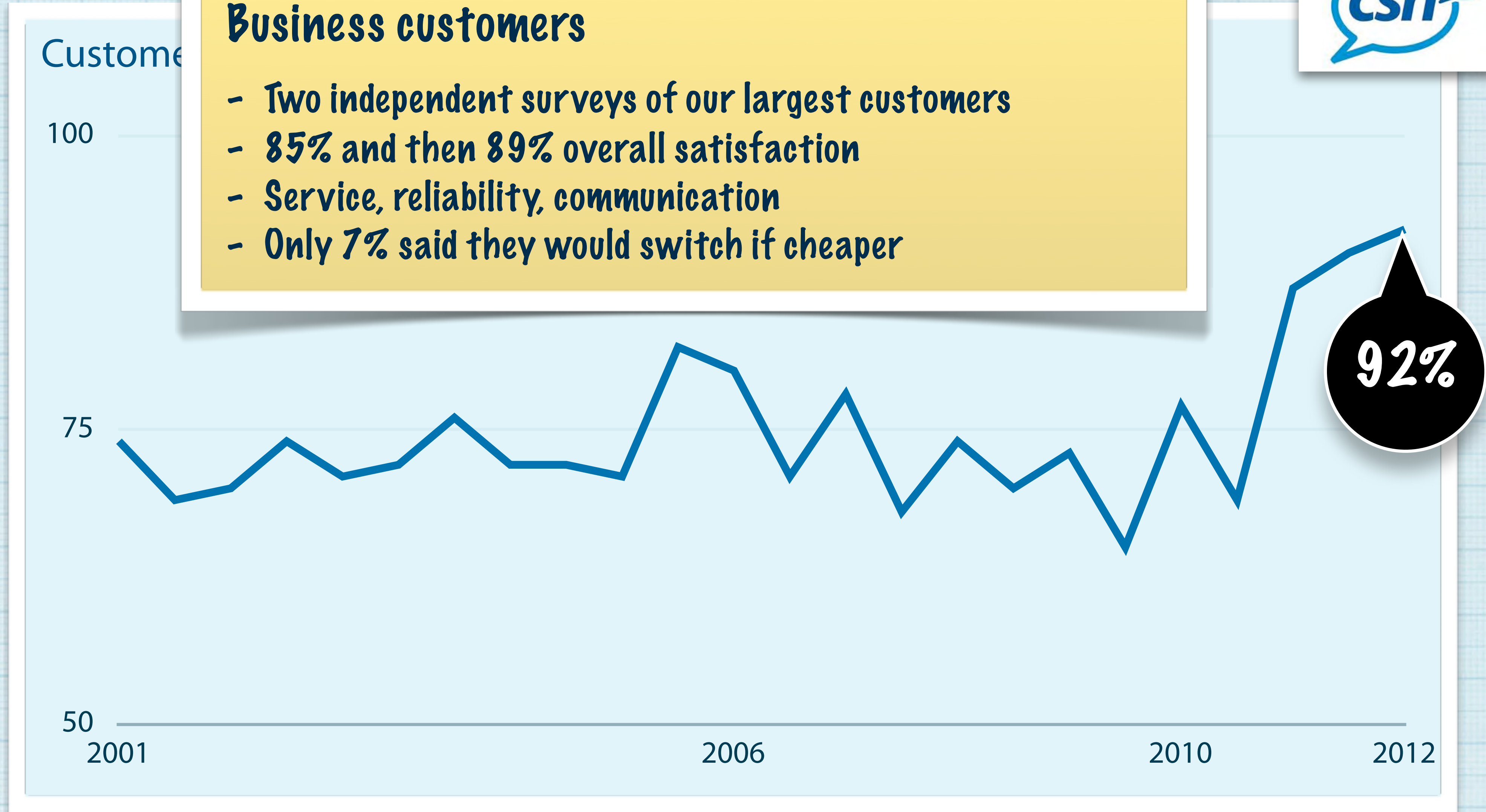
Investment programme 2010-2015



Customer satisfaction

Business customers

- Two independent surveys of our largest customers
- 85% and then 89% overall satisfaction
- Service, reliability, communication
- Only 7% said they would switch if cheaper



Employee Engagement Index

The Engagement Index is a measure of respondents' commitment to WELSH WATER. Engagement goes beyond satisfaction and can be defined as employees' willingness to invest their personal effort in the success of the organisation.

The three elements of Employee Engagement

Say Strongly advocating the organisation

Stay An emotional commitment to the organisation and a desire to stay

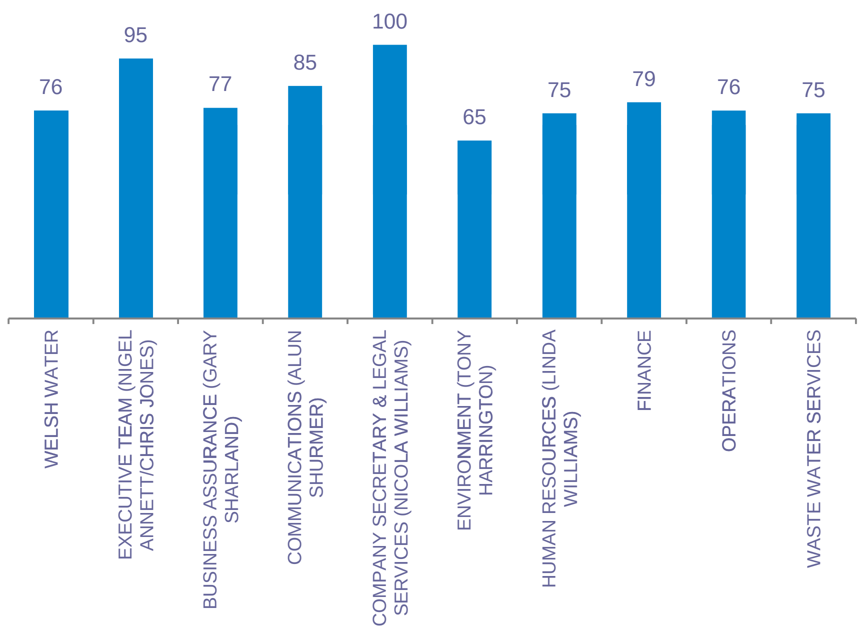
Strive Providing sustained additional effort in line with organisational goals

The following four questions have been identified as being most aligned to Employee Engagement. The Engagement Index is an average of the following scores:

Key

Positive response | Neutral response | Negative response

	Response Scale: Positive	Neutral	Negative	% Positive from 2011
38. I am proud to work for Welsh Water	83	14		+5
39. I would recommend Welsh Water as a great place to work	74	18	8	+10
40. I feel a strong sense of belonging to Welsh Water	68	23	10	+6
41. Working at Welsh Water makes me want to do the best work I can	80	16		+7

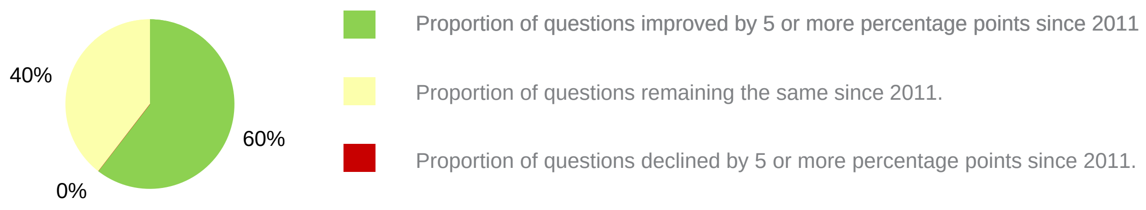


76%
ENGAGEMENT INDEX

70%
BENCHMARK INDEX

Most improved and Least improved

This section shows the five most improved questions and the five least improved questions when compared against trend data (the 2011 scores).



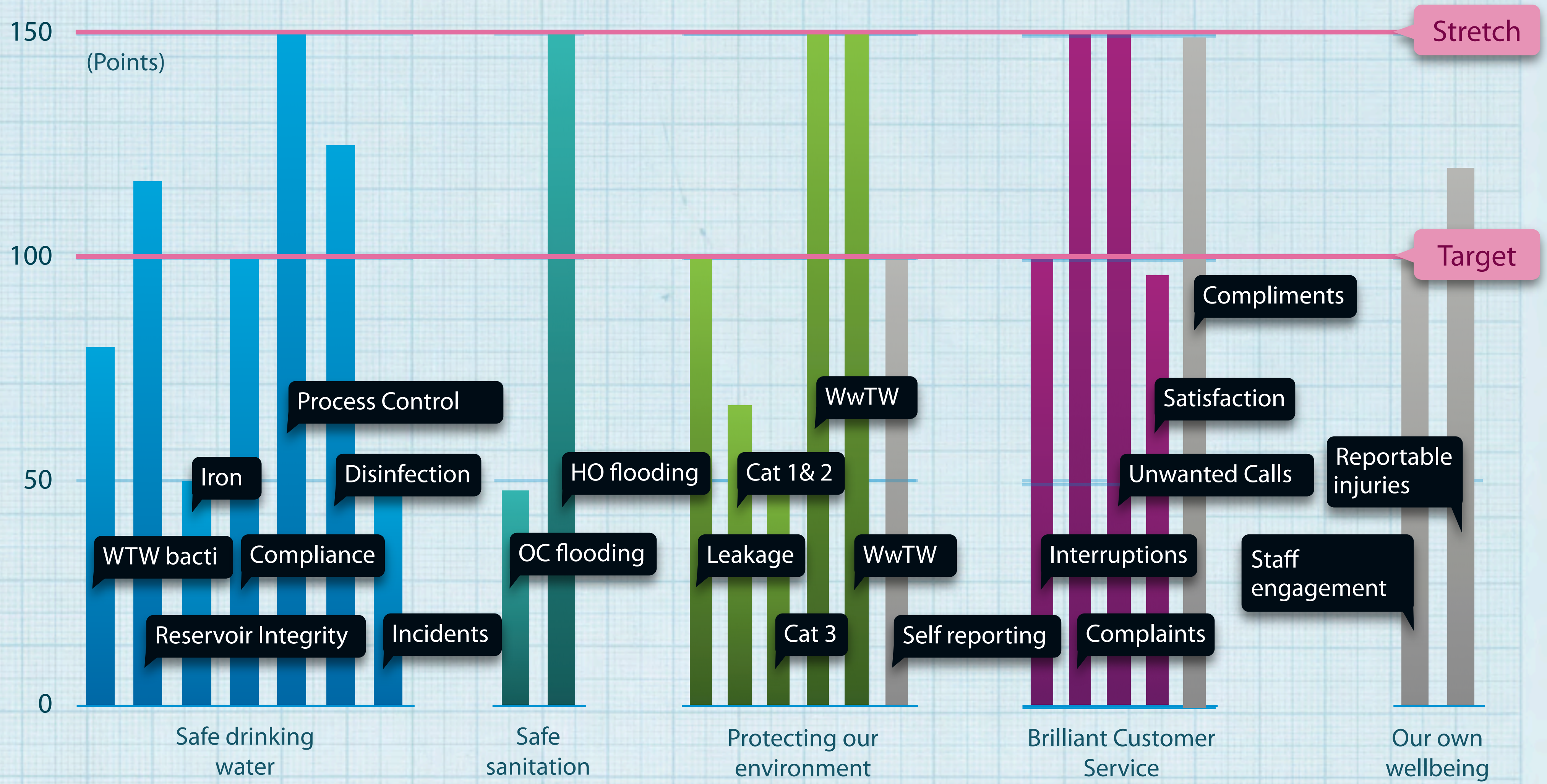
Most improved against Trend

		% Positive	Variance from 2011 % Positive
14.	I believe the Executive Team (DCE) has a clear plan for the future of Welsh Water	64	+16
15.	Overall, I have confidence in the Executive Team's (DCE) leadership of Welsh Water	62	+15
21.	At Welsh Water we are committed to developing our staff	60	+14
43.	Welsh Water does a good job of promoting health and wellbeing	74	+13
32.	I believe that Welsh Water puts customers first	80	+13

Least improved against Trend

		% Positive	Variance from 2011 % Positive
3.	I have been provided with reliable IT which enables me to do my job well	50	0
2.	I like the kind of work of I do	87	0
7.	My manager recognises and acknowledges when I have done my job well	68	0
31.	I have the right level of authority I need to deliver great customer service	56	+1
8.	I am motivated and inspired by my manager	57	+1

Our performance scorecard...



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Claire Simpson
Senior Case Officer, Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

26 September 2012

Dear Ms Simpson

Proposed inset appointment for Coed Darcy

I am writing on behalf of Dŵr Cymru in response to Ofwat's Section 8(3) Notice ("the Notice") which sets out Ofwat's proposal to vary the appointments of SSE Water and Dŵr Cymru by adding the un-served site at Coed Darcy to the area served by SSE Water and excluding this site from the area served by Dŵr Cymru. We welcome the way in which Ofwat's Notice sets out not only the possible benefits for customers that might arise from this variation but also some of the detriments. We have given this careful consideration and having weighed up all the possible benefits and detriments we conclude that this proposed variation is <u>not</u> in the interests of water customers and for that reason it should not be approved.

Future customers on the Coed Darcy site

The service improvements that SSE Water propose to offer - which are summarised in the Section 8(3) Notice ("the Notice") dated 30 August 2012 - are small (eg call centre opening hours being an hour longer on a Saturday) and are more than cancelled out by the services that Dŵr Cymru offers our customers which SSE Water does not.

For example, our Welsh Water Assist tariff offers a charge that is capped at a level well below our average household bill (ie £250 vs £430). Similarly, our Welsh Water Direct tariff offers a £25 discount to the account of any customer who elects to have their water charges paid direct from a qualifying Department of Work and Pensions benefit. We also have Water Collect and our Customer Assistance Fund which are designed to help least well off households customers afford their water and sewerage bill. Currently, we help nearly 45,000 of our household customers to afford their water and sewerage bill.

We also offer a number of other customer service innovations that SSE Water do not offer currently. Examples include "live chat" with a member of our customer service team which is currently used by some 500 customers each month (and rising) and an automated 24 hour payment service. When there is a water supply problem – for example a burst water main – we send a text within 30 minutes of detecting this to customers who might be affected to let them know that we are aware of the issue and when the service will be restored; to date this year we have sent over 135,000 texts and this is a highly valued customer service that is not offered by SSE Water. In all our dealings with customers, we as a matter of course offer to communicate and do business in either the English or the Welsh language (and we do not have any customer service staff located outside of our region).

More generally, we would expect that future customers on the Coed Darcy site (no having chosen SSE Water as their water and sewerage company) may well be concerned that the responsibility for the quality of their water supply is split between two separate water companies and that they are "one step removed" from the producer of their tap water. Future customers may perceive that they would be better supplied by a water company that is locally-owned and locally-based and they may well be concerned (because SSE Water is subject to policy set by Defra) about being denied policies and standards set by the Welsh Government that are not available in England even though they live in Wales (for example, mandatory build standards come into force in Wales on 1 October this year whereas as yet there is no date for the same to happen in England). These add up to significant and addition perceived detriments which have to be taken into account in considering whether the variation is in the interests of future customers on the Coed Darcy site.

Customers of Dŵr Cymru

The Notice does point out that the proposed variation is not cost free and that existing customers of Dŵr Cymru will be an estimated 50p per household per annum worse off when the site is fully developed - or around £650,000 per annum in total. This is a very significant transfer of value from our customers to SSE Water and/or the developer of the Coed Darcy site (but not under the proposals set out in the Notice to future customers on the Coed Darcy site). We are aware of further possible inset appointments that are being pursued by SSE Water which if approved by Ofwat would increase further this very real and significant detriment to our customers.

Conclusion

Having considered carefully the possible benefits and likely detriments we have to conclude that the proposed variation as set out in the Notice is <u>not</u> in the interests of either our existing customers or the future customers on the Coed Darcy site.

Given the significance of Ofwat's policy on inset appointments for the future shape and ownership of the water industry in Wales, the likelihood of many more inset appointments over the coming months and years and the impact this could have on customers, we consider that it would be timely for Ofwat to test its policy with customers more widely and confirm or otherwise that customers in Wales endorse its policy. In this way customers' views will be heard and Ofwat will be able to respond to their preferences.

We could also test whether our customers generally would support Dŵr Cymru offering, for example, a separate tariff for customers in newly developed areas and which would be set below the standard household tariff (available for a number of years, possibly on a sliding scale, converging towards the standard tariff). The difference between the two tariffs would reflect the cost difference between supplying a new household on a new development and supplying an existing household. This would have the advantage of removing the additional surplus that is available to an inset appointee and ensure that it is customers who benefit from the lower cost of serving a new development. With customer endorsement and Ofwat approval, such a tariff would mean that the potential inset appointee would have to challenge the incumbent water company on the basis of a "level playing field" and show that the profits which the inset appointee would hope to earn come from giving customers a better service or from genuine productive efficiency gains.

The same outcome could of course be achieved by Ofwat setting price limits for the site in exactly the same way as it sets price limits for Dŵr Cymru and other water companies - ie by setting price limits to reflect the actual costs of serving the new site. The current approach - in which the inset appointee is allowed to charge the same as the incumbent water company's cost-to-serve across its entire region, even though its costs are materially lower - does not constitute a "level playing field" and as such does not serve the public interest.

I am copying this letter to Prys Davies at the Welsh Government, Diane McCrea at the Consumer Council for Water Wales, Milo Purcell at the Drinking Water Inspectorate and Chris Mills at Environment Agency Wales.

Yours sincerely

Mike Davis

Mike Davis
Regulation Director