



Address given to an IWA Lunch on the 25th June 2001 by Lord Burns, Chairman of Glas Cymru.

I'm delighted to be with you today, and to have the opportunity to tell you something about Glas Cymru. Glas, as most of you know, bought Dwr Cymru Welsh Water in early May from Western Power Distribution, who in turn had bought Hyder last summer following a protracted take-over battle with Nomura.

I want to spend most of the next fifteen minutes or so giving you an idea of what all the fuss is about – why there is so much interest in Glas; why it has been described as “path-breaking”; and indeed why it is being regarded as a truly Welsh innovation. But before I do, I would like to highlight some important features of the water and sewerage service.

First and foremost, water is an *essential* service, which is vital to public health. Even more than gas, electricity, telecommunications, street lighting, and so on, the service cannot be allowed to fail, even for a relatively short period of time. It also plays an important role in the local economy. High quality low cost water and wastewater services are good for competitiveness and the welfare of consumers.

Second, and partly as a consequence of the “essential” nature of the service, water companies are very strictly regulated, not just by OFWAT, the economic regulator, but by a number of institutions who oversee quality and continuity of service as well. All water companies have to provide the regulators with large quantities of audited information on all aspects of their

performance. Where there is any suggestion that performance may fall short of the standards required, the regulators have extensive powers they can use to remedy the situation.

Third, since the late 1980s the water companies have had to undertake massive investment programmes to meet ever rising water quality and environmental standards. These programmes are set to continue at least for another ten years and probably beyond. Already the industry is highly capital intensive. Dwr Cymru today employs regulated assets of about £2 billion and the company will invest a further £1.2 billion over the five years to 2005.

All this means that water companies continually have to raise new finance from the capital markets to pay for these quality improvements. As a result, the cost of servicing this finance is the largest – and rising – component of household bills. This puts the issue of finance at the centre of the strategy for any water company. The rate of interest which companies have to pay on their borrowing is, amongst other things, dependent on how risky investors perceive the business to be. My starting point is that water and sewerage should be a low risk essential public service, and that the cost of borrowing for water companies should also be low. For a variety of reasons this is not always the case. As I will explain in a moment, this was one of the most important considerations in shaping Glas Cymru's proposals for Dwr Cymru.

So what is all the fuss about? Basically, Glas is a completely different and new way of organising and financing the water and sewerage services, as compared with the traditional types of company which serve customers in England. We have sought to design a structure that gives us the best chance of running a low risk, low cost of finance business.

Hence, when we set out to formulate our proposals, our starting point was to organise the provision of the services in the most efficient way possible. Since the cost of capital is, and will continue to be, Dwr Cymru's largest single cost, our primary focus was to re-finance the

whole business as cheaply as possible, by issuing low cost long-term bonds. As some of you may have read, we successfully achieved this objective in early May. To finance the purchase of Dwr Cymru, and to fund the next two years' capital investment programme, we had to raise just short of £2 billion. This was the largest ever bond issue of its kind ever attempted in the UK. In fact, the response from investors was so strong that it was 70% oversubscribed, and the interest rates we will have to pay on the bonds were very reasonable!

As a result, we succeeded in cutting Dwr Cymru's cost of capital by about a third. That is an enormous saving, and works out at about £50m per annum. Ultimately, these savings will translate into lower bills for customers. In addition though – and this is a point which is not widely appreciated – the financing secures Dwr Cymru's £1.2 billion investment programme. Twelve months ago, under Hyder's ownership, Dwr Cymru's credit rating was at an all time low, and it is doubtful whether the company could have raised new debt on reasonable terms given the situation which prevailed at that time.

Why were investors so keen to provide finance for our proposals? This has proved to be an intriguing question for industry commentators, not least of all because the English water companies have, with one small exception, been unable to raise bond finance for well over a year.

I think there are many reasons as to why the financing of Dwr Cymru was such a success. Essentially it comes back to the risk profile of the business. I want to single out some of the distinctive features which appear to have appealed so strongly to investors.

First, Glas Cymru has no shareholders. Instead, it has been formed as a “company limited by guarantee” or “CLG”. BUPA is the best known example of other CLGs, which are exactly the same as any other company except that they have “members” instead of shareholders.

Members do not receive dividends or have any other financial interest in the business, but in all other respects they act in exactly the same way as shareholders. Thirty members have already been appointed through an independent selection process and we are aiming to have around fifty members by the end of this year. Alongside bond investors, regulators and government, members have an important corporate governance role. We also want our members to be broadly representative of Dwr Cymru's customer base, and to be people who will support the company in its task of providing excellent water and sewerage services at least cost to the communities it serves. At our first Annual General Meeting next month they will be requested by the Board to vote on company matters, such as the appointment of directors, and approval of the appointment of the auditors.

Essentially, the water industry in Wales is now owned and managed on a "not for profit" basis. Investors were reassured that the new legitimacy that this structure offered would reduce their exposure to the so-called "political and regulatory risk" that is perceived to have created significant problems for the shareholder-owned water companies in England.

But this is not to say that Glas, in any way, will be any less "commercial" and "performance-driven" than shareholder-owned water companies. Nor will it be subject to undue influence by groups representing special interests. The things we are legally obliged to do are quite clearly spelt out, and the regulators are both vigilant and vigorous in making sure we do not slip up. In addition, though, the performance of the company, especially as regards efficiency and financial performance will be very closely monitored by our bond investors. As you know, some people have suggested that Glas will become sloppy and inefficient because of the absence of oversight by shareholders. I can tell you that the information we will have to provide our investors, and the rights they have to remedy poor performance, are at least as extensive as those which apply to the shareholder-owned water companies.

Second, we were able to purchase Dwr Cymru at less than its regulated asset value. Because of that we begin with reserves of £150 million. In addition we know the regulatory framework for the next four years and are able to accumulate further reserves over this period. By the end of the regulatory period in 2005 we are targeting an overall level of reserves of between £300 and £350 million, representing three quarters of annual sales. These reserves give a financial buffer against any shocks, such as drought, and give our investors a strong degree of comfort about the ongoing financial structure and our ability to meet their demanding requirements for financial performance.

Third, Glas Cymru is committed to being a “single purpose” company that is limiting its activities to the delivery of water services. It is not difficult to persuade investors that the business of water and sewerage is a low risk proposition, but what they were especially pleased to hear was that we would not, and could not, diversify into other activities. As many of you may know, all the other water companies, to varying degrees, have diversified since privatisation, generally with disappointing results. As a consequence, investors are rightly concerned about so-called “diversification risk”. With Glas, they have no such worries, and were clearly attracted by our simple, exclusive, and binding commitment to the water and sewerage services.

Fourth, we sought to organise the delivery of the services in such a way which would further reduce risks, and achieve greater efficiency. To do so, we decided to out-source the overwhelming bulk of our operations and investment activities to other companies, following competitive tendering procedures. This procurement strategy – under which we aim to work with “best in class” high quality service providers - is one of the most distinctive features of our overall plans, and has attracted a great deal of attention. Already it is clear that this strategy will contribute significantly towards the achievement of the challenging efficiency

targets which we have been set by OFWAT, the regulator. These require Welsh Water to cut its operating costs by more than 20% in the five years to 2005.

Unfortunately, as is the case with all the water companies, meeting the required targets for efficiency has meant some job losses in certain areas. United Utilities recently announced that it proposed to reduce headcount in our operational activities by around 185 as it brings Welsh Water's operating practices into line with best practice elsewhere. However, I am pleased that our partners have committed to the same policy of no compulsory redundancies that was adopted by Dwr Cymru when it was owned by Hyder. Over the years, like the rest of the water industry Welsh Water has cut its staff numbers very significantly – we employ just over half the number we did when Welsh Water was privatised 12 years ago. But all job reductions in this time have been voluntary, and quality of service has never been compromised. You cannot “cut corners” with a public service as important as water supply and sewerage. Despite the problems at Hyder and the distraction these caused for everyone working for the business, last year Welsh Water achieved best ever results on a range of measures, including water quality, mandatory coastal bathing water quality and leakage. This is an enormous credit to all the committed people who work for Welsh Water, directly and indirectly.

Employment levels in Welsh Water must of course be put in the context of the overall net effect of the Glas proposals on the Welsh economy, which is undoubtedly positive. Over 2,000 jobs are being created directly by the £1.2 billion investment programme. Tourism will benefit from the planned environmental improvements that will further reinforce Wales's position as the UK leader in terms of clean beaches and river quality. Investment in the sewer network will remove development restrictions in a number of relatively depressed areas, such as Amman Valley. And, as I have stressed, the organisation of the services in a

way which achieves such efficiencies has been essential in achieving the lower cost of financing which will ultimately translate into lower water and sewerage bills across the whole country.

This, I hope, gives you a flavour of some of the reasons why the Glas proposals have been described as “innovative”. I want to go on to say a little about the origins of the Glas proposals.

Above all, the Glas concept was made in Wales – for Wales. Contrary to some suggestions, this was not a clever scheme cooked up by bankers and lawyers in London, with Dwr Cymru the convenient “guinea pig”! As many of you will know, it was two directors of Dwr Cymru, Chris Jones and Nigel Annett, who masterminded the design and subsequent implementation of the Glas concept. As a result, it is widely recognised as a “Welsh idea”, an idea which is all about the proposition that there is a better way to provide and finance an essential public service like water and sewerage services. My colleagues and I are already receiving numerous unsolicited inquiries from people all over the world, wanting to know more about this “Welsh innovation”. I am in no doubt that the institutions who bought the bonds, the rating agencies who advised them and the regulator were all influenced by the fact that we were a well balanced team. The new team had designed the structure, were committed to it and were not only here for the deal. No-one was in any doubt about the grasp of the technical detail, the level of commitment and the determination to make it work.

But I also want to stress that our plans could not have been implemented without the support of the people and institutions in Wales. You may recall that this time last year one of the English companies, Yorkshire Water, was prevented from carrying out a similar proposal in its area. This was in large part due to the substantial local opposition to their plans.

Late last year OFWAT carried out a public consultation on our proposals, which set off a vigorous public debate. You know, for some time this was a real struggle for us, and the regulator was hearing negative views from companies, parts of the media, and most significantly parts of central Government itself. Much of this opposition was self serving – many of the other water companies, for example, did not particularly want to see the Glas precedent succeed in a way that would undermine their arguments around the need for a higher cost of capital. Similarly, the Glas model was feared in some quarters to represent an unhelpful precedent for the partial privatisation of “the Tube”. Then some of my former colleagues in the Treasury were genuinely worried about the possible loss of incentives if equity shareholders were removed from the equation. To a greater or lesser extent in all instances we were able to deal with the concerns. And backing this up, the opinions and representations of a wide range of stakeholders in Wales, from customers, opinion formers, staff, representative bodies, and the Assembly in particular, were crucial in persuading the regulator in particular that we should be permitted to proceed with our proposals. This same support was also important in providing yet further comfort to investors that investing in water and sewerage services in Wales was a low risk, safe proposition. All in all, I think we can all be proud of what has been achieved so far. But we know now that the world will be taking a special interest in how the water and sewerage services are delivered in Wales.

I would like to finish by noting two significant questions which the whole Glas experience has raised.

First, does Glas prove that the so-called equity model has been oversold and that water privatisation was a mistake? I think the answer is no. Since 1989 the equity model has brought about achievements well beyond expectations at the time, not least of all the huge strides in operating and capital cost efficiency that have been made simultaneously with

dramatic improvements in quality. It would have been difficult to match this performance had the Government put Glas-type structures in place instead. So I see Glas not as a competing model, but as a natural evolution for Welsh Water at this time.

This leads me on to the second, and frequently raised question, namely whether the “Glas model” can be readily applied to other water companies and in other sectors, especially in view of the Prime Minister’s renewed enthusiasm for involving the private sectors in the delivery of public services. I don’t think there is an easy answer to this one and I only propose to offer one short comment.

I believe, for a whole host of reasons, that it will be very difficult for anybody to replicate precisely what has been put in place here. However, the distinctiveness of Glas is not about a single theme or idea, but instead brings together many different elements which have been essential to this transaction. I suspect that these will be studied, refined, and applied selectively elsewhere. Of course, our main task now is not to reform public service delivery generally but to get on with the challenging task of delivering the unique benefits which Glas has promised its customers and Wales as a whole. That is where our energies will go in the months and years ahead. At the same time we will take the odd few moments to glance at the efforts of others to find aspects of our structure that can be reproduced. We will watch with interest.