

The proposed restructuring of the Kelda Group

A consultation paper by the Director General of Water Services

1. Introduction

The board of Kelda Group plc announced on Wednesday 14 June the conclusions of its wide ranging review of its strategy and group structure.

Kelda Group plc (Kelda) propose to separate asset ownership (and responsibilities under the Licence) from operations. It proposes the creation of a customer owned body, a Registered Community Asset Mutual (RCAM), which would acquire the shares and assets of the regulated water and sewerage undertaker Yorkshire Water Services Ltd (Yorkshire). The RCAM would be established as a Friendly Society under Industrial and Provident Society legislation. The RCAM would be 100% debt financed.

Subject to the successful establishment of the RCAM and the transfer of the assets from Yorkshire, the remaining UK water services operations of Yorkshire would be transferred to Kelda. They would be a non-regulated activity.

The recent consultation document – *New ownership structures in the water industry* – published by the Director General of Water Services (DGWS) on 6 June 2000 examines the important constitutional and regulatory issues arising from the separation of the ownership of assets and licence from the operations together with the impact of new ownership structures. This paper did not focus on a specific transaction but the majority of the issues raised in the paper are relevant in this case.

2. Key issues for consideration

The proposals are of crucial importance for the future regulation of the water industry. The existing investor owned, equity financed model has brought big gains to customers and to the environment and have led to the greater efficiency of water companies. This has enabled prices to be reduced, despite the continuation of a large programme of environmental improvements.

The proposals would need regulatory clearance before they could proceed. The DGWS needs to ensure that they are in the best interests of customers. In considering those matters the DGWS wishes to have views, in particular from customers, on these proposals.

New ownership structures in the water industry considered issues under five headings:

- Restructuring and incentives for efficiency

- Constitutional arrangements
- Procurement of services
- Competition
- Finance and risk

Each of these is relevant to the Kelda proposals and a copy of this paper is attached as annex A. The DGWS would like the views of interested parties on the issues raised in that paper with specific reference to the Kelda proposals. There are specific issues arising from the details of the proposals which require particular emphasis as set out below.

Restructuring and the incentives for efficiency

The appointed business under its new form of ownership must stand comparison with other water companies and be genuinely competitive. It would operate under a price cap and be subject to periodic reviews alongside investor owned water companies. The water company would retain the assets and all the obligations under the Licence. The Board of the regulated business must be in a position to discharge its obligations at all times.

Furthermore, the RCAM structure must ensure that incentives for efficiency are not harmed by the absence of shareholder pressure and that risk is not transferred from shareholders to customers. The DGWS must be satisfied from the outset that customers do not face additional risks – whether financial or arising from the quality of services provided.

The DGWS would welcome views on how this might best be achieved.

Constitutional arrangements

The RCAM which would own the regulated water utility would be established under Industrial and Provident Society legislation and is intended to be run for the benefit of the community. However, it would be wholly debt financed and servicing the substantial debt burden would be the first call on the RCAM's income.

The Director considers that, in view of the lack of shareholder pressure, the Board of the Appointee should contain a majority of independent non-executive directors and must be commercially focused.

The proposed board structure envisages the appointment of two executive directors and five non-executives. In the first instance, three non-executive directors would be appointed by Kelda Group plc and the two additional non-executive directors would be elected by a ballot of customers.

The DGWS would like views on the appropriate constitutional arrangements for such a structure to remain commercially focussed and whether it is sufficiently independent, in the first instance, from Kelda. Licence modifications would be required to ensure that the DGWS could be confident

that the ownership and governance structures for the RCAM are adequate to ensure that the Board could be replaced if they do not act in an efficient manner.

Procurement of services

Under its proposed procurement plan, Kelda expects that the RCAM would award initial operating contracts for outsourced services to Kelda. It expects that competitive tendering for such services would take place over the lifetime of the current price determination (2000-05) in a phased manner.

In order to maintain the pressure and incentives for greater efficiency, the DGWS believes that any mutual body must be committed to a regular programme of competition in a contestable market for operations to be provided by arms length suppliers and in accordance with a formal procurement plan. It may be necessary to disaggregate the services into elements to make them susceptible to full and genuine competition. Licence modifications would be needed for such a plan and it would require regulatory approval by the DGWS. Consequently, the timescale for such competitive tendering and the appropriate mix, type and number of contracts are key areas of concern for the DGWS.

He would also wish to consider whether the regulated utility should retain the operating capability until the operations can be competitively tendered rather than let initial contracts to Kelda with phased competitive tendering thereafter.

The restructuring proposals would mean that the regulated utility would not have an operational capability and would be required to procure all operational services from outside contractors. As the licence holder, the regulated utility must, however, at all times, ensure continuity of services to customers, maintenance of serviceability and delivery of the quality improvements required by Ministers.

The DGWS would welcome views on these issues.

3. Licence modifications

Licence modifications will be necessary to ensure that customers' interests are protected and that the regulator can carry out his statutory duties. The form of such licence modifications is discussed in *New ownership structures in the water industry*. Licence modifications would be needed to address the following issues:

- Ring fencing
- The procurement plan
- Corporate governance and incentivisation of management
- Access to information

Annex B of this paper sets out the licence modifications that may be appropriate for the Kelda proposals.

Some of the modifications proposed have developed as a result of experience from a number of mergers and acquisitions in the industry. They are designed to strengthen the ring fencing around the regulated business. Some strengthening of the ring fencing through licence modifications has already been incorporated into the licence of Yorkshire Water Services Ltd in August 1996. Further modifications of a substantial nature would be needed as a direct result of the proposed changes in ownership and structure.

4. Responses to this paper

Comments on the issues raised in this paper (including those raised in *New ownership structures in the water industry* relevant to the proposals) should be sent to Ofwat by Monday 17 July 2000.

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