THE WATER REPORT

POLICY | REGULATION | COMPETITION

MAY 2015

New hands on the tiller

MOSL, Ofwat and retail market delivery

COMPETITION WATCH

- Get big, get niche or get out: the stark choice facing companies on retail market strategy.
- Enterprise Inn spirit: pub chain plans preferred supplier by year end.
- Friend or foe? The supply chain and market reform.

INSIDE

Editor: Karma Ockenden e: karma@thewaterreport.co.uk t: 07880 550945
Art Editor: Numa Randell e: numa@randell-family.org.uk t:07754269168
Subscriptions: subs@thewaterreport.co.uk Single annual subscription £699; corporate annual subscription (10 copies plus unlimited e-copies) £1,999.
Website: www.thewaterreport.co.uk
Address: *The Water Report*, 68 Church Street, Brighton BN1 1RL
Publisher: Kew Place Limited

EDITOR'S COMMENT

Welcome to our new Expert Forum

It's The Water Report's half-birthday: it is six months since our launch copy was published, and what a half-year it has been. I was convinced when preparing to get the publication off the ground that there was an appetite in the industry for good quality information on the three core areas of water policy, regulation and competition. And that this information should be provided with constructive intent: accurately and fairly, with a view to sharing ideas, facilitating dialogue and generally contributing to the debate.

But even with that courage of conviction, I have been bowled over by the response the Report has received. I would like to take this opportunity to thank everyone who has supported us so far, be it through subscription, contribution, information-sharing, partnership or other means.

I am especially delighted this month to have been able to launch, so early in The Water Report's life, our new Expert Forum – a group of senior figures from in and around the industry, willing to share their views, confidentially, on issues of importance to water. Special thanks go to our partner, market research company Accent, for collaborating with The Water Report to bring the idea to life.

As you will see from the report on p4-6, the forum is already contributing to the debate. Again, I am grateful for the positive response we've had to this initiative. My genuine thanks go out to everyone who has joined the forum so far, and I would welcome hearing from anyone else reading this who would like to join.

Our first forum survey tells us our experts look cordially in the round upon the likely policy framework for water under the new Conservative majority government. But that this overall picture masks some diversity of sentiment on specific policy areas. In most stark contrast are the nearly three-quarters who felt positively about prospects for attracting investment to the industry now; and the just shy of a third who felt negatively about prospects for vulnerable or low-income customer support.

Elsewhere there is little alignment between what our experts would like the government to prioritise and what they expect it to prioritise; a split vote on whether Labour's water policies will resurface in some form; and a whole host of fascinating views on potential devolution of water policy to the regions.

It all makes for very interesting reading. Take a look on the next page, and get in touch to join in.

Karma Ockenden, editor,
The Water Report

Feedback, comments and suggestions very welcome.

Contact me on karma@thewaterreport.co.uk or 07880 550945.

EXPERT FORUM MAPS POLICY LANDSCAPE

Negative views of vulnerable customer help and environmental safeguarding mar otherwise positive or neutral view of Tory policy; Forum priorities don't align with what is expected of government; Labour ideas not dead and buried.

What does having a Conservative majority government mean for the water policy landscape? This was the subject of our first *The Water Report* Expert Forum survey, conducted in the week following the 7 May result. The new Forum comprises leaders and opinion formers from in and around the industry. Members are polled bi-monthly to get a snapshot of senior opinion on topical or important issues (for more details, see box – TWR Expert Forum)

Positive, negative, neutral?

Asked how positively they felt about the new government in terms of its overall impact on the water sector, 55% were neutral, 38% positive and just 7% negative. The majority neutral showing will reflect the high likelihood of policy continuity from the Coalition administration: if things don't change significantly, it is perhaps hard to feel either positive or negative about them. The high neutral showing could also be read as an acknowledgement that many stakeholders outside of Westminster, not least regulators and companies themselves, have major roles to play in the performance of the sector.

But clearly where Forum members' views did shift one way or the other, this was overwhelmingly to the upside. Chart 1 shows this result, alongside sentiment towards specific policy areas. There is interesting variety. Sentiment is overwhelmingly positive on attracting investment to water (71%) and policy stability (64%), and delivering non household retail competition (56%), with most of those not selecting the positive option in these fields feeling neutral.

Repeatedly, respondents cited the Tories as "business friendly", and as the leading Coalition partner were expected to press on with existing policy, providing stability and certainty. Liz Truss' reappointment as environment secretary is cited specifically as shoring up this stable outlook. One member enthused that it was "excellent to have a stable government that can take forward the Water Bill proposals, drive economic growth and facilitate a more diverse water sector".

On retail competition, one member commented: "Any further potential for changes (ie new party in government) would have led to further delays which would not be able to be incorporated within the challenging timescales." We must be careful though not to assume a tick in the positive box necessarily indicates support for retail market reform. One observed competition was "absolute dogma in Tory policy so for better or worse it will happen".

Neutral sentiment was dominant in most of the other policy areas asked about: ensuring customers get a fair deal (64% neutral); securing sustainable/resilient water resources (62%); environmental safeguarding (62%); and effective regulation (55%). Some of the interesting comments made in these areas were:

Customers

- "More a matter for Ofwat within the legislative framework the previous administration set out (and which this new administration is likely to follow)."
- "No one is going to pursue an overt policy against this."
- "Social tariff policy not working."

Environment

- "Environmental credentials are mixed."
- "Good track record but EU doubt."

Resilience

- "I don't think 5 year governments can really plan for energy, water etc."
- "Need to make SUDS mandatory on new developments, even if that means helping to subsidise their installation and maintenance. It will be cost effective over the longer term."

Regulation

- "Jury is out on this. So long as the government learn from the mistakes in energy and keep out of implementation, things should be ok."
- "There will be less interventionism by government in this parliament than there would have been under a Labour administration."

There were only two areas where negative sentiment had a significant showing. Firstly, 27% viewed the government negatively in terms of helping vulnerable or low income customers. In their comments, respondents mentioned welfare cuts, that customer-funded social tariffs were inadequate but likely to stand; that Labour would have done more. One more optimistic view was that: "Policy is stated as 'One Nation' so the vulnerable have to be looked after."

Secondly, 20% took a negative view of the Tories on environmental safeguarding. One member remarked that there was a "need to get agri sector to do more. Better use of agri subsidies would help but dead hand of Treasury stifles good ideas." Another observed: "The Conservatives' record and stance on the environment is weak in comparison to the Lib Dems and Labour."

Priority mismatch

Despite this overwhelmingly neutral/positive overall outlook, Forum members were not confident that the new water minister (unannounced at the time of writing) would have the right priorities. There was little alignment between our expert panellists' views on what the new government's top specific water-related priority should be, and what they expected it to be.

Chart 2a shows what Forum members would favour as a top priority. There is very little consensus, with the strongest showings going to: floods and water management (20%); effective delivery of non household retail competition (17.5%); pinning down prospects for upstream reform (15%) and dealing with water stress (15%). The remaining third were split fairly equally between: abstraction reform, better vulnerable customer help, sustainable drainage, integrating water considerations into shale gas exploration, facilitating corporate M&A (see box – A benign environment for M&A), sharing customer/shareholder benefits more equally, ecosystem services, simplifying regulation and increasing resilience.

Chart 2b shows what Forum members expect the government to pursue as a top priority. This is far more clear cut. Half expect the priority to be effective delivery of business retail competition; 20% floods and water management; 12.5% abstraction reform; and 17.5% other (from the categories listed in the preceding paragraph).

Worthy of particular note here is that abstraction reform, which the government has committed to progess in the next parliament, barely registers as a Forum priority. Meanwhile, members clearly expect delivery of the non household retail market to get far more priority than they think it deserves. Two Forum wish list priorities – pinning down prospects for upstream reform and dealing with water stress – aren't expected to get a look in. On the former, one respondent commented: "This is where the real customer benefits lie (if the DEFRA Impact Assessment is believed). It needs impetus, but it's not a vote winner." Another that: "It's important to understand how upstream reform can contribute to increase resilience and more cost effective environmental solutions." On the latter, one member remarked simply that "water efficiency programme not [a] priority".

The main area of alignment between desire and expectation is around floods and water management – perhaps because this is an area that's close to everyone's hearts. One Forum member called such issues "highly emotive" while another observed: "This matters to 'real people' – [the government] can't afford to be caught out by the next Somerset Levels event."

>

TWR EXPERT FORUM

At the start of May, *The Water Report*, in partnership with market research company Accent, set up the Expert Forum to consult every other month on a key industry issue. So far we have c85 members, half of whom are at board level and most of the remainder in other senior management positions. Many thanks to all those who have joined.

Group members are emailed surveys which will take no more than five minutes to complete. Responses are treated as confidential. Findings will be reported in aggregate only and any comments used will be anonymised.

The next Forum will take place late June for the July issue of *The Water Report*.

We would be delighted to welcome more members in senior positions. If you are interested, please email karma@thewaterreport.co.uk

CHART 1: HOW POSITIVELY DO YOU VIEW THE NEW CONSERVATIVE MAJORITY GOVERNMENT IN TERMS OF THE FOLLOWING

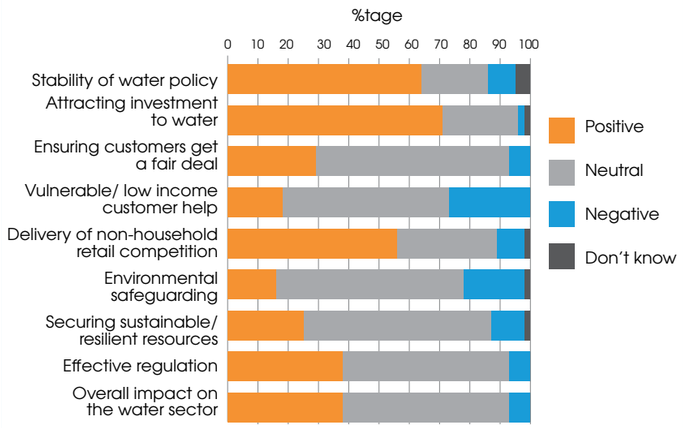
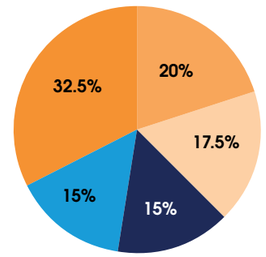
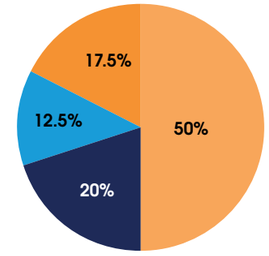


CHART 2A) WHAT WOULD YOU LIKE THE NEW GOVERNMENT'S TOP SPECIFIC WATER-RELATED PRIORITY TO BE?



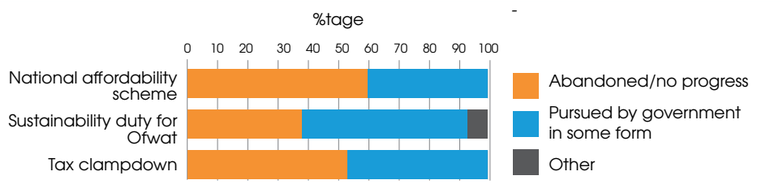
Floods and water management **20%**
Non household retail **17.5%**
Upstream reform **15%**
Water stress **15%**
Other **32.5%**

CHART 2B) WHAT DO YOU EXPECT THE NEW GOVERNMENT'S TOP SPECIFIC WATER-RELATED PRIORITY TO BE?



Non household retail **50%**
Floods and water management **20%**
Abstraction reform **12.5%**
Other **17.5%**

CHART 3. WHAT DO YOU EXPECT TO HAPPEN TO THE LABOUR PARTY'S KEY WATER POLICIES NOW WE HAVE A CONSERVATIVE MAJORITY GOVERNMENT?



Labour comeback?

We got very mixed reviews when we polled the Forum on whether the key planks of Labour's water policy would die a natural death with the party's election hopes or whether the party in government would raid the Opposition's manifesto for useful or popular policies in the time honoured way. The results are shown in Chart 3. There's a fairly even split of opinion on each aspect asked about. A small majority (55%) expect a sustainability duty for Ofwat to be pursued in some form by the Conservatives. A large minority (40%) expect Labour's national affordability scheme plan to be taken on in one guise or another, while just under half (47%) expect water company tax arrangements to be tightened up following Labour criticism. the latter two initiatives could be used to offset – at least superficially – deep austerity and welfare cuts.

Regional rules

Finally, on the back of the SNP's sweep of Scottish constituencies and David Cameron's resulting comments about regional empowerment, we asked the Forum whether it could envisage any implications for water policy in the regions resulting from likely moves towards greater regional devolution. Only 22% were confident there would not be implications for water policy, on grounds such as that devolution in general is not a political priority, and even if it did happen water would be a matter for national policy. 16% were – understandably given the can of worms the question opens up – unsure.

However, nearly two-thirds (62%) said they could foresee water implications from greater regional devolution. Along with the more straightforward possibilities, the Forum's ideas on what these implications might be were many, varied and fascinating. Among the comments we received were these:

- "Increased devolved powers in Scotland under the Smith Commission proposals already include devolution of consumer advocacy and advice. This is one area where increased devolution will allow for more 'Scotland specific' policies to be identified and pursued."
- "I think the local authorities will successfully push for a role in greater integration of capital spend. I also believe that they will push for utility supply local companies to include water."
- "I think that the regions are going to want to have their say in water policy given the devolution of infrastructure policy and spending. We are increasingly seeing this in London with the Mayor taking an active role, and I expect the same thing to happen with the other regions."
- "I expect progress to be made on the Silk Commission's recommendations, even if alignment of water and sewerage responsibilities with administrative boundaries isn't realised until the end of the decade."
- Common Agricultural Policy reform is encouraging rural economy diversification and the development of new payment for ecosystem services markets (for clean water, flood mitigation and carbon sequestration for example).
- "Devolution of powers to local authorities/city regions could lead to reintroduction of regional spatial strategies which would support better water resource planning." (See feature, p8-11).
- "It is a way off, but does raise the possibility of more Dwr Cymru type business models."
- "It is theoretically possible there could be some impact in more deprived regions or regions like the South West with higher bills."
- "Scotland already questioning recent potential shift of government buildings water retailer becoming an English company [refers to Anglian Water Business' selection for the Scottish public sector supply contracts]. Welsh do not want to actively participate in water retail. Scotland wishes to drive water as a key sector."
- "Scotland is the most likely zone for significant devolution and the 'progressive' policies espoused by SNP will probably lead to a review of benefits and costs – and sharing of benefits – from the water utility. Whether any change actually takes place is moot – it may just be 'we had a look and it is doing a great job for Scotland'. DCWW model?" TWR

AN ENCOURAGING ENVIRONMENT FOR M&A

While corporate activity is not dependent on the colour of the government, the spirits of water company investors and potential investors are likely to be buoyed by the unexpected success of the business-friendly Conservatives. As has been widely reported, the usual upswing in post price review deal-making kicked off ahead of the election with Pennon's £100m purchase of Bournemouth. The deal, still subject to CMA approval, took the market by surprise given Pennon itself, as one of the three remaining listed companies, was considered a takeover target – a "Pacman defence", as one commentator remarked. It paid what is widely regarded as a decent price, though as Indepen argues in our article on p12-13, Pennon got a great deal if they have Bournemouth's strategic value in mind.

Whether the two companies will combine their licences remains to be seen. Pennon cited its reasons for the takeover as including help to "prepare for changes in the water industry, developing more effective and efficient wholesale operations and retail services in preparation for reform of the non-household retail market from 2017". Like Pennon's South West Water, the local economy of the Bournemouth area is dominated by tourism and agriculture – a clue perhaps that these may be niche target customer groups for Pennon post 2017. In our article on p28-30, PA Consulting compares companies' non household customer numbers and average cost to serve, and suggests targeting specific customer niches is a viable retail strategy.

Perhaps even more importantly, upstream reform may have been on Pennon's mind in doing the deal. If its purchase of Bournemouth is cleared, it will flank Wessex Water to both the east and west.

A few days after the Pennon announcement, American bank Citi put its £2bn, 30% stake in Yorkshire Water on the market (with two other major Yorkshire investors also rumoured to be considering selling up). More transactions are widely expected to follow.

NEW SIM BEDS IN

With the revised Service Incentive Mechanism now up and running, keeping customers satisfied has taken on even greater importance.

Companies have now had just over a month's experience of operating under the new Service Incentive Mechanism (SIM) rules. The revised arrangements went live on 1 April, following a year (2014-15) when no formal SIM assessment took place (though some companies continued with their own monitoring).

The downtime was used to test the updates to SIM measures that have just come into force. These have been designed to take account of separately measuring service delivery to households and non-households ahead of business retail market opening in April 2017. Now, outside of Dwr Cymru and Dee Valley areas where a non-household SIM remains, the mechanism only applies to household customers.

The caveat here is that until eligibility for the non-household retail market is nailed down (Ofwat recently issued a consultation on this, with mixed-use premises the main area of difficulty), precisely which customers will be in and out of the SIM in the long run remains uncertain. Many companies are for now using the business customer definitions they employed in their PR14 business plans. So there could be some changes to come following final decisions on the eligibility criteria.

More generally though, the essence of the SIM of AMP5 stands: companies will continue to be rewarded or penalised according to their ranking relative to their peers, and Ofwat has elected to retain the same incentive range of -1.0% to +0.5% on total integrated revenues. It may in future also express this in terms of household retail revenues: +6% reward to -12% penalty.

New features

Aside from the main household-only shift, the regulator has introduced a number of other changes to the original SIM, with a view to honing the mechanism following four years of operational experience. The key alterations are:

- The previously equally weighted quantitative and qualitative components of the SIM score now favour qualitative measures 75:25
- Quantitative measures: phone availability measures have been removed. These measures were a data burden, complicated by the fact that different companies use different types of telephony. The other original quantitative measures (unwanted phone contacts, written complaints, escalations and Consumer Council for Water investigations) remain.
- Qualitative measures: the customer satisfaction survey has been significantly shortened, primarily to make it less onerous for customers, though this will also reduce operational cost. The focus is now on how customers feel and how satisfied they are, with transitional detail dropped.
- In-flight complaints: previously only resolved contacts were scrutinised for the SIM. This has now been extended to all contacts a company receives within the SIM period.
- No notice: companies no longer get advance warning of when surveys will take place.

The changes generally have company support, even the ones that will obviously challenge them more such as the abandonment of the notice period. Ofwat worked collaboratively on the SIM refresh project, and rejected some of the proposals it originally consulted on after receiving negative industry feedback – for instance, on extending unwanted contact scrutiny to all forms of contact media (social media and so on).

Nevertheless, while the new measures are clearly more evolution than revolution, they do pose new challenges, and how companies respond could be significant when the 2015-16 scores are published. The heavier weighting for the qualitative measure will be key and companies will need to focus more on what drives customer satisfaction and how they deliver it. In doing so, it will be important for them to look at other sectors that service customers, as much as to their peers in the water industry. A customer used to a one-hour supermarket delivery slot is unlikely to be impressed by a day-long wait in for a water engineer.

The 2014/15 test year gave companies an idea of their relative performance under the new measures. It will be interesting to see when first year figures for the new SIM are published who has responded well to the new challenges and whose relative position has dropped since the last proper figures came out (see table). Individual performance aside, it is hoped the adjustments continue the original SIM's success in driving industry-wide service improvement. TWR

> **A customer used to a one-hour supermarket delivery slot is unlikely to be impressed by a day-long wait in for a water engineer.**

Three year average SIM score and reward/penalities

Company	Score	Reward/penalty
S Staffs	86	0.5/2.8
Bournemouth	86	0.5/1.1
Wessex	86	0.5/12.3
Bristol	85	0.5/3.0
Anglian	83	0.3/17.4
Dwr Cymru	82	0.2/6.8
Northumbrian	81	0.2/7.2
S&ES	80	0.1/0.3
Affinity	79	0/0
Yorkshire	79	0/0
Severn T	77	0/0
UU	76	0/0
Dee	75	-0.1/-0.1
Portsmouth	71	-0.5/-0.9
SWW	70	-0.5/-11.8
SEW	68	-0.7/-7.2
Southern	67	-0.7/-26.0
Thames	65	-0.9/-84.2

Source: Ofwat

EASTERN PROMISE

Faced with extreme supply/demand pressure, water users from a range of sectors in East Anglia are collaborating to develop a regional water resources strategy – with a view to jointly funding and delivering a new large-scale water resource.

The industry-wide challenge of ensuring supply continues to meet demand in light of climate change and population growth is particularly acute in Anglian Water's area. Already one of the driest regions in the UK, it is also one of the fastest growing. It is home for four of the five fastest growing cities – Cambridge, Milton Keynes, Ipswich and Peterborough – and is fast becoming a destination of choice for more businesses, particularly those in high-tech industries. Anglian has committed £316m in AMP6 to support this regional growth.

On top of that, some of the most productive farmland in the country is to be found in the east of England, and consequently the area is home to many in the intense agricultural production and food processing sectors, both of which are large water consumers. Despite these intense pressures on demand, Anglian also needs to reduce abstractions to meet the Habitats and Water Framework Directives.

It's – potentially – a perfect storm. Regulation director Jean Spencer says scenario testing for the company's 2014 Water Resources Management Plan showed that in the worst case, "you can see us losing up to 500Ml/d over 25 years – that's half the water we currently put into supply [1100Ml/d]."

So far the company has excelled at managing supply/demand pressures. It puts around the same amount of water into its network today as it did in 1989, despite a local population increase of more than 20%. It has short term plans for AMP6 to keep up this work (see box – Making the most of existing water resources).

But according to Spencer, there is no getting away from the stark fact that in the medium to long term, new supply-side capacity will be needed to meet additional demand and to manage increasing climatic variability. Others have come to similar conclusions. Spencer observes: "There's quite a lot of work going on at the moment around on-farm storage. The question is, how resilient is that? Resilient to one dry winter maybe, but to two or three? Probably not."

Such considerations have prompted Anglian to take a logical but unconventional approach to the incredibly difficult resource issues its area faces. It has started work to consider future water needs at a regional scale and not just for its own public water supply purposes but for all users in all sectors – agriculture, industry, power generation and the environment. Supply demand strategy manager Steve Moncaster explains: "We recognise that everything that's a challenge for us will be a challenge for everyone else as well. It intuitively feels right to think about this collectively to find the most effective solution."

WREA

So Anglian is now pursuing the Water Resources East Anglia (WREA) project. The idea was hatched a couple of years ago, but the company secured funding in its PR14 business plan to develop its understanding of and approach to multi-sector planning and is consequently now beginning project-specific work in earnest. The ambition is to develop a regional water resources strategy which may lead to proposals to plan, fund, deliver and maintain – in partnership – a new large-scale water resource of one sort or another, or to support further changes to the efficient use of existing resources.

The company accepts this is an untrodden and hence unproven path, but has identified a number of benefits it believes the approach could offer (see box – The potential benefits of multi-sector planning). Ultimately it believes a multi-sector water resources management strategy will be better placed to achieve the outcomes that society wants: sustainable and affordable water supplies that underpin the economy and support the environment.

Spencer stresses that while Anglian is facilitating WREA at this very early stage – essentially to get it off the ground – the project will rapidly become a true team effort. Head of regulatory policy and strategy, Alex Plant, is explicit on this point: "If it was just us taking this forward, it simply wouldn't work. We need to recognise, understand and make a major contribution to the solution, but everyone with an interest has a part to play."

A regional group known as the Water Partnership, established some years ago has been reinvigorated and its members will form the core WREA team. These include all local water companies (Affinity, Essex & Suffolk, Thames Water and Cambridge as well as Anglian); the Environment Agency; Sustainability East; Natural England; and the Consumer Council for Water. The aim is to extend this to other key players, including agriculture, power companies and local authorities. A group which initially includes the chief executives or operations directors of all the involved water companies has been formed to steer the work.

Out with the old: multi-sector water resource planning is an innovation outside the government space

While there have been smaller scale multi-sector water collaborations in the past, nothing this extensive has previously been attempted. But participants are willing. Spencer comments: "This isn't just about water, it's about the whole regional economy and the environment." Plant adds: "The other parties have a vested interest in coming with us. Otherwise it could be a break on the economic growth potential of the region."

Plant also believes Anglian's consistent water efficiency messages have done a lot of the groundwork: "There is a longer and deeper appreciation from stakeholders in this part of the country than you might find elsewhere because of our relatively dry conditions and because of the work we've done over the last five years on Love Every Drop." With much of the farming in the area conducted at commercial scale, that sector in particular is well aware of the water resource situation. Along with improving crop yield, efficient water management is a key research focus by the area's new and growing agri-tech cluster.

Capacity options

In the short-term, WREA will examine the case for a step change in demand management. From a water company perspective, this could include significant leakage reduction and improved water use efficiency (both commercial and domestic customers). What's different about WREA is that it will also consider the benefits of demand management in other sectors, including agriculture.

However, the pressures on water resources are such that, in the medium to long term, additional supply-side capacity will be required.

So what sort of new supply side capacity might result? There are many and various options. The most obvious choice would be a new reservoir(s), with the resource allocated between the various involved parties. Other possibilities include desalination and water reuse plants, again with sectoral allocations. In each of these cases, the plant could either be sized to meet demand in a straightforward way, or built with capacity to release abstraction licences elsewhere. Moncaster explains: "For example, many of our existing reservoirs are reliant on abstractions over the summer months to maintain storage levels. A new reservoir could be designed so that it does not require summer refill, allowing the water company to stop abstracting in the summer months, thus providing additional environmental protection and increasing the reliability of agricultural abstractions."

Also part of the picture are regional and sub-regional water grids, and aquifer storage and recovery. Taking another tack >

WREA IN CONTEXT: ANGLIAN'S RECORD ON CONTRIBUTING TO THE REFORM DEBATE

Anglian Water's work on WREA takes place in the context of both market reform (abstraction and upstream) and the trend to manage water in a more holistic way, as evidenced by river basin management planning and the Water Framework Directive.

The company has been actively involved in the debate on water trading and abstraction reform in particular. Recent projects that it has been involved in include:

- **Trading theory for practice (Nov 2010):** A joint planning exercise with Cambridge Water and Essex and Suffolk Water to determine the potential for water trading in the eastern part of its region.
- **'A right to water?' (Feb 2011):** A review of the options available for reforming the abstraction regime.
- **Sustainable Water Allocation Project (2012):** The piloting of a market based approach for multi-sector water resource trading. This work was completed in collaboration with the University of Cambridge Institute for Sustainability Leadership (CISL) and involved testing of an approach to trading resources in the upper Ouse catchment.
- **Sink or swim? A multi-sector collaboration on water asset investment, April 2014:** This project was also conducted in collaboration with CISL and others. It explores four multi-sector approaches to water resources planning in the Wissey catchment.
- **Markets, water shares and drought: lessons from Australia, December 2014:** This project aims to provide evidence to inform the debate on abstraction reform in England and Wales by exploring Australian experiences of water reform, particularly the impacts of water shares and trading.

The WREA project will add to this record, in particular by exploring prospects for in-catchment water trading by drawing attention to the allocation of scarce capacity within the eastern region. Spencer says: "We think there is much more scope for working together to make the most of water resources within a catchment rather than moving water from Wales to Norwich."

Plant concludes: "Once you start asking yourself questions about how you allocate scarce capacity, the game changes totally. You want to use things like trading as a means of allocating scarce capacity. Instinctively, applying the logic of trading would allow you to discover the best use of resources in a way that no single-mind could."

- The reports listed can be found at:http://www.anglianwater.co.uk/about-us/statutory-reports/ and http://www.cisl.cam.ac.uk/business-action/natural-resource-security/natural-capital-leaders-platform.

could involve investment in more efficient irrigation which would free up capacity in agricultural licences that perhaps the water company or the environment could benefit from. Moncaster says there are examples of this approach in Australia, where water companies in Melbourne funded more efficient irrigation in Northern Victoria to free up water for domestic use.

Plant observes that this sort of approach would further enable water to be traded: "You can see that in a world of scarcity, if you can release water that is used for less productive or for uses that can be met with other means, through a change of process or technology, you can then release valuable resources back into the system. Trading then allows for the water that is available to be used in the most valuable way."

Anglian is enthused rather than daunted by this plethora of options and says it doesn't have a preconceived idea of what the right end solution is. As Moncaster explains success would be "a regional strategy that comes up with the most efficient solution for dealing with any deficit identified. It will help to ensure that all sectors, including the environment, benefit from water resources that are secure, sustainable and affordable".

Plant relishes the challenge of scrutinising multiple possible interventions to reveal the best outcome: "I think that's what's really exciting about it – it could unlock things we haven't even thought about. The contribution of others who will be seeing the water system from a different perspective will make us think differently. Traditionally, it's been done through a 'command and control' approach: we do the forecasts and say 'this is how we'll meet demand, this is what we'll do'. But the world is more complicated than that and this allows for a more nuanced response."

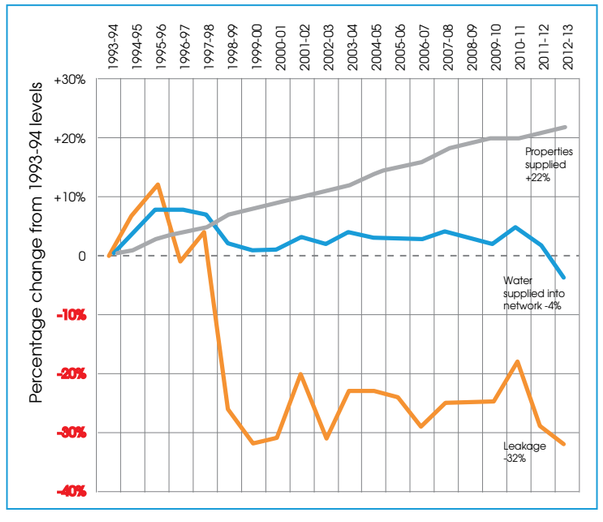
MAKING THE MOST OF EXISTING WATER RESOURCES

As the graph shows, Anglian Water has cut the amount of water it puts into supply by 4% since 1993/4 despite a 22% increase in the number of properties supplied. A 32% leakage reduction has been key. Other important factors include the promotion of Anglian's Love Every Drop water efficiency message with customers, regional transfers to areas in most need, and an enthusiastic voluntary metering campaign which this year saw 87% of households metered (and 79% paying a measured charge).

Activity will continue in AMP6, featuring:

- £42m to ensure 95% of customers have a meter fitted by 2020 (88% paying a measured charge)
- £59m to reduce leakage further, from 211Ml/d to 172Ml/d
- £5m for water audits and efficiency retrofits
- £107m to increase resilience, including £58m to improve system interconnectivity
- £4m to investigate a major new £425m raw water transfer from the River Trent, to be delivered after 2020.

(All numbers quoted in 2012-13 price base)



Workstreams

There are two key workstreams for WREA:

- **Technical and decision making projects:** this workstream will conduct a technical analysis of water resources and long term risks, issues and pressures across East Anglia. It will deploy an emerging methodology, Robust Decision Making, which assesses the performance of different options against hundreds of future scenarios rather than just a deterministic forecast.

Anglian says the methodology will "enable decision makers to make well informed trade-offs between different economic, social and environmental objectives (rather than just cost). This will be used to assess the feasibility of options and inform recommendations for the preferred long term regional water resources strategy."

- **Policy and engagement projects:** inevitably in a multi-stakeholder initiative, effective engagement with all the relevant parties will be absolutely key. This part of WREA will seek stakeholder views to: inform strategic development; reach agreement on the approach and outputs; understand and inform any policy/regulatory changes needed to ensure delivery of the WREA strategy (for example, how the financing, delivery and operation of multi-company, multi-sector strategic water resource assets could work); and share learning from WREA for future national initiatives.

Anglian has sound lessons from customer engagement at PR14 under its belt but nevertheless appreciates it faces an uphill struggle in getting lots of different parties both to collaborate and ultimately to agree on a way forward. Moncaster notes: "We recognise that it'll be challenging but also we don't think it's impossible. In Australia there are examples of where people sat down at a catchment level to work out how water resources should be managed, including what to do in a drought. So it is possible, though we understand it isn't easy."

Plant adds: "We don't have rose-tinted glasses; we don't think everything is going to be wonderful. But at least with this approach you have opportunity to explore and understand different opinions. You may be able to resolve or at least agree to differ on same matters, having talked about them."

Perhaps one of the greatest challenges will be instilling cultural change as a result of the WREA strategy. For water companies, for instance, this may mean aligning self-contained WRMPs to the regional strategy, while farmers and other large users may also need to behave or invest in new ways.

Finance and regulation

Changes may also be required to the current legal and regulatory frameworks that govern the way the water industry operates. So in addition to the two WREA work streams, Anglian is actively thinking about how a multi-sector regional water resource is paid for, and how the benefits are shared. There's not a lot to draw on. Examples of multi-sector planning and delivery of water supply infrastructure are limited. Those that do exist – for instance those in Australia's Murray Darling Basin and the Central Arizona Project in the Western US – have all had government involvement. "It's new to consider it in the non-government space," Spencer says.

The key point here is that a multi-sector asset would sit somewhere between the regulated and non-regulated space. The water companies involved would only be able to earn returns on the regulated part.

There are a number of strands to Anglian's plan to work through these complex issues:

- Learn from innovative financing models used elsewhere – for instance
  - the Kielda Water operating agreement;
  - Specified projects such as the Thames Tideway and Crossrail;
  - PFI contracts used by Scottish Water in Scotland;
  - capacity market auctions in the energy sector
  - international examples of multi-company investment in telecoms.
- Consider to what extent current and emerging (abstraction and upstream reform) policy and regulation either facilitate or act as a barrier to investment in water supply infrastructure designed to benefit multiple sectors. This will include specifying what features of the current regulatory regime may need to be updated to facilitate multi-sector water supply investment.
- Propose a range of innovative financing models for multi-sector investment in water supply infrastructure. Regulated water company finance and other private sector financing models will be considered. Anglian notes: "The options need not all be alternatives, nor need they involve radical departure from the present arrangements."
- Assess the proposed financing models – including their advantages/disadvantages, the role of regulation, barriers to implementation, required changes to the current regulatory framework, and the potential impact on interested parties. Anglian says: "This needs to be as specific as feasible, highlighting where elements of the current framework may need to be retired, spelling out changes in roles and accountabilities, and giving a realistic timeframe. The potential impact of and on other concurrent reforms also needs to be specifically considered."

Spencer says the company is open-minded about what funding model would be best, though she says intuitively it would make sense to leverage Anglian's regulated standing in some way, as it could allow access to cheaper finance. She explains there is a balance to be struck between involving broader stakeholders and accessing low cost funding. "On one hand, if it's not regulated, it ticks the box of upstream and market reform and all of that, but on the other hand, at what cost? We don't want water customers to have to pay more than they need."

Plant adds: "That's why many infrastructure projects seek to get the Treasury involved because if they can legitimately borrow at a much lower price, why wouldn't they? I think there's a really interesting set of questions around how to get the best of both worlds: not doing anything to prevent the development of competition but still ensuring you're not paying more for an asset than you need to."

Ofwat is not directly involved with the project at this stage, in line with its new preference for companies to take ownership of their own issues and to work up their own proposals for solutions. But Spencer says the regulator is in the loop: "Ofwat is very aware what we're doing. As part of their work on Water 2020, we've told them what we're doing and specifically on the potential funding options. So they are interested in it without being involved in it."

THE POTENTIAL BENEFITS OF MULTI-SECTOR PLANNING

Anglian Water admits it doesn't know for certain that a multi-sectoral approach to water resources planning will be better than a water industry only approach. However, among the potential benefits the company has identified are:

- more efficient planning, provision and use of infrastructure (both financially and in terms of water use and allocation)
- more affordable investment programmes, and consequently lower bill increases for customers
- the sharing of expertise between sectors, and in particular the leveraging of Anglian's experience of long term water resources management planning for the benefit of multiple sectors
- the sharing of risks will necessitate an upfront agreement between abstractors about how risks should be shared, which in turn will provide clarity to abstractors about the risks they are facing
- it will encourage collaboration and collective ownership of future challenges and as a result could help smooth the process of any resulting investment requirement through the planning process
- facilitation of more of the investment required to ensure that water resources are resilient to future challenges.

Spencer: balance must be found between regulated low cost finance and involving other parties

Future model?

The regulator may take particular interest in whether the multi-sector strategy proves a model that other regions might want to explore. For now, Anglian is one of the most advanced companies in terms of thinking about resources beyond its own individual requirements but the company believes the WREA project could prove interesting for others. Plant: "There will be other places grappling with both stress and growth. If we can get something up and running that develops the concept, there is no reason why others couldn't adopt it in whole or in part."

Anglian has committed to publishing a report on the group's work to contribute to sector knowledge (see box – WREA in context: Anglian's record on contributing to the reform debate).

In facilitating this innovative, challenging and intelligent water resources strategy, Anglian is certainly stepping up to the plate in the sort of way Ofwat has indicated is welcome. While experienced in water resources management planning, it is taking on a broad and potentially difficult new challenge in facilitating multi-sector dialogue and collaboration. In doing so, it is enabling WREA to step into a regional planning vacuum that was created by the cessation of Regional Spatial Strategies in the last Parliament. Plant says: "Most people who care about these issues – not least Anglian Water – felt the loss when the regional spatial strategies were abolished; the loss of something at the regional scale which set a long-term strategy for the delivery of key regional-scale infrastructure like water resources and transport. This [WREA] could replace some of what was lost." TWR

INDUSTRY COMMENT

DIVIDE AND CONQUER

Even premium-to-RAV deals like Pennon's recent purchase of Bournemouth don't touch the true strategic value of water companies. This would be revealed if each player specialised and sold services it could perform better than its peers.

John Hargreaves and Alan Moore are directors of management consultancy Indepen.

The share prices of water companies continue to trade at a substantial premium to their regulatory asset value (RAV). With the most modest of signals from Ofwat, corporate transactions have already started, with Pennon snapping up its small neighbour, Bournemouth. Some observers note that Pennon is paying a high price – others, including the authors of this article, consider that the price paid quite probably understates the true value of the business.

Is this the scope for synergistic cost cutting? Or the attractions (otherwise known as economies of scale or scope) of additional non-household retail customers? No doubt, these were important considerations in defining the potential and price of the transaction. But a question remains: does the premium to the regulatory asset base come close to identifying the potential strategic value of a water company?

Water companies have come to be valued with reference to their RAV. If the RAV is an approximation of an appropriate market value of a water business and the allowed for weighted average cost of capital is the real market cost of capital, the company should trade at a discount unless and until it is clear that the company can outperform the operating, capital and/or financial costs allowed for by the regulator. It is a game of cash rather than chance as regulators will always find it difficult to set a cost of capital that reflects the true market rate.

Every ten basis points in excess of the true market rate will add some 25+ basis points to the available equity return. And, even better for investors, can regulators ever truly understand the scope for cost cutting that exists within a water business? If they do, why can regulated companies always seem to find the scope (and the short term resources) to conduct large scale redundancy programmes?

Strategic value

Is this meant to imply that life comes too easy for investors in the water sector? No, but it is meant to suggest that attractive returns can be earned without any real focus on the potential strategic value of the water company – its potential to earn a much enhanced return and, at the same time, to deliver much improved value for money to its customers and to the community it serves.

It is all too easy to ignore the lessons of history. The break-up of British Gas established businesses where management teams were liberated to develop and exploit the competences required to maximize the value of the newly created individual business units. The market value of the business units is now a very comfortable multiple of the previously vertically integrated company, precisely because the strategic potential was realized.

> **If we were to apply a price/ earnings multiple of just 10 to the services profits, Business Stream's services business would be worth well over £100 million.**

The creation of Scottish Water's retail subsidiary, Business Stream, is another interesting example. Its separation from Scottish Water allowed it to become much more customer focused, develop a brand identity and to reduce its costs – not just its operational costs but also its need for working capital. But to focus on the brand or on the cost reductions that were achieved is to overlook the main benefit.

Business Stream identified that the water industry had consistently overlooked a third of its value chain. It identified that water companies had focused on what was required to deliver water to customers and to return appropriately treated water to our environment but had paid scant attention to what a customer does with water before it is passed back to the water company. Water efficiency was a chore, to be done because it is a licence requirement, not because it is a business opportunity. The review of discharges similarly is a requirement of the consenting regime rather than an opportunity to provide value-enhancing services to the customer. And, of course, these value adding services for customers were also value adding to Business Stream as the provider of services.

Business Stream has steadily grown a services business, which, although a fraction of its total revenue, contributes getting on for half of its profits. These profits would have a particular attraction to investors as they depend on a company being able to retain its position in a market and not on the periodic reassessment of costs and revenue by an economic regulator.

Core competences

These examples are not meant to suggest that the disaggregation of the water industry value chain is some sort of panacea – that there is some magic structure which would enhance returns for all investors. There is no such structure. Rather the message is that each individual business is likely to have particular activities in which it has particular relative competence. Correctly identified, these competences represent an opportunity to enhance short and longer run profitability.

There are many areas where such competence could exist: serving customers (radical thought!); supporting developers; managing catchments both with regard to flooding risks and in terms of water quality; and delivering innovative solutions to meeting legislative standards or customers' expectations – to name but a few. No water business is likely to be equally good at all of these activities – achieving enhanced returns will require a rigorous prioritisation and the empowerment of suitably skilled managements.

The water company may be not wholly dissimilar to the conglomerates of the end of last century. They are efficient managers of money and treasury functions but not very likely to do much that is innovative and original. Ironically, the more that regulators try to set targets for innovation or encourage companies to identify potential innovative outcomes, the further we are moving from creating the conditions for a more specialist, effective and efficient water industry.

Regulator or investor?

Regulators need to keep doing things just that little bit differently in a (what will likely be a vain) attempt to compensate for the asymmetries of information that will always exist between a regulator and the regulated company. But this very uncertainty (will the regulator honour the deal?) is a barrier to more innovative approaches. Add to this uncertainty the potential vagaries of the political process and accusations of excessive profitability.

So the initiative has to come from companies. It has to be led by the board, who need to identify rigorously their company's sources of competitive advantage. These are likely to be definable services where a business unit could be established outside of the regulatory ring fence and provide services to the legacy organisation and to others. Relative competence should mean that both the service provider and the client are able to benefit. These benefits will come both in reduced costs and enhanced quality of service. Shareholders and customers can benefit.

Reality not fantasy

Some may be beginning to consider this vision for the industry as being far-fetched – but it is not. Actually, it exists today. Bristol and Wessex Water identified that a joint venture in billing services could enhance value – it lowered costs and improved their competence in this area. Perhaps an even better example is the development of the Echo Managed Services business established by South Staffordshire Water. It successfully services not just its own needs and those of several other water companies but also others outside of the utilities industry altogether. This seems to be a worthy example of how competences can be exploited and a business opportunity maximised.

Essentially, this vision for the water industry is one where the current water companies do less for themselves and focus on those activities where they have real relative competences. They will still have that local coordination (some may call it a system operator) function but would seek out partners who are better at providing certain services. Just as Echo Managed Services provides billing and call centre services to some water companies, some of those water companies could be better at providing catchment management services or developer services to South Staffordshire Water. It is a market for specialisms and is likely to result in lower costs and better service levels. The benefits for customers and for our environment should be obvious.

Opportunities

The benefits to investors could be significant. A commitment to market testing different activities reduces the scope for regulatory challenge of costs and almost certainly reduces the uncertainties that abound in the run up to a price review. But more importantly, there is the opportunity to establish business units to provide services to others in those areas where an incumbent water company has particular competence. These businesses have the opportunity to grow their revenue and profits and the opportunities for transactions should not be discounted.

To return to the example of Business Stream, notwithstanding a declining market share in its original core business, its profits have increased. Cost cutting may originally have explained some of this increase in profits, but the real driver is the development of its services business. Today, this services business is largely limited to customers based in Scotland, but as we move towards the opening of the non-household retail market in England, Business Stream is likely to want to exploit the opportunities presented. It is highly unlikely that Business Stream has done much more than scrape the surface of the opportunities available in Scotland so the potential value creation opportunity with the market opening in England is huge.

If we were to apply a price/earnings multiple of just 10 to the services profits, Business Stream's services business would be worth well over £100 million. Given that the regulatory asset base was untouched by this reform, this value accrues wholly to the shareholder. Perhaps this is a more positive reason for the Scottish Government's keenness to see a timely opening of the non-household retail market in England. It is not just about compensating for Business Stream's loss of market share.

What are the constraints on a customer service business? They are probably limited only by the ability to identify opportunities. Water and energy efficiency may well go hand in hand and are energy suppliers tied to generators as likely to want to assist customers with reducing their consumption of energy? Process re-engineering, on-site treatment opportunities, water re-use…the list is long.

But if credentials are developed in working with a site owner to make better use of water and energy and the management of drainage, further extension into the broader field of facilities management becomes possible, even likely. So what is the potential for such a business? It could easily become a major driver in the growth of profits and, consequently, enterprise value.

Develop your strengths

Some investors and management teams may be quite happy with the status quo. But it is unlikely that they will be allowed to enjoy it for too long. Other investors, with their management teams, are likely to identify that the opportunity afforded by a water company is much more valuable than the return that can be earned from the regulatory game.

Boards need to consider carefully the areas where they may have particular and enduring competence. This could be a function of particular experience or of particular management interest and expertise. They need to ensure that it puts in place good management with relevant skills and experience and that it suitably empowers them. It needs to take the steps required to create a profit centre that allows risk capital to be appropriately employed and its return carefully assessed.

This is a radically different model for the industry but it is one where investors and their managers take the lead. It exploits real potential and not the theory of some stylised response to a regulatory demand. The potential is substantial. It is in the hands of the investors but it will require a fundamental reassessment of what it means to exploit the potential value of the water company franchise. TWR

CAP IN HAND

Southern Water's Customer Advisory Panel is one of the first CCG successor bodies to get off the ground. Chair Anna Bradley explains the new group's role and responsibilities, and why quality regulators won't be participating.

It is a great testament to the success of the principle of embedding customer views in water company decision making that virtually all companies intend to voluntarily institute some kind of Customer Challenge Group (CCG) structure going forward. This is an explicit acknowledgement that, what started as a customer-side and Ofwat-championed initiative, in the event proved its worth to the industry too.

Exactly what lessons are learned from the CCGs and PR14, and how these lessons are applied to customer representation arrangements in PR19, is obviously yet to play out. Some have already flagged that the next logical step would be moving to a system of negotiated settlement, whereby customers and companies work through and agree a plan together without regulatory involvement.

But pinning down PR19 arrangements is clearly some way off. In the meantime, most companies plan to set up a successor body to their PR14 CCG, with a view to it working with them on business plan delivery through to 2020.

One of the first out of the traps is Southern Water, which is poised to launch its new Customer Advisory Panel (CAP) under the chairmanship of Anna Bradley. Bradley chaired Southern's CCG throughout PR14, closing the last meeting of that group in January. The induction meeting of the new CAP will take place on 12 June, with its first official meeting scheduled for the first week of August.

"Particularly for those in the voluntary or charitable sectors, payment could make the difference between engagement and non-engagement."

Southern Water chief executive Matthew Wright explains his company's decision to get a new group up and running swiftly. "There's a very straightforward reason why we're retaining a CCG-like entity at Southern Water and that's because our business plan was all the better for the challenge and advice the CCG gave us through the PR14 process," he says. "Put simply, it worked, and it worked for the benefit of customers and the company. I want to retain this value as we move into the delivery phase of the plan."

At the time of writing, the group's terms of reference were being finalised by the Southern board and will go to the panel for sign off at the June meeting. There is a working assumption that the CAP will continue its work for the full AMP6 period, though options have been built in should the group need to change in line with regulatory demands for PR19. Bradley explains: "My contract runs for three years, so contractually we have the flexibility to adapt three years in, if it proves necessary to evolve for PR19."

Composition

Southern Water's new CAP will comprise eight to ten members. Aside from Bradley, two previous CCG members – representatives of end user customers – will be reappointed. The remaining members were being actively recruited by a headhunter at the time of writing. Bradley explains that the intention is for the group to made up exclusively of "representatives of users of water and sewerage services or of the environmental goods that water and sewerage services have an impact on – for example, leisure users of water and sewerage services". She confides that among those members being actively sought, the CAP is looking for someone who can speak for older users; a representative of the younger population who will have an eye to future and well as current services; and someone active in the housebuilding/planning space. "All of them will bring to the conversation expertise in what the issues are for the customers they represent."

Crucially, the CAP will not count any of the quality regulators that were part and parcel of the CCG among its number: no Environment Agency, no Drinking Water Inspectorate, no Natural England. "I have said before that I was uncomfortable with having quality regulators on the group," Bradley recalls. "It created difficulties." Speaking to *The Water Report* shortly after the publication of final determinations late last year, a number of CCG chairs raised the issue that some of these quality regulators struggled on a practical basis with the commitment level demanded by the CCG process. But there was also the ideological issue of whether these regulators should sit on, or be external to, consumer groups. Bradley argued that these regulators have separate, statutory responsibilities – for instance, they report to Ofwat on whether company plans meet statutory quality obligations – so it is more appropriate for them to engage outside the consumer group.

Consequently in forming the CAP, such representatives have been excluded – "with their agreement," notes Bradley. "They felt it was uncomfortable too." She stresses, though, that provision has been made for the CAP to engage with these parties in two important ways. Firstly, they will be able to observe meetings at the chair's invitation. And secondly, they will be invited in to report and answer questions in a formal way on specific issues

of relevance to Southern Water's implementation of its business plan and delivery of AMP6 promises.

The format is in line with the "quadripartiteplus" structure highlighted as a distinct possibility for PR19 by *The Water Report* in January. Under such an arrangement, each company would thrash out its business plan as part of the regulatory process with customers and, as separate entities, the quality regulators. Only unlike the original quadripartite arrangements of PR09, "customers" would no longer mean CC Water alone but independently-chaired, multi-customer bodies featuring strong input from CC Water.

Fair terms

CAP members will be paid on a sessional meeting basis. This is clearly a lesson learned from PR14, where CCG members (apart from chairs) were unpaid and felt the pinch at times of peak workload. "Some may want to pass the payment on to their employers by way of time recompense," Bradley notes, "but either way it is unfair to expect serious commitment without payment. Particularly for those in the voluntary or charitable sectors, payment could make the difference between engagement and non-engagement."

On a number of fronts, the composition of the CAP differs from recommendations CC Water made for CCG successor bodies (see box – CCG successor bodies and CC Water's recommendations). Of particular note is CC Water's insistence that chairs should not be in the direct pay of the company; a position that no doubt extends to other group members too. Bradley has made her views plain in previous interviews that her independence has never been compromised by her payment arrangements and won't be going forward. She advocates tailoring customer representation arrangements company to company in line with local needs, rather than imposing blanket requirements. In short she is robust in her defence of the role she and her group performed – and will continue to perform – for local customers.

New features

So aside from the absence of quality regulators and the consequent bolstering of actual customer /customer representative numbers, how else will the CAP differ from the CCG? Bradley highlights a key issue being that the new group is company rather than regulator driven. "So what happens is in our control – we are masters of our own destiny," she gleefully declares, adding "at least until Ofwat re-engages for PR19."

There is another caveat though, and that is "Ofwat is unlikely to have entirely averted its eyes". While it is not in any way prescribing that a CCG successor group should at this stage even exist let alone how it should conduct its affairs, Bradley says she would be very surprised if the regulator didn't take quiet interest. This is particularly in light of the fact that Ofwat is focussing now on improving company reporting so how each company is performing is more plain to all stakeholders. Key to this work is development of a reporting dashboard, which Bradley believes the new CCGs will play an important part in. She observes: "So you might actually see Ofwat stepping in if isn't happy with how things are going."

Bradley is of course confident that that won't be necessary in Southern's case, and is unfazed by the absence of a statutory underpinning of the CAP. "I saw the way the company embraced the CCG process," she explains, "and am confident of its commitment to this. The might of the regulator behind us is not as essential as it might have been at the start of the CCG process." Moreover, while there was no regulatory requirement to establish a customer group for AMP6, Southern Water committed to do so in its business plan for 2015-20, so the group took on a degree of security when that plan was passed.

Bradley sees clear upsides in herself as chair and Southern as a company being able to call the shots. Alluding to the widely acknowledged lack of forward visibility from Ofwat and the tight timescales that characterised PR14, she muses that now she will be better able to manage demands on group members' time, schedule meetings at regular intervals and circulate documents to people in good time.

Another difference between Southern's CCG and the new CAP is that for the first time, the customer group will report directly to the public. Under its terms of reference, the group is committed to report annually to the public and other stakeholders on how well Southern is delivering on its promises. "This is a new and interesting challenge for the group," Bradley observes.

Role and remit

In terms of specific functions, Bradley identifies three key roles the CAP will perform:

Monitoring business plan delivery: the CAP will want to make sure that the deal Southern Water struck with customers and the regulator back in December will actually materialise in 2015-20. This featured six priorities and 26 promises. The group has a budget should it need to call in external experts in any area, and it can also request that Southern provides expert audit commentary.

Gateway reviews of bathing water investment: Southern Water's CAP will perform a role unique to it among CCG successor groups, in scrutinising bathing water spend. To Bradley's great disappointment at the time, bathing water improvement priorities clearly expressed by customers were left out of Southern's draft determination because Ofwat didn't have confidence in company costings. However, an innovative solution was found in time for the final determinations: that the CAP would act as a "gateway" to the release of funds. Bradley explains: "In the past, development work for investment was done in one AMP, to support a case for investment in the following AMP. That means the work takes at least ten years. Our CCG and the public wanted faster progress: for investment to go in one AMP.

"So we debated with Ofwat late on in the process how that investment could be built into the plan but assurance be given that funds allowed by Ofwat were being spent in the most efficient way. Various models were developed but the one we agreed was for a predefined set of criteria to be drawn up that would be used to judge which beaches should receive investment. The CAP has a role in scrutinising and challenging how Southern's intentions fit with that criteria." She adds: "The board could choose to ignore our advice but I think truthfully it would be at their peril."

Challenge: Bradley explains that the challenging role the CCG performed won't vanish just because the price review is over. The CAP will pick up the mantle and continue to challenge Southern on customer and shareholder engagement arrangements, business plan implementation and – with an eye to the future – preparations for PR19. She says Ofwat chair Jonson Cox's recent Policy Exchange speech "left people in no doubt" that the changes we have seen in regulation so far are the beginning not the end, and hence that plenty of challenge will be needed going forward.

Throughout, the CAP will seek to embed the customer insight work that came to characterise PR14 and to make it simply part of the day job rather than a special one-of arrangement for the price review. Bradley acknowledges that this will take some doing on Southern's part and must be accompanied by a transition from thinking in terms of stakeholder engagement with customers to working in partnership with customers. "It won't be easy to work collaboratively in the long term but it will be necessary as there are some aspects that Southern won't be able to deliver alone." She cites as examples reducing demand – the company has a financial incentive attached to the per capita consumption commitment it signed up to – and catchment management – "which will be a cultural challenge for companies, not least Southern". Neither of these things are in Southern's gift alone and will require customer and wider stakeholder support.

Moreover the CAP will be looking to effect a substantial degree of change, to raise Southern's position relative to its peers on things like SIM scores and complaint numbers. So Bradley has in her sights not only providing assurance that the company is delivering on its business plan promises, but also that it tries hard to catch up with industry-leading firms.

Bradley also has on her radar a difficult issue but one that Ofwat is determined to pursue as part of its trust and confidence agenda: ensuring customer interests are fairly balanced against those of other stakeholders. Bradley sees the CAP's role in this area as majoring on working with the company to provide clear, accessible information. "We will be working to uncloak company structures and the corporate and financial dimensions of the water business," she explains. "We need to report to customers and other stakeholders on the fairness of returns to shareholders against the prices customers pay and the benefits they receive."

Central consumer advisory?

Finally, some have raised the matter of whether Ofwat should follow in company footsteps and establish a standing customer body to advise it on sector-wide consumer issues and to consult on matters such as its annual plan and future strategy. It did set up its own Customer Advisory Panel in 2011 which existed until the completion of the price review, but this kept a low public profile and had minimal interaction with CCGs. Should it set up a standing consumer advisory now, the body would be up to speed by PR19 and well equipped to comment on sector wide issues such as cost of capital. What does Bradley think?

She is clear that the CCG successor bodies that emerge over the coming months do not need to be centrally directed or facilitated – indeed, she suggests this could actually be a hindrance to innovation and meeting local needs (see box – CCG successor groups at other companies). "We don't need a mothership to keep us moving in the right direction!" she rebuffs.

"However, would Ofwat find it helpful to have a customer advisory panel sitting alongside it and challenging it as companies will have? There's certainly a strong argument for saying that's a good thing. It is a tried and tested model which many other regulators employ." She lists as examples Ofcom, the Financial Conduct Authority and the Legal Services Board and notes that Ofgem too had such a panel but now it is part of a more general consumer policy function located at Citizens Advice.

Should Ofwat go down that route, the obvious question is would a new group need to be formed or could CC Water move into that space? Bradley's view: "If I was the new chair of CC Water, I would say, why not look to us to play that role."

Editor's note: *The Water Report* would welcome hearing about plans for CCG successor groups at other companies as and when they are established. Anyone involved or interested, please contact me on karma@thewaterreport.co.uk TWR

CCG SUCCESSOR BODIES – CC WATER RECOMMENDATIONS

CC Water has already set out its initial thoughts on how CCG successor groups would best be structured and composed. These include:

- Independent chairs (not the local CC Water representative) should be appointed and re-munerated under CC Water's auspices via an industry levy to avoid the issues arising from direct payment by companies.
- No one should chair more than two groups.
- Around 15 group members is optimal. These must be well inducted and provided with clear expectations regarding their role, remit, duties and the process.
- Subgroups are recommended, along with greater use of experts who can dip in and out of the process when relevant.

CCWater said later this summer it will publish research into customers' views on how they would like their voice to be heard during price reviews, and the themes around what pro-cesses and approaches within CCGs would give them the most confidence that their voice was being heard.

CCG SUCCESSOR GROUPS AT OTHER COMPANIES

While most water companies have indicated they intend to establish CCG successor groups, there are different rates of progress across the industry. All six companies that had independent (non CC Water) chairs for their CCGs in PR14 have reappointed these chairs and are understood to be forging on with getting successor groups up and running.

Some of the companies whose CCGs were chaired by CC Water regional chairs are de-veloping successor bodies now, with a view to putting them in place between autumn and the new year. Others will take longer to get their groups up and running.

Bradley sees merit in the various groups and their chairs sharing experiences, but argues there is no need – or in fact disadvantage in – trying to drive consistency across the indus-try. She says: "For me, the value-added in sharing experiences is the opportunity to ex-plore different ways of addressing the same issues; to gain exposure to other people's thinking. I am uncomfortable with the notion of commonality. It is not what Ofwat ever wanted but it is even less appropriate in this period than in PR14 (in light of growing com-petition). We must take the opportunity for innovation and difference."

The six independent CCG chairs met to share experiences in PR14 and Bradley says this collaboration will continue. "In fact we are all meeting in a few weeks," she adds. Liaison with CC Water-chaired groups was relatively limited in PR14. Bradley explains: "There was a practical difficulty in that those regional chairs met under the auspices of CC Water. It was not deliberate, but that was an exclusive club. Late on, we did all meet under Ofwat's auspices and that proved fruitful."

She would welcome closer liaison with the previously CC Water-chaired groups in AMP6 and says: "As more chairs are appointed, I hope they will be invited to the meetings."

WICS SETS OUT INNOVATION AGENDA

Third-party owned rural networks are one of many regulatory innovations Scotland's Water Commission is exploring.

Small rural water networks in Scotland could end up being owned by parties other than Scottish Water. This is one of a number of options being examined by a group including WICS, the Scottish Government, Scottish Water and quality regulators, in a bid to improve the quality of private rural supplies across the country.

While upstream reform is not specified on Scotland's water agenda in the way it is on England's, allowing third parties to provide services where it is beneficial to do so is being considered. The rural provision project aims to identify innovative and cost-effective solutions in rural communities.

Speaking at CIWEM's annual conference, Ian Tait, WICS director for investment and Hydro Nation, said it was possible Scottish Water would not end up owning new rural assets. "It is not always economically sensible for Scottish Water to own networks," he commented during questions. "There is a reason they don't currently supply services to some remote areas – because it is very expensive. As a regulator, we have to be alive to opportunities." Tait suggested localised, area-specific solutions might be the way to go, under which the work needed to improve the quality of supplies could be bundled up and then delivered by whichever party was best placed to do it.

Improving rural provision is one of a number of projects WICS is pursuing as it seeks to inject yet more innovation into its regulatory framework. According to Tait, there is "scope for plenty more innovation", which the regulator will seek through work dubbed "IR³".

Under IR³, WICS is focusing on innovation, risk, returns and reporting. On the innovation side, priority is being given to embedding customer views into the regulatory process on an ongoing basis; unleashing the power of new entrants; ensuring the regulatory framework doesn't hinder innovation; and learning from best practice in other sectors.

On risk and return, the focus will be on improving the identification and management of risk; looking at financing innovations such as higher risk/higher return mechanisms; building resilience through "innovation and efficiency, and not adopting a knee-jerk approach"; exploring how other countries achieve cost-effective compliance; and engaging quality regulators in examining the cost/risk trade off. Tait gave an example to explain the last point: "Is 95% compliance at ten sites better than 100% compliance at one site?"

On reporting, Tait pointed to the need to evolve reporting mechanisms to capture evidence on the progress of innovation and risk management, and to update regulatory tools in light of reduced benchmarking information. Important to all reporting would be "embedding customer engagement at the very start," he observed, adding: "The days of ivory tower regulation, if they ever existed, are gone."

Aside from the rural provision work, WICS is conducting a number of specific projects to help further these objectives. These are set out in the box.

The projects will build on the many regulatory innovations WICS has already delivered, including price setting for 2015-21 in reference to CPI not RPI; initiating a rolling investment programme for Scottish Water; allowing customers to negotiate their own deal for this regulatory period; and establishing the financial tramlines approach to ongoing monitoring of Scottish Water's financial position.

Tait specified a number of features of the Scottish water landscape that provide a positive backdrop to innovation. These include its world-first non household retail market and the Scottish Government's Hydro Nation agenda. Some of the practical results of the latter include an innovation service to support new technologies; an international programme; and an expert Hydro Nations Forum to coordinate research activity.

On top of that, Tait said WICS' small size (23 staff) means it can be "fleet of foot", while "all the key players in the industry can get into a room – and regularly do." TWR

KEY IR³ PROJECTS

- **Scoping study on regulatory barriers to innovation.** WICS has commissioned a scoping study from Strathclyde University to establish a view on how the existing regulatory framework could be further developed to address any inherent barriers to innovation. This study follows on from the work of WICS' Innovation Panel and involves carrying out extensive literature research and interviews with key stakeholders. Tait explained there would be focus on learning from mistakes of the past – for instance, the fact that "ring fencing innovation projects has not worked". Project outcomes should include removing blockers and increasing innovation incentives.
- **Project on the economic regulation of catchment management.** WICS is currently involved in a project led by Centre of Expertise for Waters (CREW), which aims to assess how catchment management can be integrated in the existing framework of economic regulation. Costs and benefits of catchment management solutions will be compared with those of traditional treatment solutions. The design of appropriate incentives and reward mechanisms within the regulatory framework will be considered.
- **Wholesale cost allocation project.** With the opening of an Anglo-Scottish competitive retail market, wholesalers will need to able to justify their charges in relation to specific classes of customers or services and will be exposed to challenges under competition law. The aim of the project is to conduct a "bottom-up" examination of the allocation of wholesale costs for each type of service provided to assess the degree of cost reflectivity of existing charges.
- **Working with other regulators to develop the regulatory approach to innovation, risk and returns.** Through forums such as the UKRN, WAREG and WICS stakeholders groups, the different approaches to risk will be assessed to establish best practice and to investigate mechanisms which drive customer benefits.

Regulators seek strength in numbers

UK regulators have set out plans to collaborate more to improve their incident planning and response to serious challenges – for example flooding or cyber attack – that affect multiple sectors.

The UK Regulators Network (UKRN) published the first phase of its Cross-sector Resilience project last month.

UKRN identified three key areas where regulators have the potential to improve cross-sector resilience by improved collaboration. It proposes the following are developed:

- Cross-regulator emergency plan. The watchdogs will explore the benefits of introducing a regularly reviewed and exercised framework to facilitate communication and cooperation during major incidents affecting infrastructure resilience. The objective is to establish a more formal arrangement for direct regulator-to-regulator contact to maximise information sharing and ensure a coordinated response to major incidents with cross-sector impact.
- Shared approach to assessing the state of regulated companies' cyber security. Subject to any information sharing constraints being addressed, this will draw on the experience of the UKRN members that are most active in this area. It is hoped duplication of effort will be avoided and high quality comparable outputs delivered.
- Joint exercise coordination. Consistently involving stakeholders from other sectors in resilience and emergency planning exercises can help to identify and better prepare for the impact of interdependencies. This work will establish a framework to ensure regulators are well informed about the range of exercises being planned and share this information with relevant stakeholders in their sectors to maximise opportunities for involvement.

Bristol at CMA: evidence piles in

The Competition and Markets Authority (CMA) has set out a slightly revised timetable for its determination of Bristol Water's appeal against the price settlement Ofwat issued in December.

The 3 September final decision date still stands. The key events before that are: initial main party hearings in June; provisional findings in July; further main party hearings in late July; and a final representation deadline of 7 August.

In the evidence submitted so far, unsurprisingly both Ofwat and Bristol put forward a robust defence of their case. Since Ofwat's initial referral of the case to the CMA in March, Bristol has stated its case; Ofwat has replied to this; and Bristol has responded.

In addition, a number of other parties have made submissions, including Bristol's Customer Challenge Group (known as the Local Engagement Forum), the Consumer Council for Water, the Drinking Water Inspectorate, and two other water companies.

The next issue of *The Water Report* will carry analysis of the evidence submitted to date, ahead of the main party hearings in June and a 15 June deadline for representations before provisional findings are issued.

On the CMA panel are: Anne Lambert (chair), Robin Aaronson, Katherine Holmes and Stephen Oram.

Ofwat takes AIM at sensitive abstractions

Ofwat has invited water companies and other interested parties to join a new taskforce to flesh out how best to incentivise reduced abstraction in environmentally-sensitive areas when water is scarce.

Five companies that have Abstraction Incentive Mechanism (AIM) related performance commitments in their AMP6 business plans – Affinity, South East, Thames, United Utilities and Wessex – have kicked off the group and are joined as members by Ofwat and the Environment Agency. The companies have taken joint responsibility for appointing an independent chair and co-ordinating taskforce meetings.

The taskforce will be responsible for:

- proposing to Ofwat by 1 October 2015 the requirements that all companies will need to report their performance against the current reputational AIM during 2015-20
- confirming the list of environmentally-sensitive sites that each company in England (Dwr Cymru and Dee Valley are not covered by AIM) has agreed with the Environment Agency
- agreeing solutions to the data issues identified in earlier work on the AIM
- presenting options on how the reputational incentive should work
- providing advice on the development of a financial incentive that Ofwat can use in 2020-25.

Inadequate data quality prevented Ofwat from introducing a financial AIM at PR14. In this price period, companies will be rewarded with praise or penalised with criticism, depending on how well they perform on sensitive abstraction, and parties will work to resolve the data issues with a view to implementing a financial incentive after 2020.

NEWS IN BRIEF

- **OECD duo:** two water reports were published last month by the OECD: The governance of water regulators, which studies practice across 34 water watchdogs (available at http://bit.ly/1lybW44) and Securing water, sustaining growth – a report of the Global Water Partnership/OECD Task Force on Water Security and Sustainable Growth (available at http://bit.ly/1lybuTv)
- **Scot RBMP:** the Scottish Government is consulting on the delivery of River Basin Management Plans until 22 May.
- **Being responsible:** Kelda, Northumbrian Water, Southern Water and United Utilities were recognised as being among the most responsible businesses in the country by Business in the Community's Corporate Responsibility Index 2015.
- **Out and in:** Severn Trent is expected to complete the sale of its Water Purification business to its joint venture partner Industrie De Nora, for £61.9 million by 30 June 2015. Last month the company announced Emma FitzGerald, currently gas distribution CEO at National Grid, will become MD of wholesale operations from 1 July.
- **Bog on the Tyne:** Northumbrian Water is in the final stages of commissioning an £8m gas to grid plant at Howdon on Tyneside. This will clean and purify biogas to create biomethane for injection into the national grid.
- **Casework:** Ofwat has announced it is investigating two new cases: an appeal about Bristol Water's proposed charges for self-lay service connections, and a complaint about work done by Wessex Water on private land.

THE SUPPLY CHAIN: FRIEND OR FOE?

The relationship between water companies and the supply chain looks set to become more complicated as the water market is reformed. On one hand, supply chain companies could play a growing role in assisting incumbents to deliver in competitive retail and wholesale markets – for instance, through increasing efficiency, improving service, innovating and managing risk. On the other hand, in some market segments they could well end up competing for business with the water companies they currently serve. This would muddy the clarity of historical relationships, be they of the traditional master/servant type or as partners or allies.

Last month, the Indepen Forum – a group of senior influential figures from all parts of the infrastructure sector (including service providers, investors, regulators, policy makers, contractors and advisors) – gave the subject an airing. The exam question was "what light can the supply chain shed on market reform?" and the context was the entire UK infrastructure sector rather than the water sector alone.

All three opening speakers concurred – albeit in various ways – that market reform presents both challenges and opportunities to existing service providers and that the supply chain is indeed very capable of shedding light on the matter.

Nicholas Pollard, chief executive of Balfour Beatty Construction Services, argued the skills, knowledge and innovation capacity of the construction sector is consistently under-leveraged by utility clients. But that when it is occasionally tested, it can deliver in a big way.

To get the best out of the supply chain, he urged utilities to stipulate the outcomes they want delivered rather than the specifics of what must be done – for example, that water quality needs to rise, not that a new treatment plant needs to be built. He also called for clients to engage very early with companies like his so that risk can be positioned with those best able to discharge it.

Steve Smith, Lloyds Banking Group's competition and regulatory strategy director, and former managing director of markets at Ofgem, made the case for enthusiastically pursuing the reform agenda. He said competition was our best hope of coping with huge challenges such as population growth and climate change impacts and that he would like to see monopolies questioned and more competition potentially introduced.

Mark Ripley, UK regulation director at National Grid, saw the role of the supply chain doing nothing but growing in importance. As further competition in energy networks is pursued, and as his company seeks more efficiency, he noted supply chain relationships could prove the differentiating factor between competition winners and losers.

Monopoly v competition

The thorny issue of how more competition should be introduced into monopoly markets dominated the discussion, with participants observing that market reform is no natural friend of the monopolist.

The Forum identified that it would likely fall to regulators to push, prod and make a case for more competition to really reveal opportunities for the supply chain. This is natural regulatory territory, where Ofgem and other watchdogs have a track record of slaying sacred cows and where Ofwat is currently finding its feet.

Of course there would be a role for policymakers too, in providing as much clarity, certainty and stability as possible to give the market confidence to constructively manage change. And a role for incumbents – to respond appropriately.

Elsewhere, attendees openly acknowledged the benefits utilities could reap through collaborating with supply chain partners – including around innovation, creative tension, greater efficiency, risk mitigation and an all round better end result. The debate explored how such benefits might be protected in a more competitive environment. There were no easy answers, but it was argued that collaboration with potential partners is best sought early to reap the most benefit, and that once a collaborative arrangement is in place, the companies party to it should compete together as a single unit against other market participants.

All in all, the Forum debate raised a flag on the changing relationships between water companies and their suppliers that are likely to fall out of market reform. It was a useful early airing of a topic that will need to be revisited in detail over the coming years. TWR

THE NEXT BIG THING…SOCIETAL BENEFIT

A trend to watch for water companies surfaced at the Forum: Balfour Beatty's Pollard observed that forward-thinking organisations are factoring in societal benefits when they award deals – by, for example, selecting suppliers who guarantee a certain number of local jobs or apprenticeships; who reserve a proportion of their spend for small to medium sized businesses; or who commit to go the extra mile on environmental performance.

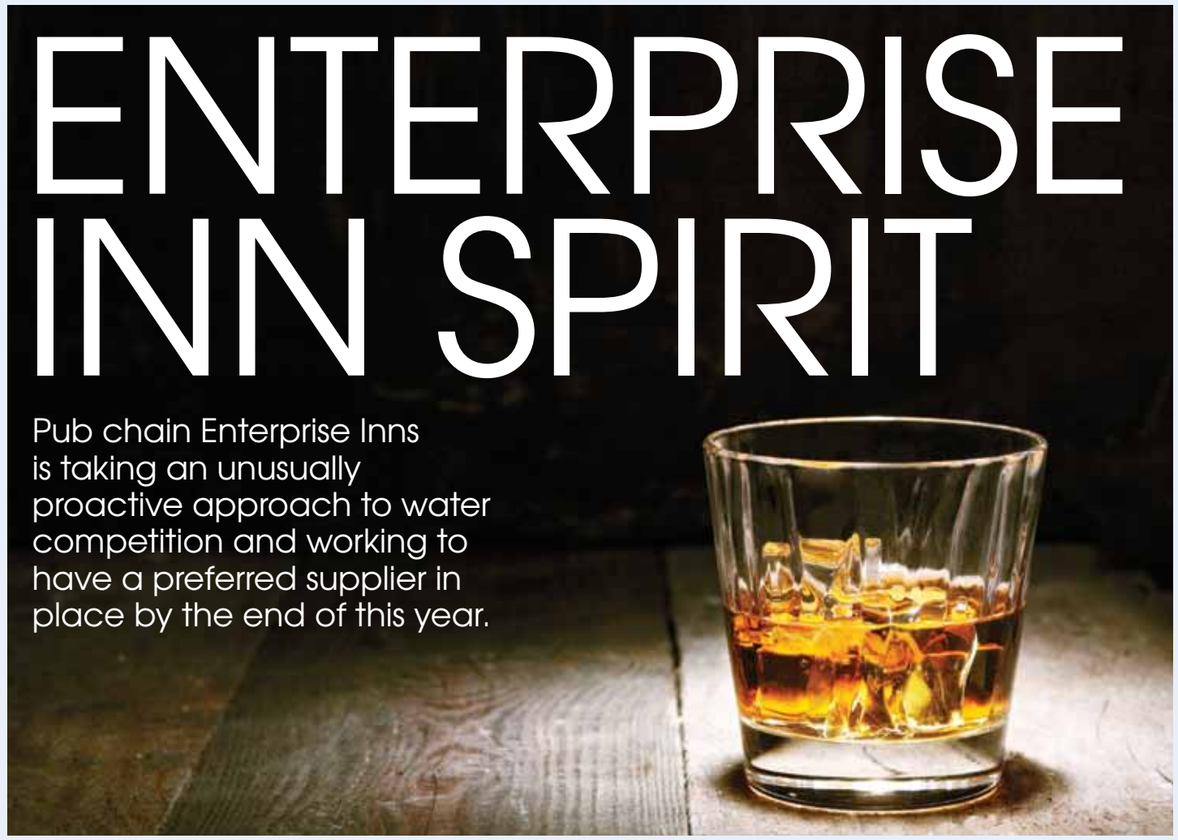
Some Forum members raised a concern that without regulatory support, paying heed to such matters could be deemed uneconomic or inefficient.

Some of those outside the regulated industries expressed surprise that regulators did not hold companies to account on issues beyond pure economics – things like company performance on job and local wealth creation, carbon reduction, water use reduction, waste minimisation, noise reduction, spend with SMEs or the employment of apprentices and graduates.

Taking a proactive stance on the inclusion of community considerations when contracts are let would fit well with Ofwat's agenda to encourage water companies to gain public trust and legitimacy.

ENTERPRISE INN SPIRIT

Pub chain Enterprise Inns is taking an unusually proactive approach to water competition and working to have a preferred supplier in place by the end of this year.



For most business customers in England, the possibility of being able to switch water supplier in two years time is, at this stage, little more than that – a possibility; something to keep a watching brief on; something to learn more about. The least engaged will not know the market is due to open. The most engaged will be actively informing themselves of the detail now and starting to prepare their data and other arrangements for potential market participation post April 2017.

But few are as ahead of the game as pub chain Enterprise Inns, whose business process transformation manager Andrew Wilson is keen to have a preferred water supplier in place by the end of this year. Wilson says: "If you start early enough, you give yourself the best chance of getting the right deal. The closer you leave it to market opening, the more pressure there will be."

Because of Enterprise's business model and utility arrangements, he is especially keen to leave himself plenty of time to communicate to publicans how the market will change in 2017 and what impact it will have on their business. Plenty of time will also be needed to agree processes and form relationships ahead of go-live. Ideally he would like to enable his publicans to sign up with Enterprise's preferred supplier before the market even opens.

The Enterprise business

Enterprise Inns owns the freehold on 5,500 public houses across England and Wales and as such has dealings with every water company south of the border (it has no pubs in Scotland). Those who run the pubs are leaseholders and tenants, who pay rent to Enterprise as the landlord. Each publican is responsible for their own utility contracts, including water. Wilson explains there is great variety in terms of water consumption across the estate, depending on pub size, popularity, additional services provided (some double as night clubs or hotels or even have shops), efficiency of water infrastructure and the consumption behaviour of pub management.

The two issues that really single Enterprise out from a water supplier's point of view are the need to keep on top of changes of tenancy and the need to provide debt management support. Wilson says that while the vast majority of publicans are good, responsible bill payers, it is simply part of the nature of the industry that non-payment of bills and debt will feature in a small number of cases.

Since the start of the recession /credit crunch in 2008, Enterprise has been far from idle on the issues of payment and debt. It recognises it can be a problem so aims to be supportive of both publicans and suppliers alike, by offering assistance to both parties. It has developed a well honed and successful strategy for energy and telecoms services (see box) and is now looking to replicate this strategy for water.

Part of Enterprise's broader utility strategy is in fact already active in water. The GENESIS system is used to keep water suppliers abreast of change of tenancy just as it does energy and >

telecoms suppliers, and Enterprise has trialled the active debt management techniques it deploys in other utility sectors with one English supplier. Wilson says the trial has been successful and has provided him with valuable insight. "I've identified that some water practices may lag behind gas and electric, particularly on billing and process. Hopefully by talking to water suppliers early enough, the problems we face can be identified, and processes established that overcome the challenges".

Desirable features

Now a national preferred water supplier will soon be an option – where Enterprise looks for preferential prices and service in exchange for active engagement – Wilson is keen to seal a deal. He knows the contract won't appeal to everyone. The debt situation is "fraught with difficulty" despite Enterprise's best efforts, and at least one water company turned down outright Wilson's initial approach. "So it depends how the supplier wants to view it," he says. "If it wants market share, we can offer that. We can also offer our close attention, positive management and willingness to grow a close relationship." Sensibly, he says he has been very honest with all parties so as not to waste anyone's time.

So what is Enterprise looking for in a preferred water supplier? It will need to have a national, full service offering and be willing to fit in with the arrangements Enterprise already has in place in energy and telecoms. This means being quick to respond to tenancy or operational change at pub level, both to close exiting accounts and to proactively sign up incoming publicans. "I'm looking for good welcome processes, ideally a personal visit which would help overcome some of the challenges we face. The supplier could perform the essential meter read function (reads are not always collected on the day of change as regional managers cannot always find the water meter), but also provide a welcome pack, show the publican where the meter is, answer any questions, get everything set up right so it is easier going forward."

Enterprise is of course looking for a robust debt alert process and clear, accurate bills as well as consolidated billing on its newly announced managed house division. Because Wilson is concerned about the quality of the data he has on water meter locations across his estate, he would also like his choice of supplier to work with him next year on getting this data market ready. "I would like to agree a choice of supplier and then work with them to improve our understanding of our own estate," he explains. "But until we've sat down and chosen them, I'm not sure where we stand on that."

While the Enterprise contract will be service rather than price orientated, its preferred supplier must offer pricing competitive enough to convince individual publicans to switch away from the incumbent. Finally, the company will be looking for a supplier who doesn't exhibit the negative characteristics some of its publicans have experienced in the past with gas and electric – for instance poor contractual and back billing practices.

Story so far

Wilson's quest for a preferred water supplier started in earnest in July last year after he attended a Major Energy Users' Council water group meeting at Ofwat's head office in Birmingham. He was proactively approached by a number of English companies at the event, and was also provided by WICS with a list of all the suppliers active in Scotland. In October, he prepared and distributed a brief for the contract, on the back of responses to which he has drawn up a shortlist of six companies: three the retail arms of English incumbents and three from Scotland. He has already spent a good session with each at their own offices, and has just issued a second brief setting out what he would like the suppliers to cover when he meets them again in September, along with the Enterprise group financial controller and the managing director of Energy Direct.

"We have six, 90-minute sessions planned, so we'll see each supplier in turn," Wilson explains. He remarks that because communicating Enterprise's choice of preferred supplier to publicans will be crucial to the success of the project, he can't help but factor into his thinking how the name of the new supplier will go down. "It may be harder to introduce a company that has a geographical based name than a company whose name sets out clearly what it does," he considers.

He moves on to say: "The feedback we've had so far is that the shortlisted suppliers are currently not in a position to talk about price very much; it's all very much about service. One or two have indicated they have some innovative ideas for SMEs, so I look forward to an explanation of what they can offer."

Bar bills: managing tenancy changes and debt are Enterprise's core service requirements

Even though he is looking for a primarily service oriented deal, the price issue is important to Wilson because he realises he will have to trade off the early sign up of a preferred supplier and all the benefits that offers (certainty, time to prepare, time to communicate what's happening to publicans and so on) against waiting for more price certainty. "I have to decide how late I want to leave it to factor price in; what weight to attach to price," he mulls.

Market concerns

All in all, Enterprise Inns is exceptionally keen to take advantage of the service improvements being able to switch supplier will offer, and Wilson personally is incredibly driven and working hard to put his company in the best possible position. So when he looks at how the market is shaping up, does he have any concerns?

He briefly mentions not having absolute certainty that the market will open on time but focuses on what type of market it will be. "My biggest concern is that it will turn out to be a damp squib," he muses. "I suspect the amount of money each customer will be able to save will be quite limited so people might think the benefits of moving are not worth it. If the pricing position is not attractive enough, our publicans might just stay signed up with the incumbent and all my time and effort will be to no real avail. The communication with the publicans on the changes however cannot be a bad thing if only to make sure they can make an informed choice."

A related concern is tight margins for retailers, particularly on jobs like his where they will have to pay commission to intermediaries. "Energy Direct gets a small commission on sales to publicans who sign up to our preferred suppliers. This covers the cost of the administration of the GENESIS change process. It is a small amount – we work on the basis of a small amount of commission but a large number of pubs, not the sort of commission rates TPIs [third party intermediaries] usually get – but from the supplier point of view, they will have to make enough money to pay that commission and still keep a margin."

Wilson would also like to see more clarity around access to central market data – specifically, whether Energy Direct as a managing agent will be allowed access. Finally he makes the point that the Welsh Government's choice to opt-out of opening its business market to competition complicates life for companies like his. "When we communicate what's happening next year, we'll have to point out that pubs in Welsh Water and Dee Valley areas won't be able to take part. That's going to be tricky." TWR

ENTERPRISE'S WIDER UTILITY STRATEGY

Despite each publican being responsible for their own utility affairs, Enterprise and its official utility managing agent Energy Direct take an active role in keeping suppliers informed of tenancy and operational changes. Under a process known as GENESIS, the regional manager of the pub affected by a change (closure; change of publican; re-opening; sale) is required to notify a central team at Enterprise on or around the day of the change, of the full details of the change and the relevant meter readings. This information is then passed via Energy Direct to the relevant energy and telecoms providers. In addition, Energy Direct provides a web portal to enable suppliers to verify for themselves data such as periods of publican tenure, meter readings and forwarding address information.

Accurate and speedy notification of changes has helped reduce supplier cost to serve and led to more accurate billing and fewer wrongful disconnections, thereby saving Enterprise and its publicans time and effort on bill validation and problem resolution. It also gives the supplier an opportunity to make contact with the incoming publican, with a view to early resolution of any issues and early establishment of a relationship.

On the back of these arrangements, Enterprise has struck deals with four preferred suppliers, one each for electricity, gas, LPG and telephony/ private broadband. Under these deals, Enterprise and Energy Direct provide support to help the supplier mitigate its debt position in return for a fair price (assisted by collective buying), preferential service and dispute resolution.

The arrangements are not without their tensions. Some tenants are unhappy with Enterprise taking an active role in what they see as their utility supply arrangements, while regional managers have raised that preferred suppliers chase smaller amounts of debt far more actively than other suppliers. Wilson appreciates the interests of individual publicans are not always perfectly aligned with those of Enterprise as a business, although he believes it is actually better for publicans with a payment issue for it to be highlighted while it is still manageable rather than once it has become sizeable.

He says the data speaks for itself: "At present we only have 21 meters disconnected through debt across an estate of 16,500 meters (circa three meters per pub – gas, electric and water). He believes this is due to the GENESIS process working, keeping suppliers informed of changes and allowing communication from day one of the publican's tenure.

NEW HANDS ON THE TILLER

Head held high, OWML will walk away from delivery of the retail market at the end of this month, having produced – most of – MAP3. MOSL and Ofwat will step up. It is critical that this transition is smooth and that the rate of progress doesn't slacken.

A casual observer could have been forgiven for missing the publication on Monday 11 May of the nuts and bolts of the third Market Architecture Plan (MAP3) from Open Water. There was certainly no fanfare as a clutch "technical appendices" slipped quietly out early evening. And yet the documents and the circumstances under which they were published are significant. The documents themselves offer a refined, improved and expanded set of codes, agreements and processes than was contained in MAP2, all of which form the essential underpinning of the competitive retail market in England.

And these documents were the last major outpouring of the old guard. At the end of this month, responsibility for market delivery will transfer from Open Water Markets Limited (OWML) fronted by WICS chief executive and OWML board member Alan Sutherland, to industry-led Market Operator Services Limited (MOSL) and Ofwat (with delivery partner).

It will be absolutely critical, given the tight timetable of just under two years until the scheduled market opening date of 3 April 2017, that this transition is smooth and that momentum is not lost in the handover.

There was universal agreement from all parties spoken to for this article that OWML will walk out with its head held high. Sutherland says: "We are leaving things in really good shape. There's a full set of rules and detailed code subsidiary documents. Market arrangements are in a vastly different place to a year ago. Companies are focused on the data issue [preparing data for central systems]. If we compare where we are in England at this stage compared to where we were in Scotland at the same point, we are way ahead in England on data, on procurement, on understanding. And we are substantially under budget – half a million pounds under budget at 31 March. It's been a first class job."

Ofwat agrees, with chief executive Cathryn Ross publicly thanking Sutherland for his achievements in her letter announcing the change of delivery plan in February.

One fly in the ointment is that OWML was unable to leave a clean slate and publish MAP3 in full on 11th as had been planned – for reasons beyond its control. Ofwat has decided to review the credit arrangements proposed in MAP2, which, says Open Water, has implications that are "significant for both wholesalers and retailers and may change the way in which the market operates. In the light of these proposed changes it was not possible to write the more strategic chapters for MAP 3. The issue of credit terms influences many aspects of the way the market would work including tariffing, financing and funding the retail business and the supplier of last resort arrangements." (See box – To its credit?)

Nevertheless, the technical appendices published take things on considerably from MAP2 and provide a wealth of information that will assist companies in making preparations for the market (see box – MAP2 to MAP3). Sutherland says he is at this point "100% confident" that the market can be delivered on time – providing the industry remains engaged and progress continues at the current rate.

Of immediate import are workshops scheduled for June and the need to get MAP4, due in July, "as close to final as possible". According to the overview document published alongside the technical appendices, "given the extent of the consultation that has already been undertaken, the focus has to be on closing down the drafting process". After July, MAP3's authors recommend that changes are required only as a result of specified issues – namely:

- technical input from the vendor;
- the issue by DEFRA of the draft exit regulations, CMA appeal regulations and its charging guidance;
- the issue by Ofwat of charging rules, eligibility guidance, licensing and appointment documents, an interim supplier code and its statutory consultation on the wholesale-retail code.

The overview document stresses: "It will be particularly important that the July version facilitates an effective dialogue with the [systems] vendor both before and after the contract negotiation. There is a risk that the systems may not deliver the required outcomes if this dialogue is not fully effective. The work plan still includes an expectation that this will all have been completed by the end of September."

This sounds like a bit of friendly advice, from the departing market-maker to the incoming, perhaps with the last minute credit arrangement change from Ofwat fresh in mind.

OWML and WICS

Privately, many have expressed disappointment that Sutherland and his team won't >

MAP2 TO MAP3

The MAP3 documents build on material from MAP2 – refining and improving it where necessary following extensive stakeholder engagement. For instance, there has been considerable development of the material to support the calculation of settlement, following the publication of companies' wholesale charges in February 2015.

There is also some completely new material that didn't feature in MAP2 – for instance, a market assurance framework. Elsewhere, the data catalogue has been expanded in line with all the new data items, in particular the tariffs.

The key elements of MAP3 are:

- The wholesale-retail code: this statutory code will govern operational arrangements between wholesalers and retailers, the requirements wholesalers and retailers have to follow in maintaining the central register at the MO and the business terms which will apply to their relationship.
- The wholesale contract: this is a short standardised contract, which will be drawn up between each wholesaler and each licensed retailer trading in their area. It will incorporate all of the detailed rules set out in the statutory wholesale-retail code into that bilateral relationship and allow wholesalers to charge retailers for their services and be paid accordingly.

Note: Ofwat is expected to consult in its upcoming licensing consultation on introducing a licence condition for companies that choose to remain legally integrated requiring them to have written arrangements in place between their wholesale and retail functions that are equivalent to the terms of the wholesale contract and statutory wholesale-retail code.

- The market arrangements code: to make the market function effectively there will need to be multi-lateral governance arrangements in place. The market arrangements code deals with these. It will apply to all wholesalers and retailers in the market and is multilateral (in contrast to the statutory code, which is bilateral in nature). The market arrangements code deals with the set up and governance of the market operator and the set up and operation of a panel to review future changes to both the wholesale-retail code and the market arrangements code.

Ofwat has recently initiated the establishment of an interim codes panel to perform this role until an enduring panel is established after market opening. Market participants have until 22 May to identify member candidates ahead of an election and appointment of an interim panel chair in June. Ofwat says its aim is to have all members of the interim panel in place by the beginning of July 2015. This should allow the interim panel time to meet to agree working practices, before taking responsibility for changes to the codes in mid-July – after the publication of MAP4. This will include the latest versions of the wholesale-retail code and the market arrangements code.

Other elements of MAP3 include:

- a draft assurance framework;
- a document highlighting issues that companies may want to consider in assessing their readiness
- an update on data upload requirements (published on Friday 15th).

be continuing in the pivotal role they have hitherto played. The regulator recalls that his early interest in opening the English market was with a view to galvanising activity in the Scottish market (open since 2008), knowing full well that English companies would go north of the border to try their hand if the prospect of their own market opening in time was real.

WICS' hands-on involvement in Open Water followed the passage of the Water Act last May. "We were worried about what had been done in England compared to what had been done in Scotland at that stage," Sutherland recalls. "Progress wasn't great. The new and different price review was distracting. There wasn't the level of debate about the impact the market would have on retail, on corporate structure, on wholesale."

And so a year ago began Sutherland's active involvement in the Open Water programme, supported by a team of around 15 (mostly seconded) people. It is this group that has taken the market from the conceptual stage to where we are today. Sutherland reels off that this work has included: "45 full day workshops, four rounds of chief executive engagement and a couple of thousands of pages of codes".

Had OWML been able to remain in the driving seat of market delivery, Sutherland and his team would almost certainly have stayed on to see it through to April 2017. But this plan was thwarted by HM Treasury, which against expectations classified OWML as a public body. After that, the decision was taken by mutual consent to wind it down and to transfer the programme to Ofwat, simply because this would be a more efficient way of ensuring the market was ready on time.

For a while WICS was in the frame to remain centrally involved as Ofwat's delivery partner. But, says Sutherland, the plan floundered on a lack of clarity about budget and the scope of work, with Ofwat proposing an arrangement that the WICS board found "impossible to sign". In February, Ross announced that a new delivery partner would be sought.

With OWML out and being Ofwat's delivery partner off the agenda, Sutherland confirms that "at that time, we will step back". And by 'we' he means WICS "and at least some of the wider WICS team". He provides the example of law firm Shepherd and Wedderburn, for instance, which worked with WICS on opening the Scottish market and has been working with it in England. It will continue to work with WICS in Scotland – Sutherland notes there is about two months' worth of work to do to improve the Scottish market codes in view of the code arrangements that have emerged in England – but not on preparing the English market.

Transition

So from 1 June, delivery responsibility will transfer to Ofwat, who will allocate specific tasks to MOSL, a private company led by United Utilities, Northumbrian Water and Anglian Water. Ofwat is expected imminently to publish a document setting down precisely how it will divvy up roles and responsibilities between itself and MOSL. *The Water Report* understands the transition may be phased because MOSL is still in the process of readying itself to take on the work.

TO ITS CREDIT? OFWAT PUTS NEW CREDIT OPTION ON THE TABLE

A few weeks before MAP3 was due to be published, Ofwat announced that it intended to review the credit arrangements that had been discussed at the Open Water workshops. Unlike in Scotland where wholesaler Scottish Water is paid by licensed providers up front, in England, MAP2 proposed that retailers pay wholesalers 30 days after the end of the billing period or 15 days after the issue of an invoice, whichever is later. Credit risk was to be managed via an escrow account system under which each licensed retailer would establish an escrow account with each wholesaler with whom it wanted to trade. The minimum balance in an escrow account will be £50,000, until 75 days' wholesale charges exceeds that amount. At that point, the account should be topped up such that its balance is consistent with 75 days of wholesale charges.

Some market participants fed back that the £50,000 limit was too high and would act as a barrier to market entry. According to one estimate, a retailer operating nationally could need as much as £1.5bn in working capital. The rules could potentially have applied to incumbent retailers too under level playing field rules.

Johanna Dow, Business Stream chief executive, says: "We fed back that the limits were too high. Open Water understood that and took it on board, and it looked like the limit was going to be reduced to £20,000, which would have been helpful."

However, the Ofwat proposal is entirely new and would allow each retailer to negotiate its own payment terms with each wholesaler. *The Water Report* understands this was motivated both by concerns raised by new entrants and incumbents since MAP2 came out – one estimate suggests half the already small retail margin available could be swallowed by the credit demands – and by a belief from the Ofwat team that will be picking up the market delivery work from Open Water at the end of the month that the escrow proposals were inefficient and out of line with standard commercial practice in other sectors. Commonly elsewhere, the seller of services makes its own judgement on necessary payment terms its buyer must abide by, depending on the creditworthiness of that buyer. Should this route be adopted, and it is looking likely, the question arises whether the such bilateral payments would belong in the wholesale retail code at all.

While no doubt grateful that their barrier to entry concerns have been heeded, the negotiated route poses two main issues for retailers:

Complexity. Business Stream has previously expressed concerns about the lack of standardisation in wholesale arrangements – tariffs and service standards – across the industry. Dow comments that the proposed new credit arrangements will "add further complexity into the market".

Discrimination: Dow explains she is concerned that "allowing negotiation could make it easy for wholesalers to offer preferential terms to their associated retailers as there would be no credit risk".

Sutherland indicates that while resolution on credit terms should be achievable without posing any significant delay to the market, the implications of going down the Ofwat route are more complex. He observes: "It would be a very different market in feel and substance from what was discussed at the workshops. A very different market to Scotland, which poses an issue for the seamless Anglo-Scottish approach." He adds that different payment terms could have implications for how incumbents structure themselves for the market and even that DEFRA will want to have a say. "Ministers gave resolute assurances that the Water Bill envisioned a regulated access framework," he explains. "There was no element of negotiation."

Ofwat will need to be alive to these concerns as the credit issue unfolds. It will need to balance the upsides – (giving wholesalers choice, allowing for innovation and lowering cost of entry (for the creditworthy at least) – against the downsides of more complexity (which in itself can add cost) and level playing field issues. Perhaps above all it needs to resolve the matter quickly one way or another before codes have to be frozen and more formal change procedures come into play.

Ofwat will be well aware of the need to both keep the confidence and engagement of the industry and keep up the tempo of work. Dow says she has "no reason not to have confidence" in the new arrangements, but emphasises the need for "the transition to be handled in a smooth way".

To its credit, Ofwat has committed to a transparent stock-taking process (hitherto dubbed "gateway reviews") at key points between now and until after the market has opened. These reviews will consider risks, resources, governance and progress and be conducted independently. The first is being done to coincide with the delivery transition at the end of May, and will be published, as will Ofwat's response to it.

Ofwat and MOSL

Ofwat itself is expected to keep responsibility for a reasonably limited number of roles after June – specifically licensing, charging and tariffs, overall programme planning, business customer engagement and some aspects of assurance. It will share this work with a delivery partner. The bids are in and the regulator anticipates making its choice known shortly – perhaps within the month.

The bulk of the work is expected to go to MOSL. It is already well underway with one of its core duties: procurement of central systems.

Janice Smethurst, United Utilities' director of supply chain management, has been seconded full time to MOSL to head up the procurement of the core IT platform. She confirms this work is "progressing well and we remain on track to deliver our award recommendation by the end of July".

She continues: "We are expecting outline proposals from our five bidders to be submitted today [14 May], following which these proposals will be assessed by our evaluation team, made up of representatives from across the industry. Having this industry representation ensures a robust assessment of submissions and is a key step in awarding the final contract to the right IT delivery partner. We will then be issuing our 'request for detailed solution' in early June which will seek to build upon the work done at outline solution stage and where development of the final proposed solutions will begin."

According to Sutherland, the key thing to guard against on systems procurement is gold-plating. "It's not a complex task to perform. It's essentially a registration and settlement function and all the technical processes are already there so it should be fairly cheap. We paid £2.1m in Scotland, though one of the bids we had in priced it at £20m!"

Beyond its core systems role, MOSL will be responsible for the establishment of the market operator (MOSL will need a different corporate structure if it is to morph over time into the MO; Sutherland flags up that there could also be an issue securing a private classification for the MO given its role will include statutory functions given to Ofwat and subsequently delegated). In addition, it is thought MOSL will take on codes, processes and procedures, including the role of design authority, responsible for maintaining the integrity of the codes and making recommendations to the codes panel. Beyond that, MOSL will oversee company readiness and engagement arrangements and be responsible for aspects of assurance relating to the MO.

Given it will have the lion's share of the workload, it is vital that MOSL is both ready and adequately resourced to perform its job effectively. It is not there yet, but is working hard on it. One pressing issue is the constitution of MOSL's board. Another is recruiting members beyond the three founding companies. The expectation is anyone who wants to participate in the market will have to be a member, but because members incur costs, some may try to join later rather than earlier. The rub there is that adequate funding will be vital for MOSL's progress. MAP3 notes: "It is…crucial that MOSL makes quick progress in developing the resources to add support to individual companies' efforts to ensure that they are ready for market opening. Experience from Scotland suggests that such readiness support is important to an orderly and effective market opening."

Smethurst provides an update on these issues. "The articles of association have been agreed by all licensed undertakers and a number of potential new entrant members. Membership requests which are received this week will be approved by the interim board on Monday the 18th May, however companies are able to apply for membership at any time.

"We're very pleased to confirm that Peter Bucks, chairman of OWML, has agreed to become an interim independent director of MOSL. This is a positive step for MOSL bringing continuity to the transition phase as well as Peter's own significant experience and valuable knowledge.

"We continue to work towards the appointment of an independent chair and independent directors with the help of an external specialist consultant and we plan to transition from the current interim board to a full MOSL board in July so as to allow the full board to approve the final contract award for the core IT platform."

> **New entrants have got to feel involved. It's non-negotiable.**

OWML has proposed a five strong board: three independent non-executives including a chair; one elected incumbent representative; and one elected new entrant representative.

MO delivery will now be incumbent-led MOSL's job rather than OWML's (which included incumbents alongside regulators, government and new entrants), constituting a board that is perceived to be fair and balanced to all parties will be essential. If it looks like an incumbents' club, new entrants will be put off. Dow says she will be content "as long as appointments to the board are made in accordance with the articles of association". She stresses: "There must be equal representation for new entrants and incumbents; it's important new entrants have a strong voice."

Sutherland concurs: "New entrants have got to feel involved. It's non-negotiable."

Ofwat is understood to be confident that risks are manageable, assurance is robust and systems are procurable; in short that it and MOSL will be able to deliver an effective market on time. Sutherland's recommendations to his successors as he steps back from a job well done are that the industry be kept engaged and the market developed collaboratively; there needs to be absolute clarity on budget so companies understand how their money is being spent; and new entrants absolutely need to be listened to. "They will ask for heaven when a few high clouds would probably do, but they absolutely will be raising the right issues." TWR

INDUSTRY COMMENT

GET BIG, GET NICHE, GET OUT?

Water companies face three stark choices in deciding on a retail strategy for the non household market. It's a tough call, but the industry is awash with information that will help. By PA Consulting Group.

Get big, get niche, get out. It is probably not quite the way they teach it at Harvard Business School, but it is a well-respected business adage for the strategic options companies face in new markets. The non-household water market is such a market and companies are currently considering their strategies. So, how active will the market be and how, and importantly when, do you take this key strategic decision? Are big, niche and out really the only options? What about the in-area retention strategy? And which is the best option for your company?

The Water Act set in place the extension of water competition in water and sewerage services in the Non Household (NHH) Retail market from 2017. This is an extension from the current 5Ml water market, significantly increasing the number of business premises that can switch, from 27,000 to 1.5million, and adding in waste services. This increases the value of the market, which, based on PR14 returns, is worth in the region of £170m per annum. DEFRA, Ofwat and Open Water Market Limited (OWML) have been driving forward the change that will enable the market and, with PR14 resolved, the mood of the industry has seen a distinct change from "will this happen?" to "this will happen".

Predicting activity

The potential extent of activity in the market, and hence impact on strategy, is not easy to predict. Those who believe it will be a very slow market point to the low early rate of switching in the Scottish market, the low anticipated margins for business and savings for customers.

The Scottish market has been open since 2008 but has seen limited activity (although more than 60% of customers have successfully renegotiated contracts). The average NHH net margin has been set by Ofwat at 2.5% and at an overall size of £170m pa, many argue this does not represent an attractive market for incumbents or new entrants. This in turn, it is argued, will limit potential benefits for customers and so limit activity. This analysis is leading some companies to adopt a "steady as she goes", or "wait and see" strategy. This is based on a focus on in-area retention, built around current strong relationships, with no, or negligible, activity out of area.

> **Severn Trent Water's cost to serve is circa £26, while United Utilities' is circa £42.**

There are however predictors of a far more active market, which could make this a dangerous strategy. We have seen an upsurge of activity in the Scottish market, with ten new entrants over the last two years and there is also increasing activity in the English market with a total of 11 licensees now appointed. Companies are privately and publicly declaring their strategies – we talk to many companies aiming at 25+% growth – which cannot be possible in a constrained market. There will inevitably be casualties if these companies are to come anywhere near to success.

Perhaps most importantly, the "slow market" prognosis does not capture the potential disruption and change that may happen in the market or acknowledge the transparency that will enable it. Specifically, much of the NHH retail cost to serve is a fixed cost; every time a company loses a customer their cost to serve will hence increase. This will result in reduced profit, assuming tariff increases would not be allowable. Either option is unpalatable and, further, it risks creating a vicious circle that will make your customer base an increasingly attractive target for competitors, that will in turn drive up your cost to serve.

This raises the question of how to decide your strategy. There are very important issues around the value of a customer base, positioning for longer term upstream and potential household competition and what drives value for stakeholders. Firstly, however, it is important to consider that this is an almost unique market in the transparency of data available to help the strategic decision.

Highly transparent

Through the final determination process, Ofwat has created a highly transparent market. Each incumbent company included a section on NHH Retail, and default tariffs were set for each customer group proposed by the companies. In assessing the deemed tariff, Ofwat considered the cost to serve for each customer group and published this alongside the tariff data. This provides a wealth of information to use in considering retail strategies including the profit margin by customer group, average consumption, number of customers, bill size, wholesale cost and others. The information provided is indicative: prices could change and companies could offer different value added services, reducing margins to ward off competitors. However, the information does show:

- *Companies' spread of customer types*
- *The weight of importance of individual customer groups*
- *The relative price charged for a customer group compared to competitors, indicating competitiveness.*

The table above right sets out the overall number of customers (orange bars) and average retail cost to serve (blus squares).

This shows some very significant differences between companies. For the eight smaller companies, Portsmouth's average cost to serve is circa £20 per customer, while Affinity's is nearly treble that at circa £55 per customer. For the large players, Severn Trent Water's cost to serve is circa £26, while United Utilities' is circa £42.

There is clearly much data behind these figures which helps explain some of the differences. For example Affinity Water also has the highest revenue per customer of the water only companies (WOCs), which could be a major reason for the increased cost to serve. However, they do provide a quite remarkably transparent set of information to support strategic decision-making. Among the questions it prompts are: if your company has a very high cost to serve then are you realistically going to compete? What is your target market and how do you drive cost to serve down? Equally, if you have a low cost to serve and want to expand your business, how do you best use the information to target your sales strategy?

The information set out above is valuable, but there is much more detail in the returns. These allow you to break down revenue and margin by service and customer type, to an extent. The example below left shows a high level assessment by customer number and revenue by margin. The three orange service groups represent about £6m of revenue and 85% of customers. Circa £1.25m of this revenue is in a customer base with margins nearing 50%, a potential prime target with lower cost to serve in these areas.

> **[Exit] presents a significant risk to the company in the event that its application is refused. The undertaker would retain the legal responsibility to supply but may not have the infrastructure or capability to do so**

The company shown below right conversely seems in a relatively sound position.

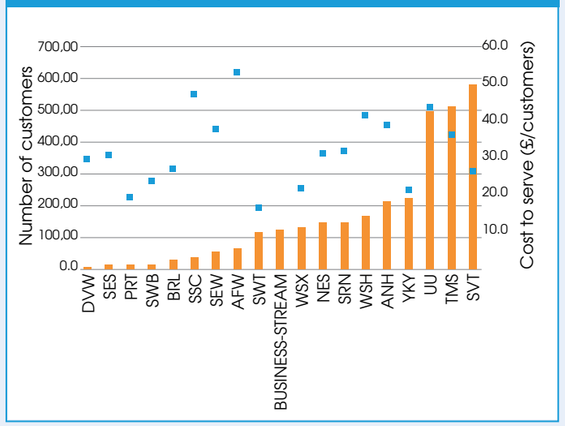
The high volume customers are operating at a low margin and so are arguably less vulnerable to acquisition. The higher margin business is spread across a smaller number of customers who may be harder to target. However, in contrast, the revenues indicate this is a small company and potentially more vulnerable to losses. Furthermore, if the company suffers some losses in its high margin customer base then the overall cost to serve will be driven up.

In addition, some aspects of company sales strategies could cut across the elements above. For example, national deals could take customers from all companies irrespective of margin.

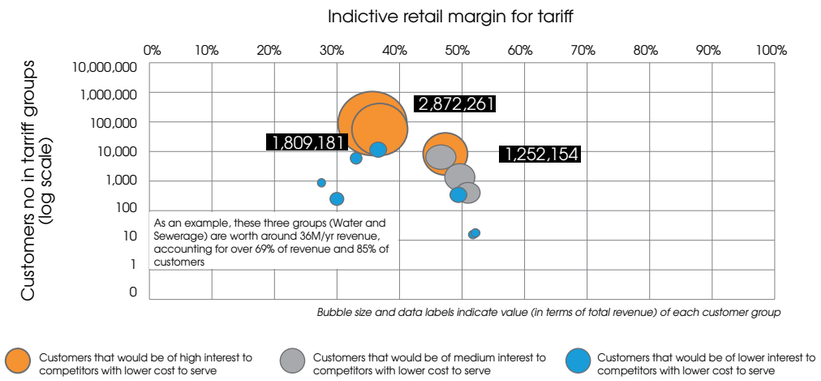
Strategy choices

The above indicates how, if utilised, this type of information can be

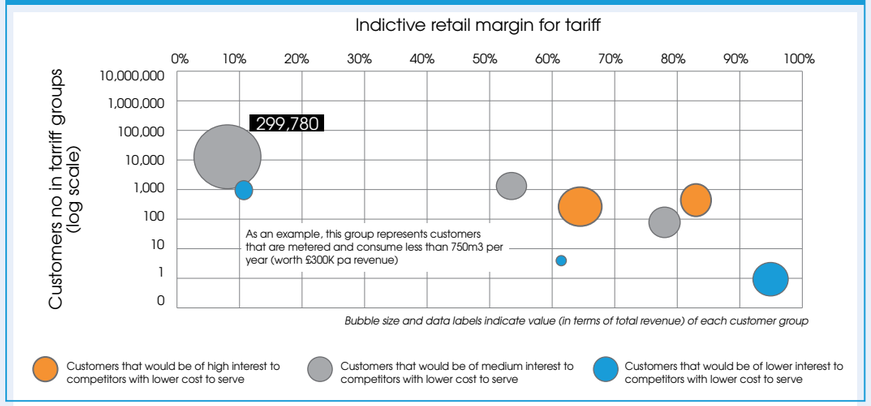
CUSTOMERS/AVERAGE COST TO SERVE



TARIFF GROUPING CHARACTERISTICS



TARIFF GROUPING CHARACTERISTICS



INDUSTRY COMMENT continued

invaluable in determining your strategy. What then should that strategy be?

Get big?

This is clearly not an option open to all, or certainly not in the short term. Several of the larger players have set out their stall and are active in the market. They are developing capabilities, sales and marketing strategies and active positions in Scotland and the 5MI market. Several are starting to consider national deals which could have a significantly disruptive effect on the market. The recent announcement of Anglian Water as the preferred bidder for water and wastewater services to the Scottish public sector showed a strong intent.

Although scale is valuable, these large companies are also vulnerable from rivals using the transparent information available above. Targeted sales strategies against them could undermine their cost to serve and lead to a need to focus energies on protecting the home front.

Get niche?

Transparent information again helps companies to develop a niche. This could be by targeting particular types of company, regions, or services. It could be by using a capability as the basis for the offer; the most obvious example would be a digital only service, building on the increasing prevalence of digital markets.

Perhaps the most obvious current incarnation of niche is the in-area focus approach. Many companies are pursuing this, aiming to maximise their current relationships, putting in place strong account management and differentiated value added services for key local customers. The lessons from the energy industry on this are not, however, that positive. Local loyalty was frequently rapidly eroded in the face of advantageous deals, particularly for large national or regional players. As noted above, each customer loss will drive up cost to serve and drive down margin.

This is therefore a challenging strategy, but companies can be creative in how they pursue it. One potential approach would be white-labelling. This is used extensively in energy and other industries; companies outsource the delivery of their products and services through a partner organisation, while they themselves focus on the brand, sales and appropriate aspects of customer service. M&S Energy is delivered through SSE, for example and John Lewis Broadband is delivered through PlusNet. This approach could substantially reduce cost to serve risk and facilitate an in-area strategy, if providers are available.

Conversely, a water company could become a provider of white-labelled services itself, if level playing field concerns could be overcome, providing a service to other companies or new entrants to help balance cost fluctuations arising from loss or acquisition.

> **Much of the NHH retail cost to serve is a fixed cost; every time a company loses a customer their cost to serve will hence increase. This will result in reduced profit.**

> **We talk to many companies aiming at 25+% growth – which cannot be possible in a constrained market. There will inevitably be casualties if these companies are to come anywhere near to success.**

Get out?

The 'get out' option would see companies exiting from the provision of water and sewerage services. The viability of this option is not yet clear. The provision to allow exit was introduced at a relatively late stage in the development of the Water Act 2014. DEFRA has issued a consultation which sets out proposals for companies to seek secretary of state approval to exit, together with proposed policies for addressing the consequential impacts.

One particular issue is the protection to be provided to customers of the exiting company upon transfer. It is proposed to use deemed contracts for all customers who have not negotiated specific contracts with their licensee. These would include arrangements to ensure customers do not lose price and non-price protection as a result of a transfer.

These proposals are based on the principle of equivalence, whereby customers should have access to the same safeguards as they would have had if they had remained with the original company. It is proposed to extend this principle beyond the initial exit and transfer: in effect the customer may have a right to transfer back and the original company remains the default service provider up to two years after the original transfer.

Companies wishing to take advantage of the exit provisions will wish to avoid the need to invest in the new systems, processes, people and infrastructure that would be required to operate a market ready retail business. But the application process itself will not open until October 2016 with the secretary of state decision following in December 2016.

This presents a significant risk to the company in the event that its application is refused. The undertaker would retain the legal responsibility to supply but may not have the infrastructure or capability to do so in the new market arrangements. An undertaker wishing to exit will therefore need to be very sure it can meet the requirements before deciding not to invest. More clarity may emerge in DEFRA's response to consultation, but for now this does not provide a low risk strategic option.

Retail strategy is a crucial element in approaching the new market. The backdrop to developing that strategy is challenging. On the positive side, there is a plethora of information; far more than is normally available. On the negative side, the ability to take major decisions, in particular on exit, require more certainty. The economics of the market suggest not all will survive and thrive. Get big, get niche, get out – what is the right strategy for your company? TWR

Ted Hopcroft is an energy and utilities expert and John Parsonage is a water expert at PA Consulting Group.