THE
WATER REPORT

POLICY | REGULATION | COMPETITION

JULY/AUGUST 2016

The long view

Outgoing CEO Martin Baggs on retail exit, new resources for London and his legacy at Thames.

COMPETITION WATCH

- MOSL returns to amber
- Southern Water's exit to Business Stream
- Household market cost benefit analysis
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THE WATER REPORT COMPETITION WATCH

Editor: Karma Loveday 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
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EDITOR'S COMMENT

Going, going, gone

There is a distinct theme of departure running through this issue. Departure from the European Union, of course (p4-6). Two WASCs in the last month announcing exit from the business retail segment (Thames p8-11/p32 and Southern p26-27). And two well known company CEOs imminently on the move (Martin Baggs p8-11 and Luis Garcia p14-17). Collectively this goes to show that change is always interesting but only sometimes for the better.

It is difficult to find much positive to say about Brexit for water. The truth is no one really knows yet what the effects might be. As our article shows there are plenty of opinions, but even those that can be classed as 'positive' seem to hope at best for things not to get any worse. There is no sense at all of a Brave New World.

Which contrasts starkly with the news of Thames and Southern's decisions to exit the business retail market. Both companies think it is best for them to focus their attentions elsewhere, and the mass acquisition of market share has given two dedicated retailers a much better start than if they had to grow purely organically. The deals should be good news for the customers involved – both Business Stream and Castle Water come armed with service options and enthusiasm from their Scottish experience, though in terms of history and scale they are of course very different propositions. How Castle manages its transition from a challenger to a quasi incumbent will be interesting, as will how things pan out in the south east corner of England where the two new retailers are neighbours and set to compete for water only company customers.

Soon perhaps household customers will be able to leave their suppliers if they are dissatisfied or to get a better deal, too. Ofwat's domestic retail research makes for fascinating reading (p28-29). Should the market be opened, bundled services look inevitable which begs all sorts of questions for the longevity of water companies in retail markets. Ofwat's work is extensive but further analysis will almost certainly need to be done if the government is minded to press ahead – not least to quantify the costs of actions that will be necessary to mitigate impacts on certain groups.

And finally, to end on a high note, this month we celebrate 35 years of WaterAid. Our feature on p18-21 details the intertwined relationship between the charity and the industry. That is an unadulteratedly fantastic achievement of which everyone should be very proud.

Karma Loveday, editor,
The Water Report

Feedback, comments and suggestions very welcome.

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

WHERE DOES LEAVING THE EU LEAVE THE WATER SECTOR?

Despite a new top team at DEFRA, immediate changes to water policy seem unlikely. However in the medium to long term, there is undeniable uncertainty for the environment, investment, prices and market reform.

It is approaching a month since the UK voted to leave the European Union, but the topic continues to dominate conversations on sofas, street corners and news reports up and down the country. The water industry has been no exception, with Brexit coming up at virtually every meeting and event since 23 June, regardless of the original agenda topic. But despite all of the conversations, so far there has been little of any substance anyone can say.

The water industry seems to have made a sensible decision to effectively hold fire on taking any action in the hiatus period that followed the political resignations after the Leave win. It was by all accounts waiting to see the nature of the new political top team, to at least have a chance of second guessing how it might approach the industry's important issues. Advisors in Brussels are also understood to have counselled UK companies to lie low on the European scene until wounds are a little less raw.

Now of course we have a new prime minister, a new environment secretary in Angela Leadsom and a new ministerial team at DEFRA. Former water minister Rory Stewart has secured a ministerial role in the Department for International Development. At DEFRA now are Thérèse Coffey MP and Lord John Gardiner of Kimble as parliamentary under secretaries of state; and George Eustice MP as minister of state.

This is all still so fresh that there is little more clarity than before, though Leadsom's environmental credentials have already been scrutinised and found wanting by some of the nationals: the *Independent*, for instance, reported her voting record to show opposition to climate change measures (including voting against setting a target on reducing carbon emissions) as well as support for fox hunting and forest sell offs. How her views will translate to water sector policy remain at this time a matter for speculation only.

COASTING ON THE BACK OF BREXIT COULD DAMAGE LEGITIMACY

Ofwat chief executive Cathryn Ross has fired a warning shot across the bows to water companies to do everything in their power to keep prices down for customers should Brexit result in diverging fortunes for customers and investors.

Speaking at Marketforce's Water Market Reform conference in early July, Ross pointed out the economic scenario raised by the Bank of England among others of higher inflation, lower interest rates and lower growth. She said: "I want to point out now that that scenario could pose a very significant challenge for the water sector. A challenge of customer legitimacy. Because it is a scenario in which water companies could remain a very attractive investment proposition, water companies and their investors could enjoy substantial financial outperformance, at precisely the same time as their customers become poorer and find it harder to pay their bills."

She told companies to plan how to avoid customer trust and confidence being damaged should such a scenario materialise, referring specifically to them ensuring "that there is no let up in their search for totex efficiencies, for better ways of using resources, for new and better ways of doing things." She added: "To be completely clear, I should also say that I see no reason at all to change the wider policy framework for our regulation and specifically for PR19 that we published back in May. We remain of the view that markets have great potential to inform, enable and incentivise companies to achieve new frontiers in efficiency."

Short term stability

The official line from DEFRA is that there will be no immediate changes. Speaking at a Westminster Energy, Environment and Transport (WEET) Forum at the beginning of the month, DEFRA's head of water services Holly Yates said: "The clear line from the government is that there aren't going to be any immediate changes. We're still a member of the European Union, we will need to assess our approach in the coming months as we prepare to negotiate our exit."

Ofwat chief executive Cathryn Ross likewise has expressed the view that in the short term, it's business as usual. She noted firstly that Ofwat is independent and while government policy does have an impact on the sector "I don't see the drivers for policy change being noticeably different today than they were a few weeks ago…we only recently saw the enactment of the Water Act, in 2014, and the delivery of the Wales Water Strategy, which paves the way for reforms that will keep us busy for several years – we were not 'due' a new policy framework."

Ross added that compared to sectors like energy, water's legal situation is far less entangled with EU policy. "There is no European Single Market in water. There is no Europe-wide market architecture. No EU rules on access pricing. Or capacity allocation," she observed.

Environmental regulation

Where there is entanglement of course is in the area of green regulation, much of which in the UK derives from EU law. There is a broad range of views on how in the longer term our water environment could be affected by UK independence. Many seem optimistic that the high standards driven by Europe will continue outside of it, not least because most environmental directives from Brussels have been transposed into UK law. One government

official remarked: "No one voted to stop protecting the environment. The values we hold remain the same…DEFRA is still there to protect the environment and prevent deterioration. And issues like water scarcity and climate change haven't gone away…There's a lot to work through but I don't see any reason to believe things will dramatically change."

Some environmental groups including WWF remain optimistic (see box p6) too, while others have pointed out that we have motivators other than Brussels diktat to continue to look after our water. The Environment Agency's deputy director for water resources Trevor Bishop said: "I think the coincidence of the situation we find ourselves in and the work of the Natural Capital Committee is really useful because I think, as a country, we need more visibility and understanding of the value that managing our natural resources in an appropriate way brings to us, so that it isn't all just costs out the door, and costs to customers. Actually, as part of a circular economy there is a value to our economy; to our credibility as a society."

Meanwhile Martin Osborne, technical director, Mouchel, pointed to reputational drivers to keep standards high: "I've done some work with Jersey and Guernsey, who are not part of the European Union, and so European Directives on the environment don't apply to them. But they comply. For reputational reasons, they can't afford the damage of being 'the dirty man of Europe'. And I don't think we can suffer that reputational damage either, so I think we'll keep complying."

Ofwat's Ross takes a pragmatic line, noting that the future of environmental protection depends "on the appetite of the UK government to row back on environmental regulation that forms part of UK law, but which has its origins in the EU. But right now, and until any change is agreed and implemented, the companies' obligations are what they are."

However, others have expressed concern that, without powerful European legislative drivers, it might be tempting to save money by scaling back our green ambitions. PWC's UK water sector leader Richard Laikin said: "As we think about the water sector, and we think about PR19… and we think about the timing of some of the investments that are required under WFD and other European Directives, I think as we move into a post-EU world, there will be potentially more flexibility about the timing of investment, and the scale of investment. And whether the government chooses to direct companies to meet certain requirements at certain points in time, and that leads to some trade-offs, around investment, environmental performance, and customer bills…I think some of that will play out over the next few years, as we get into some of the detail, particularly as we go into PR19 business planning and thinking about the next AMP."

Angela Smith MP and co-chair of the All Party Parliamentary Water Group (APPWG) remarked: "I don't think that the legislation that we have at the moment embedded in UK statute is particularly at risk, but it's going forward, I think, that we face the risk. There's a risk of divergence from the European Union in relation to environmental regulation and other standards which will endanger our position within the single market and trading with the European Union Member States. So for me, that's the danger going forward."

Water UK's head of corporate affairs Neil Dhot stressed the fundamental importance of the customer voice as environmental and water quality standards outside of Europe are worked out. If the message is that customers expect ongoing improvements, or standards to be maintained, this should be a driving factor. He said: "It's important companies talk to their customers about this and make sure regulators and NGOs who are perhaps once step removed from customers, hear the customer voice."

Clearly, UK compliance with environmental regulations could be tied up with striking a single market deal. Baroness McIntosh of Pickering, APPWG co-chair, wryly (given the well reported short-

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age of trained negotiators at Whitehall) questioned Yates at the WEET Forum on DEFRA's capabilities here: "How many people will Defra have who will be able to actually negotiate?…Will you all be on standby to leap into the breach when negotiating the environmental aspects?" Yates diplomatically replied: "As you'd expect, there's a huge amount of work going on internally about making sure we've got the right resources in the right places."

Finance and investment

In the short term, water companies potentially stand to financially benefit from Brexit, assuming forecasts of low interest rates teamed with c2-3% inflation rises come to pass. Ofwat's Water 2020 senior director David Black said early in July that there hadn't been a huge impact on the cost of debt immediately after the vote, though companies will obviously be considering their financing options in light of the latest developments. Listed company share prices have held up well compared with those of companies in many other sectors. Ofwat has wasted no time at all in telling companies it expects them to manage the trust and legitimacy challenge that would result from divergent investor/customer fortunes (see box p4).

In the area of investment, water company management teams will however be concerned about the prospect of a loss of funding from European institutions – in particular the European Investment Bank (EIB). Water UK's head of corporate affairs Neil Dhot said this was in fact "the biggest thing troubling our board members at the moment and in effect is really the only crystallised risk so far".

Dhot reports the EIB has been incredibly supportive of UK water, even front loading loans to the UK for the first half of the year to demonstrate solidarity with us as the referendum approached. But good will can only go so far: there will simply be no funding available once we leave because only a tiny percentage of EIB funds go to non-EU countries and then it has to be for a physical connector such as a bridge or gas pipe. Dhot said: "We certainly won't be pumping water across to Calais and vice versa [and] therefore [have] zero chance of EIB funds." He said the key question now is what the UK government does with its 16% share of EIB equity – will it be put into a UK infrastructure investment fund with similar rates?

Black remarked: "One of the key sources of financing in this sector has been from the EIB and it is very unclear whether it will have any ability to provide finance in the next two years, let alone what may happen beyond that time. So it may be that an important source of financing is no longer available to companies."

Market reform

One final area to consider is how the market reform agenda might be affected by the Leave vote. There is widespread consensus that business retail market opening will continue largely unaffected. Encouragingly, both parliamentary Houses found time to debate the retail exit regulations early this month, despite the wider political chaos. Yates advised: "In terms of the work on Open Water what I can say is it's clear that the government will continue to deliver its agenda and this includes the implementation of existing legislation such as the Water Act 2014. And so the implementation of the new retail market is still on track for April 2017."

The loose schedule for opening the household market, however, could well be thrown off course by Brexit. On practical grounds, there may simply not be parliamentary time for it given the swathes of EU disentanglement ahead (the same issue is relevant to abstraction reform legislation). On political grounds, the new government may not have the stomach right now to deal with the emotive issues household retail competition will throw up – price changes, metering and so on – particularly with energy competition many miles from being deemed a success. MOSL chief executive Ben Jeffs observed: "It would take brave political leadership to extend water competition [to households] at this time."

One final thought. Before his departure from the water brief, Rory Stewart spoke of growing the UK's presence on the world stage by stepping up the export of our water capabilities: our knowledge and skills, our engineering and our world class regulatory and governance model. The wholesale review that Brexit has forced would be a good time to redouble our efforts on that front and make a virtue out of the necessity of renegotiating our relationship with both Europe and the wider world. TWR

INDUSTRY COMMENT: A VIEW FROM WWF

As the implications of the referendum result sink it, it is all too easy to get caught up in the gloom, worried that, post Brexit, the UK will reclaim its title as the dirty man of Europe. However, the benefits of improving our water environment are clear – for customers, for resilience and for wildlife. The Water Framework Directive has been crucial to this and importantly, is enshrined in UK law requiring an Act of Parliament to change it. So it's likely to be with us for a while to come.

Even with a potential Brexit on the cards, the next price review will be the greenest ever. The industry is innovating with ecosystem and catchment approaches delivering clean, secure water supplies at a fraction of the cost of traditional assets. There's huge scope to replicate and upscale – bringing big savings for customers as well as the environment. In PR14 customers told companies loud and clear that they wanted more investment in the environment - in some places, going above and beyond statutory requirements, to invest in cleaner rivers and beaches by tackling sewage pollution.

As we look ahead, climate change and population growth are huge challenges and we cannot let the referendum vote distract us from dealing with them. Investment in natural capital now will ensure that tomorrow's customers have clean, secure water supplies and that the services companies provide are more resilient.

The Water Act 2014 gave Ofwat a new resilience duty which means that they have a legal requirement to actively promote, through their decision making process, "a range of measures to manage water resources in sustainable ways, and to increase efficiency in the use of water and reduce demand for water so as to reduce pressure on water resources." This alone should see more action on water efficiency and metering in particular.

While the challenges we face are huge – wastewater is one of the biggest threats to the water environment now, and unsustainable abstraction is a significantly growing risk - I feel encouraged that the water sector seem ready placed to deal with it. The right thinking and discussions are going on and we must not let uncertainty about Brexit distract us. So while we wait for the Brexit fog to clear, the water sector should crack on delivering environmental commitments already made to customers and developing green PR19 plans.

By Rose O'Neill, water policy manager, WWF-UK.

WALES EDGES TOWARDS CONTROL OF WATER AND SEWERAGE

Wales Bill looks at devolution while governments consider practical implications

The latest Wales Bill, under scrutiny in the Commons at the time of writing, looks set to give the Welsh administration new legislative competence over both water and sewerage policy as part of further devolutionary moves.

The earlier Silk Commission which looked at Welsh devolution recommended that water and sewerage should become devolved matters. The existing version of the bill – as drafted – only covers sewerage but ministers have made it clear that water will be added once the intricacies involved are agreed between the UK government and its Welsh counterpart.

The two administrations recognise that water and sewerage devolution is complex given the fact that river basins and current company networks don't follow administrative boundaries.The English government set up a Joint Governments Programme Board with the Welsh Government to look at the practical issues facing the efficient delivery of water and sewerage services, consumers and the water companies.

Junior Welsh minister Guto Bebb told MPs on 12 July: "That work has concluded and the government is considering the evidence before deciding whether and how the recommendations will be taken forward. We will consider carefully the interests of customers and businesses on both sides of the border before reaching that decision. It should be stressed that this issue is under consideration." TWR

By Roger Milne

NOT FOR PROFIT GLAS CYMRU TURNS 15 AND GIVES CUSTOMERS SPENDING SAY

Welsh Water is consulting with customers until 19 September on how it should spend its c£30m annual financial gains going forward. Customers have been invited to choose between a number of options in an online consultation, *Have Your Say*. These include:

- Money off bills
- Extra help for people who struggle to pay
- Investing more in assets to continue providing high-quality services
- Investing now to help save money in the future through renewable energy and innovation
- Supporting educational and recreational projects in communities
- Speeding up improvements for people who experience repeat problems with their services.


Chris Jones

Chief executive Chris Jones said: "This is an unparalleled move to give a real say over how we spend any returns we achieve – and reflects how our not-for-profit status is rooted in working with customers and for customers."

The move came shortly after Glas Cymru celebrated its 15th anniversary since setting up as a not-for-profit company and acquiring Welsh Water. Jones told a celebratory Westminster reception last month, hosted by secretary of state for Wales Alun Cairns (who has remained in post in Theresa May's government), that "Across the board, there is a lot to be proud of… but also plenty plenty more to do." Cairns volunteered that the innovative nature of the company – it was the first and remains the only not-for-profit water company – gave him cause for "questions, even a bit of scepticism" initially but that the initiative managed to gain cross party support and its subsequent achievements are cause for "great celebration".

The following are among the achievements cited by the company:

Customers. Welsh Water is placed second in the SIM league and leading in a Consumer Council for Water customer survey released last month.

Compliance. Huge progress has been made in many areas since 2001, including health and safety (40 accidents in 2001; 20 this year); annual pollution incidents down from 351-112; leakage down 248-180Ml/d; and drinking water quality up 99.76-99.98%.

Costs. Operating costs are down 7.2%, while all other companies have seen operating cost increases.

Community. 55,000 customers on assistance tariffs, with another 45,000 targeted by 2020.

Bills. Lower in real terms than in 2001, with sub inflationary rises each year. This year £32m was returned to customers in the form of service improvements, assistance schemes, renewable energy investment and the development of leisure facilities after the company recorded its best year in overall performance since becoming not-for-profit in 2001.

Investment. £1.4bn in water and £2.3bn in wastewater. Forty seven Welsh beaches have Blue Flag status, up from 18 in 2001.

Gearing. Down from c90% to c60% today.

Jones said the not for profit, customer owned structure had proved "a great model for a long term industry like ours – shareholders can drive short term investment decisions". He added it had proved motivational for Welsh Water staff and that everyone strived to achieve the company's mission to earn customer trust every day.

The company plans to raise the profile of its unique structure in coming months, with a view to leveraging it for further customer benefit. This includes through the screening of its first television advert which is specifically aimed at raising awareness of the *Have your say* consultation and the company's not-for-profit status. Welsh Water said: "Our research has shown customers want a bigger say in how we operate, and there's growing trust in the company when they learn about our not-for-profit model, as well as greater support for the use of our gains in long-term investments."

VIEW FROM THE TOP

From championing water resources for London and developing a new model for infrastructure delivery to retail exit: Martin Baggs reflects on six years at the helm of the UK's biggest water company.

In just a few weeks, Martin Baggs will bid farewell to the highest profile job in the water industry. As chief executive of Thames Water, he is responsible for the UK's largest water company, and the company that serves the capital. He is best known as a champion of infrastructure and in particular of the urgent need to shore up London's water resource position. But the day before we meet, Thames has announced plans to exit the business retail market and transfer its 200,000+ non household customers to independent retailer Castle Water. So inevitably we start with that.

Baggs opens with: "For us, it was entirely the right thing to do, but that doesn't mean it was an easy decision." For Thames as for all water companies, Baggs says it's decision time. "One of the biggest challenges for the companies is to have a very clear direction and decide what they want to be in life. This has been the case now for a while and I think it's going to get more and more so."

For its part, Thames has decided to focus "on the retail household customers in our region but more importantly on the wholesale services to our household and our non-household customers in the region and not get distracted by what's happening from a wider national position". He describes billing and cash collection in a competitive market as a "highly specialised activity" and one in which Thames is not best placed to perform. The deal allows Castle Water to play to its strength – providing retail services tailored for business customers on a national platform.

He explains the company's decision has been well received by key stakeholders Ofwat and DEFRA: "They see this as a major move in opening up the market." Staff were briefed on the day of the announcement and while there was initial shock, Baggs says most understood the direction once it had been explained.

He sees other companies facing similar choices imminently, and the opening of the retail market driving wider change in and around the south east. "The patchwork quilt of south-east England doesn't make sense. There are great companies out there and I've worked with a few of them but if you look at what's actually happening now, particularly on the retail side, you have to ask the question: does it make sense for all the separate companies to roll out their separate systems with all the overheads and costs that are being incurred, all to do what is basically exactly the same thing? It doesn't make sense. I think there's got to be a huge opportunity there for some form of consolidation through some kind of vehicle of those back office retail functions."

Fleet of foot

Industry watchers are unlikely to have been entirely surprised about Thames' decision to exit, but choosing Castle as the area's new retailer is bold. Castle has built itself a solid reputation in Scotland as a customer focused and innovative young supplier, and has so far managed the transfer of Portsmouth Water's 17,000 customers with apparent ease. But taking on all the capital's businesses plus those in Thames' other regions has a different order of magnitude. For Baggs, it is precisely Castle's size and position that make it a good choice.

He explains: "The new entrants to the market have got a significant advantage over the incumbent companies because they are far more agile, far more fleet of foot, innovative – they haven't got the legacy and all the baggage that we as the large incumbents carry. As a result they can actually move far quicker and have got a far lower cost base then we have. So they have got some real advantages there and I think ultimately if they can actually provide the service that we have aspired to and go beyond that level of service and also at a lower cost to customers, that's got to be a good thing."

The deal came out of a private arrangement between the two companies rather than a formal tender type process. Castle Water will take on retail activities for business customers on behalf of Thames Water in tranches from autumn 2016 and then acquire the business retail operation when the competitive market opens nationally from April 2017. "So it's not going to happen overnight," Baggs assures. "We are going to migrate customers over to Castle Water over a period of time so actually when we do get to April 2017, it becomes a date in the diary, not a massive changeover point. That would be high risk and ultimately high risk for the customers."

A migration plan kicked in immediately covering all relevant aspects including: systems (Castle will use its own), processes, customers and communications. A small number of Thames staff, typically in key account management functions, will transfer to Castle and Thames will redeploy as many others as it can manage. "The big aim for us has got to be to avoid any compulsory redundancy wherever we can. We've given that commitment very, very strongly," Baggs assures.

Readiness and risk

But for Thames the decision to exit amounts to far from downing tools. Clearly its commitment to being an effective wholesaler remains unchanged – and it needs to be one that can deal with multiple retailers not just Castle "because we do see the market developing". On the retail side, it is committed to doing everything it can to ensure the transfer process is seamless. Baggs comments: "If you enter into this sort of arrangement, you have got to be certain it's going to work. So we've been putting a lot of work into understanding how is the migration going to work? How's the system going to work? How is the transfer going to work? Even down to the minutiae of some of the processes and systems that will be in place afterwards as well."

Moreover Thames will work with Castle on interactions with MOSL: "As a business we've got to make sure we are ready for all eventualities so we will continue with our programme in place. Clearly the programme is going to change with Castle Water involved, but that doesn't mean we don't need to ready the business – we do."

Baggs observes too that it will be critical for all market participants to be ready on time. "Everybody's got to be ready because the businesses are going to work through a central market operating system." The interfaces between individual companies also need to work, particularly in the south east where water only companies frequently bill on the incumbent sewerage provider's behalf. Baggs emphasises the effort put in by the industry and MOSL over the past 18 months has been "absolutely phenomenal".

He continues: "If people aren't ready, it won't be for the want of trying and hard work. There's a huge amount of commitment and dare I say also a huge amount of investment. This has cost the industry far more than anybody expected…you maybe could say that is a bit of a sore point for people. But actually as an industry we have accepted that, we've got on with it, were delivering it. You don't hear people bleating about it and you don't see anybody putting up any barriers – quite the opposite. I think that everybody realises that we need to make this happen."

Nevertheless, risks clearly remain. Baggs: "You've taken all these companies right across the industry and you're trying to set up the central system that's actually going to manage all the data and interfaces from all those companies, in the timescale that it's being delivered – I've not seen it done this fast before. And I've not seen it actually done this way before where you're concurrently running building, testing and migrating all at the

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same time. And if you run it at that rate, there's going to be some risks and there's going to be some problems."

Household retail

Referencing the energy market, Baggs sees domestic and commercial retail as two distinct activities and confirms Thames' interest in the former despite its withdrawal from the latter. He confirms too that the company's investment in a new billing and CRM system remains on course and is still very much needed to serve the 95% of customers (households) Thames will be keeping. "So we are still very much continuing with that major programme. And that's very much a big message from the team here…we are still continuing with our plans, we are still investing heavily because everyone understands just how much these new systems cost to put in place – not just in terms of the money but also effort."

On the day Thames revealed its plan to exit to Castle, Ofwat published its cost benefit analysis on opening the household market to retail competition. Baggs' views on the merits of this boil down essentially to whether it would deliver benefits for customers. Paramount is the maintenance of service quality. He points out that water is a fundamentally different proposition to energy and telecoms, particularly in terms of quality and the consequences of failure. But if those service levels can be maintained and extra benefits delivered for customers on top, domestic retail is likely to have legs.

He says: "If I take my water company hat off and my Thames water hat off and put that all to one side, quite frankly if someone knocks on my front door and says 'Mr Baggs, I can provide you with one bill for water, gas, electricity and telecoms and at the same time you save £10, £20, £30 – will that be of interest to you?' The answer's got to be yes. Now fundamentally and quite frankly, we're all a little bit lazy – we all like an easier life and we all like saving money. So why wouldn't you say yes if behind all that, you can still have the level of service that you need?"

An open household market would, though, take water into a very different world: a world of bundled services underpinned by smart metering and other technologies; in time, smart homes. Baggs says he fundamentally agrees with Ofwat's analysis on bundled service prospects, explaining: "From a retail point of view, there is no difference in the process for a water bill, gas bill or electricity bill; it's about managing data and managing a service to customers. And the more you can bundle these services from a retail perspective, the better value proposition you can offer."

It is the above two challenges – business retail market opening and improving customer service – that Baggs identifies as his successor from 1 September Steve Robertson's biggest challenges.

Resources and infrastructure

Shifting the conversation on to more familiar ground, one of Baggs' legacies from his time at Thames will undoubtedly be his work championing the need for new water resources for London and the South East. He and likeminded others have pushed the issue up the political agenda and we are potentially on the brink of seeing some concrete results.

The statistics on supplies to London are frankly terrifying. The population of the capital is set to swell by 1.5m people over the next decade or so in an area that is already water stressed. High level water restrictions would cost the city broadly £300m a day and could cause long term damage to its reputation. A reservoir (one of a number of supply side options) would cost around £1.5bn. Baggs points out rather starkly: "If it ever came into use, it would pay for itself in five days. It's a no-brainer. And if you had to put those sorts of water restrictions in London, it wouldn't just be for five days; you would probably be talking about four, five or six weeks."

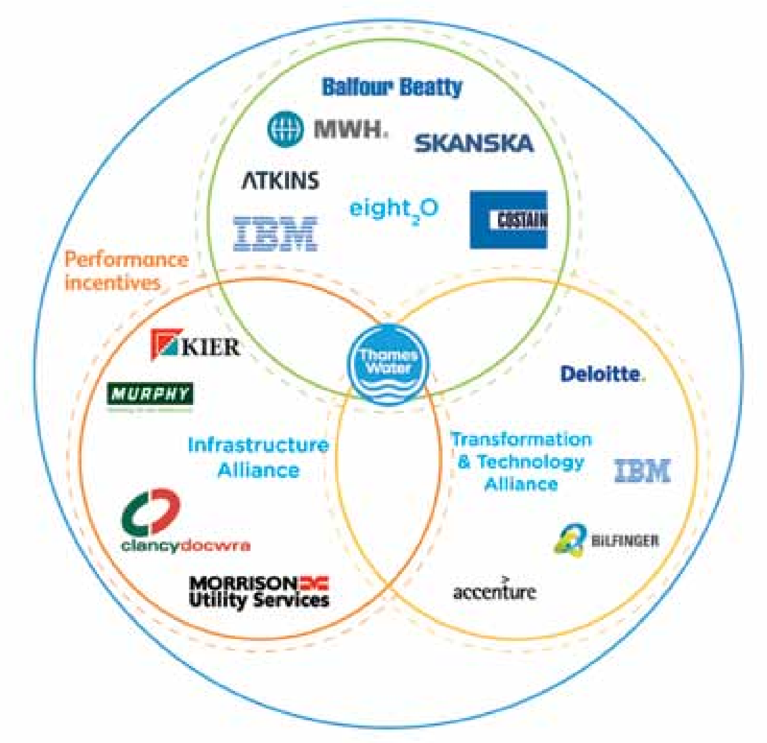
He recalls specifically the highs and lows of London 2012 – "the absolutely superb" Olympics on one hand and the horrendous prospect of restricting water on the other. Baggs: "In February/March time, all the models looking at what would happen in the summer predicted we would have to put water restrictions on in London at literally the same time as the Olympics. You imagine it. My fear that year was being in front of a TV camera during the Olympics, trying to explain to people why we have water restrictions on in London."

In the event, by an incredibly slim chance, London was saved by a deluge. Baggs recalls: "The quote I always remember was from Richard Benyon [then water minister] that 'we dodged a bullet'… The probability of us receiving the level of rainfall we received that year was 3%."

On the back of such close shaves, Baggs argues: "One of my big passions – and I have many of them – is there is no national plan for water. How ridiculous is that?" Local investment by individual companies has served well, he says, but "when you start looking at the bigger picture, you do get into areas of national infrastructure… If you're looking at large transfer schemes, large desalination plants, large storage solutions – you're into a national plan."

Baggs believes the scale of the challenge is such that an extensive combination of supply and demand side solutions will be required, but that a new reservoir in particular has a lot going for it. "A new reservoir is such a straightforward easy decision. There are hurdles to overcome, sure, but it's robust, it's resilient, its sustainable and actually it's a superb asset from an environmental point of view." He looks back wryly on the 2012 Olympics-saving deluge,

THAMES' SUPPLY CHAIN ALLIANCE MODEL



pointing out that when the rain came, "where did it all go? Straight down the river and out to sea. We have more than enough water in this country. It's how we manage it, catch it, store it and use it when you need it. It's not rocket science."

He observes that: "The real challenge for a reservoir is it would take between ten and 15 years to build it. Well, probably four to five years to build it, but eight to ten years to get all the permissions." And that is why he says we need a national plan; to underpin decision making and fast track planning, as happened with the Thames Tideway Tunnel. "The big, bold, brave decisions are really key; a commitment that this is the right thing to do and that this is a nationally significant infrastructure project."

In this, outgoing water minister Rory Stewart will be missed. He has moved to DFID in the recent May government reshuffle. Baggs says Stewart "has been a great champion of pushing some of these debates forward" – including on asking the industry to do a 50 year water resources report, which is due to be finalised shortly. "High level political support on any of these issues is absolutely key," says Baggs, adding that so are cross party support and an immoveable end date.

The Thames chief is nevertheless feeling optimistic that the new minister will continue Stewart's work, particularly as wider momentum has gathered over the past year. Baggs cites specifically the National Infrastructure Commission, to which he has had an advisory role, and the rise of resilience in wider industry debates.

"That resilience debate is a really important one. If we don't develop the long-term plans and consider what this means, you will end up driving and driving efficiency. I have no issue with that at all – it's got to be there on the table. But like any system, the more you drive efficiency, the more you increase risk. What we've been doing for the last 20 or 30 years is we have been taking the headroom out of the system…we've taken the ability to deal with large-scale shocks out of the system. That's what resilience is about – the resilience of the system to deal with shocks and recover." He confesses: "There is a part of me when I look back to 2012 just wishing that dry weather had continued for another three or four weeks because it would have driven some big decisions."

There are other relevant live initiatives too, as scoped out in DEFRA's March document *Creating a great place for living*. These include a new Strategic Policy Statement setting out strategic objectives and priorities for Ofwat; joint work on water trading and upstream markets; a decision due in autumn on whether there will be a National Policy Statement for Water to fast track planning under Nationally Significant Infrastructure Project rules; and a decision also due in autumn on whether the secretary of state will take up the levels of service prescription powers scoped out in the Water Act.

If Baggs set out to put these issues on the map, he has achieved that.

Groundbreaking models

Baggs leaves a legacy in three other areas of industry wide significance – and even beyond that.

Direct procurement: "I'm extremely proud of the Thames Tideway Tunnel not only from an engineering point of view but as a new model for the industry for a separately regulated, separately financed stand-alone business. There is no reason why you couldn't use a similar vehicle to develop a reservoir or a whole host of infrastructure projects [in and outside the sector]." He adds, however, that a one size fits all approach is not appropriate as the nature, type and size of each project will be relevant considerations.

Supply chain alliance model: "Five or six years ago, quite frankly some of the major contractors wouldn't work for Thames Water. We had a reputation for being a big arrogant organisation who never listened to anyone…I think today that relationship has changed and we have some great relationships." In the past 18 months, Thames has formed three major alliance (see diagram) and within each, each partner is on an equal footing and shares risk and reward. "People always talk about it as thinking outside the box. What we're trying to do is make the box as big as possible to tap into our partners' knowledge and experience. I think this is a game changer for the water industry, and we've now got people from other sectors coming to talk to us, asking how have you done this and how does it work?"

Health and safety: Baggs speaks passionately about keeping all his people – employees and contractors/suppliers – safe at work. He has personally driven a new health and safety aware culture in Thames, including by setting up an ideas sharing website; holding an annual conference; and kitting out each and every employee with a card which entitles them to call a halt to any activity they are worried by, with Baggs' personal authority. In the last three years, the number of accidents at Thames has halved.

> **One of my big passions – and I have many of them – is there is no national plan for water. How ridiculous is that?**

Baggs seems to have mixed feelings about moving on, explaining it is both the right thing to do and that he has a heavy heart in doing it. He says he will miss Thames' people most of all, talking in warm and personal terms about people at all levels of the organisation, from the executive team to WaterAid fundraisers, graduates and even work experience staff.

But he has much to smile about. "When I look back over my time at Thames Water, I like to think I am leaving it in a far better place than I found it. I like to think the performance of the business is far stronger than it had been; we hit targets year-on-year and I like to think our investors are happy with the way we have performed. Our relationships with our stakeholders and regulators are in a better place now than they were a few years ago – and that is down to performance. You can't have a sensible discussion with people unless you have achieved good performance."

In structural terms, too, Baggs reports: "I don't think Steve needs to lose sleep over the way the business operates. We've made huge progress. The fact we now have a separate water business, wastewater business and retail business – that has created a real mindset change in the business. It has increased ownership and accountability and what goes hand in hand with that is increased empowerment."

Above all else, Baggs characterises his time at Thames as being about "doing the right thing". He says he is extremely proud of the team and after six years with plenty of change, he hopes it is now a better, safer and happier place to work. TWR

MINISTER MOOTS MORE RESERVOIRS

It is worth spending more to build resilience to drought, former water minister Rory Stewart urges.

Rory Stewart told the All Party Parliamentary Water Group on 5 July that his gut instinct is we will need to build more reservoirs to make the country more resilient to drought.

The water minister, who has now moved to DFID, urged the government to keep an open mind on spending more on infrastructure investment, adding it may need to convince "those sceptical, serious people at Ofwat…it may well turn out to be the case that it is worth spending a little bit more to make ourselves resilient to drought".

Any investment should be underpinned by consensus-building in society, on the back of an open conversation, Stewart said. In particular, there is a need to be "more honest with people" when talking about resilience: what kind of risk are we willing to adopt; how should that risk be measured; and how much risk are we prepared to take? He gave an example: are we prepared to go through a drought every four to five years, or would we prefer to pay more to reduce that risk down to every 30 years?

The minister argued we shouldn't pin our hopes on the emergence of a new technology or a massive culture change in tackling the problem, as governments that are short of cash often do when faced with a challenge. Rather, it was better to "plan for the worst".

Responding on Ofwat's behalf, Trevor Bishop said the economic regulator's benchmarks for giving the go ahead to investment had always been cost benefit analysis and willingness to pay. This would continue to be the case for the most part, but resilience is "unique": cost benefit analyses cannot be easily done, and relying on willingness to pay would boil down, for example, to asking customers to pay £5 more per bill despite the fact they may never see the benefit in their lifetime. "How can we close that leap of faith?" Bishop questioned, observing this amounted to "an uncomfortable place for an economic regulator to be". TWR

HIGH HOPES FOR THE NATIONAL INFRASTRUCTURE COMMISSION

A lot of people are pinning their hopes on the National Infrastructure Commission (NIC) to properly deliver an independent and unbiased assessment of our long term infrastructure needs. The strength of feeling on this was evident at last month's Indepen Forum, where infrastructure industry leaders, regulators and policymakers gathered to chew over the role, remit and prospects of the new Commission. Among the themes discussed were:

NIC independence: One participant made a plea to the NIC to fiercely defend its independence. He said the infrastructure challenges it faced were not new but if it did not act independently, its voice would be lost, (he remarked Infrastructure UK's voice was lost once it effectively became a sub-body of Treasury). Another member pointed out that not only must the Commission be independent, but it must demonstrate its independence publicly. Yet another urged the NIC to make the most of its unique position to challenge existing structures and practices if they are not optimal, as well as independently assessing infrastructure needs. However one member observed that viewing the NIC as a source of virtue because of its independence is too simplistic. The notion that politics gets in the way of good decisions is flawed – politics is part of the picture; there are choices to be made, processes to work within. The NIC should look for the sweet spot where it is influential but does not pretend the government is an obstruction.

What is long term? The enthusiasm of Forum participants from the water industry was dampened somewhat by the c30 year horizon over which the Commission plans assess national infrastructure needs. Many indicated this was too short a period for infrastructure that, in some cases, has to last three or four times as long. One described the timeframe as way too under-ambitious, noting that the Victorian engineers on whom we still rely for transport and water infrastructure catered for generations to come. He added that we need bold, brave decisions like they took to deal with challenges such as the population of London swelling by the equivalent of the populations of Birmingham and Edinburgh. Looking just 30 years out will drive short termism and simply isn't long enough given it can take ten years to get a project signed off let alone built.

Multi-scenario: There was consensus at the Indepen Forum that the NIC's assessment must cater for a multi-scenario future: it must not be about making a prediction and providing for it but rather about accepting the possibility that the future could unfold in a variety of different ways, and hence that infrastructure choices must be about finding the best fits. This would require stakeholders to adjust their expectations to a new future environment; one which is more dynamic (where things get reinvented as circumstances change) and more complex. Investors in particular will need to think differently: the days of 40-year low-risk index-linked returns are on their way out. One member said "no regrets" investments – actions that make sense whatever the future looks like – should be the priority. Such investments have the additional advantage of being more likely to be consensual, and hence lower risk.

Proactive not just reactive: One member pointed out that in considering future infrastructure investments, we need to be mindful of the fact that investment choices can actually make the future, rather than just react to it. Each choice can trigger reactions and over time mini ecosystems can grow up around the choices. So we need to think about what we actually want, rather than purely how we should react.

Who pays? According to the Forum, one of the big unknowns about infrastructure investment is how it should be funded. It boils down to two basic choices: either users pay or taxpayers (national or local) pay. One member observed it has become convenient for government to pile costs on to users – but that this is deeply regressive and needs to be addressed. Another suggested that if users are to pay for infrastructure investment, giving them the power to accept or reject certain proposals on a willingness to pay basis would be short sighted. Had Bazalgette asked Londoners if they were willing to pay for the capital's sewer network, we are unlikely to still be reaping the benefit of it today. This would cut across the PR14 model of basing discretionary spending on customer views – a model set to be deepened at PR19.

INDUSTRY COMMENT

GOING DUTCH

Pooled funding could deliver catchment outcomes more effectively than silo spending. Indepen's David Baxter looks at lessons from the Dutch.

Could a single system operator achieve better outcomes from the money currently spent by 50 or more entities in each catchment on flood, drought and a good quality natural environment? The answer is undoubtedly yes, but how this is best brought about is less straightforward. In June, Indepen asked Professor Paul Leinster, former chief executive of the Environment Agency, to chair a roundtable discussion to look at how we manage catchments in England, including what we could learn from the Dutch. The main area we explored was governance, and the need for ways of accelerating improvements in flood risk, resilient water supplies and water quality, without increases in funding.

Dutch approaches to water level management are highly regarded, including their model for governing spend on water and flood schemes, the water boards (Waterschappen). These are probably closest to the idea of an integrated catchment system operator. Dutch catchment governance has evolved over 700 years. It is not obvious that the Dutch approach should be imported, wholesale, to England. But that does not mean there are no lessons to be learned.

The Dutch consider the merits of catchment investment around a series of outcomes, not just those relating to flood protection. Economic, social and environmental issues are all considered at the same time. Their water boards function on the basis of interest – if you pay, you have a say. Decisions are taken through a democratic process where voting rights and charges are assigned to sectors according to their degree of interest in the outcomes from catchment management. Rural catchments have more farmer votes, urban catchments have more town council and business votes. These features could be explored in England with allowance for the English context.

The views that emerged from the roundtable panel included the following:

- *One-size will not fit all and any proposal to improve co-ordination should flex to local geographic and economic needs. Other things being equal, Local Enterprise Partnerships and local councils must be involved and the scope of the discussions should include how investments in catchment resilience can support environmentally sustainable growth.*
- *Co-ordinated governance of all funding that provides water-based outcomes is the aim. This is relevant to the National Infrastructure Commission and their consideration of how to assess long-term infrastructure needs (see report on facing page).*
- *Water companies should be involved in catchment governance. They are responsible for about one third of the £13 billion spent on catchment management in England each year (see table) and many aspects of integrated river basin management. However, they must be transparent with, and accountable to, their customers when considering their involvement with the delivery of wider catchment outcomes.*
- *The circumstances are right for water companies to take on new roles. Ofwat and the Environment Agency encourage a focus on outcomes and the government and Ofwat support markets and innovation to meet the challenges of resilience and improved services to consumers.*

To take things forward, the panel felt that water companies should take a lead, but not necessarily aim to be the leader. They identified the keys to success as collaboration and taking a broad view of the most appropriate approach to resilience. A range of pilots would be needed. Ideally, these would create opportunities for community involvement and a market for innovative solutions.

The panel saw the flood partnership funding mechanism as one area that could evolve. The panel discussed an approach that could be tested in this area. Under this, small (initially) allocations from some of the 50 or so sources of catchment spending could be combined into a pool to pay for common catchment outcomes. The pool could make payments to communities and land managers in return for adaptions that reduced the need for other catchment spending. The payments could be linked to the avoided costs of asset schemes.

The UK faces an uncertain economic climate. Ensuring better outcomes from the various sources of funding through a local integrated framework will be attractive in any event. To make this happen, organisations have to put their best foot forward. It would seem that water companies have support from others to do this. TWR

ANNUAL SPENDING ON ENGLAND'S CATCHMENTS (£M) - BY PURPOSE

PURPOSE	TOTAL ENGLAND (£M)
Pollution control and enhancing natural capital of land	**7,653**
Rural land management	2,444
Water company sewage treatment	1,877
Pollution control	1,831
Green infrastructure	761
Conservation management	354
Catchment regulation	302
Green growth	84
Flooding, drainage and raw water supply	**5,699**
Water company - drinking water collection and initial treatment	1,389
Flood damage	1,280
Water company - sewers and drains	1,195
Drainage and irrigation	931
Inland flooding - capital	412
Inland flooding - operations	230
Research	165
Inland waterways	97
Grand total	**13,353**

David Baxter is a partner at Indepen. Indepen's report on the roundtable, will be published on www.indepen.uk.com at the end of July.

BRISTOL FASHION

Luis Garcia has had to take tough decisions – including restructuring Bristol Water and closing its defined benefit pension scheme – to meet the demands of market reform and the CMA's final determination. He reflects on leaving Bristol in good shape to deliver for the future.

In water sector circles, Bristol Water is probably best known right now for its recent trip to the Competition and Markets Authority (CMA) to dispute its PR14 price settlement. The appeal led to a more favourable settlement than Ofwat had put on the table but nonetheless made Bristol controversial in an industry where every other company swallowed its determination without complaint.

Outgoing chief executive Luis Garcia points out, however, that this reputation is completely at odds with the way Bristol Water's customers and other local stakeholders view the company. In and around its area, he says Bristol Water is well known and well respected. It has a long tradition as a community company, having been trusted to supply top quality drinking water for approaching 170 years.

Garcia elaborates: "There is a perception from the sector about Bristol Water [because] we have been to the CMA. They are completely different to the views that our customers have. Our local reputation is very strong. We are part of the community and embedded in the history of the region. It's very common to find people with bonds with the company."

Garcia, who is imminently leaving Bristol to rejoin Suez after seven years at the helm, argues "we need to deal with that" difference in perception because on the ground, the company is doing just what the regulator has indicated it wants – putting customers at the heart of everything it does.

Bristol can cite a number of concrete achievements to back its customer-focused claim, including:

- A SIM score up from 80/100 to 86.2/100 in the last year.
- In its annual customer service tracking survey, 83% of customers rated its service as excellent, very good or good, compared to 69% the year before.
- A steady improvement in its reputation scores and value for money ratings, along with a significant reduction in written complaints and negative billing contacts.
- In partnership with Wessex Water, its affordability assistance is seen as industry leading; the company has also just introduced additional support for those on Pension Credit.
- It is spearheading a local but inspirational and potentially exportable initiative encouraging Bristolians to save money, stay hydrated and reduce marine plastic pollution by swapping bottled water for free tap water when on the move in the city (see box, Refill Bristol).

New operating model

These achievements have been delivered against the backdrop of an undeniably difficult year for the company, and the industry as a whole. All incumbents have had to adjust to the new and demanding totex operating environment, and have had to ready themselves for market reform. In common with its peers, Bristol has been deeply immersed in preparations for business retail market opening, including developing a wholesale/retail interface and a wholesale services desk.

It also has an eye on upstream reform. Developments in the water resources area are particularly pertinent: Bristol owns three major reservoirs (Chew, Blagdon and Cheddar) and a number of boreholes but nearly half the water used in its area comes from rivers outside its area of supply including from the Severn. The company was one of two water only firms Moody's highlighted as being at increased risk of a market approach to water resources, given its >

BRISTOL'S PRICE APPEAL – THE KEY NUMBERS

	Bristol business plan	Ofwat final determination	CMA provisional	CMA final
Wholesale totex	£537m	£409m	£429m	£428.6m
Base expenditure	£385m	£318m	£346m	£340m
Enhancement expenditure	£152.3m	£91.2m	£83.1m	£88.6m
Average annual bill	£187	£155	£159	£160
Cost of capital	4.37%	3.6%	3.65%	3.67%

geographical needs and asset/cost allocation.

So it is unsurprising to find that well before the CMA result, Bristol had already embarked on a programme of activity to ready itself for this new world The cornerstone of this work is a new operating model, which started to take shape back in 2014 and continues to be implemented today.

Firstly, Bristol has completely separated off Water2Business, its business retail joint venture with Wessex Water. Garcia says that while demanding, the business retail preparation work is "on track" and that the company's data is of good quality, in part because it already operated (again in partnership with Wessex) a separate billing operation for 15 years.

Secondly, the remaining business has been separated into a production unit, under production director Alan Marvin, and a network unit under network director Gary Freake. Household retail (for now at least) falls within the customer services segment under director Ben Newby. Within each unit, decision making is joined up regardless of whether it concerns opex or capex. Three execu-

A PATH THROUGH PENSION REFORM

Over the last few weeks, two major business stories have shone a light on just how deep corporate pension fund liabilities can be. First, Tata's attempt to sell its UK steel operations, where the government put forward proposals to change the pension system for steelworkers to cut the deficit and hence make a sale more attractive. And of course the collapse of BHS, where MPs have taken a keen interest in the juxtaposition of a £500m+ pension fund deficit and dividend payments of the same order over the 15 years of Sir Philip Green's control.

Away from such high profile controversies, many water companies are looking to reform their pension scheme arrangements – typically to move from defined benefit to define contribution schemes – on cost efficiency grounds. Clearly this is a highly emotive issue, which in some areas has triggered industrial action.

Garcia explains Bristol Water managed to hold off proposing reform of its defined benefit scheme as it adjusted to totex and market reform, but was forced to change its stance once the CMA had ruled it must cut prices by 16%. He comments: "It's the kind of measure you don't want to implement. It's a difficult one. We had this possibility there but we only decided to implement it afterwards (after the CMA ruling)."

Before 2001, Bristol's employees had access to a final salary scheme, called the Water Companies Pension Scheme (WCPS). It closed this to new joiners in 2001, offering them instead a defined contribution scheme. So at the start of 2016, 131 members of staff, around 28%, were on the old scheme, with all the rest on the new. In February, Bristol proposed closing WCPS and entered into a six week period of consultation with staff, unions and trustees.

It was motivated specifically by the need for greater control on costs at a time of increasing regulatory pressure for efficiencies and tough price controls; volatility in company cash flow caused by variable funding positions; and consistency of benefit provision. Garcia explains: "We needed to deliver efficiency and be more in control of our costs. You have to permanently fund the pension deficit and there is considerable volatility in the requirements in the schemes. You can have the deficits changing very quickly. For us in our current circumstances, with our final determination, the uncertainty is problematic."

He raises two further motivators. First that alternative cost saving measures could have been even worse for staff: "If we didn't implement the pension measures, we would struggle and we would have to look at other measures that could affect more people." And second the matter of "financial differentiation" – between those on the defined benefit as opposed to the defined contribution scheme.

The WCPS closure consultation featured both company/trustee briefings and the provision of external independent advice for staff. Bristol ultimately took the decision to close WCPS and the next day transitioned all 131 affected employees onto its defined contribution scheme. Garcia describes the whole process as "emotional" and was obviously hard for some staff to swallow. But the company has managed to avoid industrial action and now, a few months later, has been able to move on.

Garcia believes this is in part due to the process Bristol followed in handling such a delicate situation: "When we decided to implement the closure of the pension scheme, the first thing I would say – the most important thing – is we have the highest respect for our staff. We ran an extremely open process with the staff and made clear we were consulting and hadn't made a decision from the start; an honest and open process. Effective two-way communication and a genuinely consultative process resulted in a solution that better matched the needs of those affected."

How did the news go down? "At the beginning, as you can imagine, the staff were surprised we had started this process. They did not trust that we would run an open approach and said we had already decided and asked 'why are you doing this?' But we did bring everybody into the process and made it interactive. I personally met all of those affected (with a handful of exceptions on practical grounds). I had 12 meetings with ten people each, in a small room so they could ask any question comfortably. We briefed and reported back. So there was very high respect for everyone."

But Garcia says the reasonably smooth process was also in part because many employees understood it had tried to fight its corner and secure higher revenue, but had been knocked back. Garcia: "We improved the determination with the CMA, but the line has been pushed and we've had to respond…We've done this from a position of need."

Communications manager Alison Jennings offers some lessons the company learned during the process that could be useful to others who need to close defined benefit schemes:

tive roles straddle the units: chief executive; CFO (Mick Axtell) and strategy and regulation director Keith Hutton.

Garcia explains: "The main driver is to be more efficient for our customers through the implementation of the totex model. And we have separated network and production also keeping an eye on upstream reform… For us this is a big change in structure. We had operations and maintenance in a different department to capital and asset. Now asset planning has all the data coming from operations and decisions are taken there; operations are a delivery unit. Everything is integrated."

The new structure will result in an overall reduction is staff from 527 to 463. The reduction has largely been achieved through voluntary leavers but has inevitably and unfortunately led to redundancies, with the company now over 90% of the way towards completing the project. Undeniably this has been a difficult time for both staff and company, with the network and production teams most affected. But Garcia argues the measures taken have been necessary and will help ensure Bristol Water can continue to supply customers as it has done for the past 170 years. "The message is the measures we've put in place are tough but that we will continue to be Bristol Water and that means a lot to people, both staff and customers."

Garcia adds the changes leave the company in a far stronger position to deliver for the future and that the past year's good performance is evidence the new operating model is working. Among the achievements it can cite here are leakage outperformance; drinking water quality up year on year; and a fall in the number of negative water quality contacts received over the last few years, with 2,329 in 2015 below its target of 2422.

Final determination

But of course on top of the challenges that are common to all – totex operation and market reform – Bristol also had a final determination imposed on it that it considered very difficult to live with. As the table shows, the CMA's ultimate ruling was substantially below the company's business plan numbers in all crucial areas – though the CMA offered some wins on Ofwat's offer, including a 10% higher cost allowance for projects that made the final cut; a better result for financing costs, regulatory targets and financeability; and an approach that Bristol considers resulted in a more balanced outcome and valuable lessons for the industry moving forward.

By its own admission, the company is now emerging from a year of tough financial reconciliation necessitated by the determination. On top of the operating and structural changes detailed, it has been forced to make tough changes too – in particular to the pensions arrangements of its staff (see box).

Looking forward, Garcia says Bristol Water will be determined to build on this year's initiatives to ensure it continues to deliver improved customer service alongside enhanced operational efficiency. Its precise future direction will of course depend on the views of its new yet-to-be-named chief executive. But the future trajectory of resilience policy will also be important. Bristol Water's proposed new Cheddar 2 reservoir was not allowed by the CMA. Outgoing water minister Rory Stewart recently indicated he saw value in spending more on infrastructure investment to safeguard supplies (see report, p12). Should his successor progress the sentiment into policy, Bristol's customers may yet get the new resource their water company thought they needed. TWR

REFILL BRISTOL

Refill Bristol was developed as a Bristol 2015 European Green Capital project. It was the brainchild of project City to Sea, which aims to stem the tide of marine pollution from urban use: 8m tonnes of plastic waste enters the sea from land each year, including many plastic water bottles. Around 200 businesses and venues across Bristol (from cafes and restaurants to opticians, dentists and doctors surgeries) have signed up to enable people to refill reusable bottles with tap water for free, as an alternative to buying single use plastic water bottles at up to 1000 times the price.

Bristol Water has partnered with City to Sea to help spread the word and the uptake – through customer communications; by developing a new free map app showing the 200 participating venues in Bristol; through a summer of events and activities designed to get people hydrating when on the move, including a pop up water bar at the city's Pride party in July and at Bristol's famous International Balloon Fiesta in August; and by selling durable bottles at half the standard retail price.

Do not raise "fairness" as a justification for change: "When we set out the key reasons that the company was making the proposals, as well as cost control and volatility reduction, we explained that we wanted consistency and "fairness" in pension provision among all employees. This acted as an inflammatory statement to the unions and the employees affected by the proposals. From the viewpoint of the members of the scheme, the final salary schemes were part of their employment package when they joined, they had no choice in that and they had based their future financial planning on the schemes remaining open." She adds there was a sense that the company was "trying to set colleague against colleague by highlighting the difference in the two types of pension arrangements… this of course is the last thing the company would wish to do. In hindsight, we should have used the word and concept of consistency only."

Don't pre-empt what employees want. Bristol opted for an open consultation, not initially proposing anything other than transferring people into the defined contribution scheme. "The advantages of this approach are that we were able to respond to feedback throughout the process, effectively re-designing it as we went along," says Jennings – for instance, by funding individuals' consultations with an independent financial advisor. Jennings adds: "The feedback that we have received from many affected employees since closure is that while they were disappointed with the ultimate decision to close the schemes, they believe that the consultation process was fair and that people were listened to."

Work through the unions. More than half of the affected employees were not members of the two unions that Bristol Water recognises. Many of these employees formed themselves into a "pension action group" and requested formal recognition from the company, similar to the status that unions are granted. For legal reasons, this was not possible, but Bristol undertook to be responsive to the group and to provide it swiftly with any information requested. The unions provided a healthy challenge and helped shape the outcome for all the affected employees.

WATER FOR LIFE

35 years on, and 38 countries and 25m people later, and the water industry's partnership with WaterAid is as strong as ever. The whole sector should be proud of what has been achieved for many of the world's poorest people.

This year, 21 July is a special date in WaterAid's calendar. As well as marking 35 years of delivering safe water and sanitation projects around the world, the charity is celebrating 35 years of a unique partnership with the UK water industry.

As many readers will know, WaterAid was set up by water industry leaders in 1981. Richard Flint, Yorkshire Water chief executive and a member of WaterAid's trustee board since 2011, observes the charity has been "constant and growing" ever since (see box, p22). It now works in 38 countries across Africa, Asia, Central America and the Pacific Region, and has reached almost 25 million people with safe water and 24 million people with sanitation. "That shows the power of a good idea," Flint says, adding: "If the founders could see what has been achieved, I think they would be very, very proud."

Richard Flint

We do not do the work of governments, but we can be a voice on the shoulder of governments.

Hearts and minds

The backbone of this achievement has been the enduring support of water companies and their contractor partners. At a corporate level, those who have followed WaterAid's founders in leading the industry, have also followed in their support for the cause. But the sector's partnership with the charity goes well beyond the executive ranks: it involves many thousands of staff at all levels; millions of customers; and many other partners who work with or around the sector. It truly is a whole industry thing – something that is inherently unusual in business. Plus, it is something that has proved itself strong enough to survive privatisation and multiple changes in individual water company strategies, owners and structures.

Flint's personal involvement in WaterAid is reflective of the breadth of the industry's commitment. He describes it as a "huge honour" to be serving on the charity's board for a second term, but has also fundraised at a grassroots level, including by "hobbling through the London Marathon" and "climbing various mountains". He makes light of these achievements, but note the "various mountains" include Mont Blanc and the highest peak in each of the six regions of the British Isles. Far from light, these feats show real commitment to the cause.

Flint follows a long line of water leaders who have gone the extra mile for WaterAid, including Severn Trent's former chief executive Vic Cocker. Cocker knew WaterAid's founding father David Kinnersley and was involved from the outset. He led Severn Trent's contribution as CEO between 1995 and 2000, and between 2001 and 2007 served as WaterAid's chair. "I still get involved with events and meetings today," he explains.

So what is it about WaterAid that so motivates the industry's people? "It's a heart and head thing," says Cocker. "The charity is about the business we do, staff fully understand and identify with the need for water and sanitation. They know how important it is, and they feel driven to help. WaterAid is actually part of the industry's DNA. I think there would be outrage if the partnership ceased."

Cocker's recollections of the origins of the charity and the way it picked up steam illustrate his point. He explains Kinnersley was senior economic advisor to the government's National Water Council and organised the Thirsty Third World Conference in 1980 after returning from a UN conference in Argentina in 1977 where the idea for a Decade of Drinking Water and Sanitation (from 1981-1991) was first discussed. "David saw the need, pointed it out to others and got them to come on board. At first it was the senior people on the Council [chairs of the water authorities], but they went back to their areas and spread the word and others quickly got drawn in."

Flint concurs with Cocker on the depth and spontaneity of the water sector's partnership with WaterAid. "As an industry, we are there to keep everyone safe from harm. That core value underpins what we did yesterday, it underpins what we do today and I think it will be there tomorrow." He continues: "The only thing separating the experience of the economically developed part of the world and those who don't have access to clean water and sanitation is about 100 years."

He explains that as a country, we and every other developed economy have first-hand experience of the problems – health, social and economic – that lack of access to basic services can bring. "Hundreds of thousands of children die every year as a result of diarrhoea related illness. We know how to stop it. We can stop it. That's what drives everyone to push on with the vision for everyone, everywhere to have access to safe water, sanitation and hygiene by 2030." Flint adds that the personal values of many of those who choose to work in the industry – at all levels – chime with these values, and that involvement with WaterAid is a unifying force, whatever else might be going on in the sector.

>

On top of these unifying core values, Cocker credits the professionalism and good governance of WaterAid the organisation for keeping the industry's faith. "Thousands of people contribute time, money and energy, and WaterAid has built goodwill and trust that it will spend the funds wisely on the ground. It has built scale in terms of beneficiaries and behaves logically and professionally – for instance in publishing its numbers transparently."

Extensive partnership

Today, the water industry's activities to support WaterAid are many and varied and include:

- **Extensive fundraising** – among staff, partners and (through WaterAid appeal leaflets in their bills), customers. Customers recruited through these bill inserts continue to donate £16.5m a year.

- **Volunteering** –from organising fundraising events and manning stands to project visits.

- **Awareness raising** – again this takes many forms, from educational sessions for schools and local community outreach to big splash activities such as an annual presence at Glastonbury Festival (ever since WaterAid was named as one of the Festival's official charity partners in the 1990s)

- **Campaigning/lobbying** – WaterAid believes influencing governments is key to addressing the lack of access to water and sanitation globally. Last year, campaigning efforts from WaterAid supporters helped to secure a dedicated goal for water and sanitation in the UN's new Sustainable Development Goals. Flint explains this lobbying function has grown out of WaterAid's experience with grassroots projects. "WaterAid has reached out to tens of millions of people and has built the credibility to talk with governments; to say 'you can do so much more' and to point out the wider economic and social benefits that come with clean water and sanitation…We do not do the work of governments, but we can be a voice on the shoulder of governments." For every £1 invested in water and sanitation, an average of £4 is returned in increased productivity.

- **Knowledge transfer** – as part of the current Global Strategy, companies are sharing their skills and knowledge with developing world partners to strengthen the capacity of local utility providers.

To provide a more concrete example of this support, Flint's company Yorkshire Water is mid-way through a five year campaign called the Big Wish, to raise £1 million to support WaterAid's work in Ethiopia – enough to bring safe water and toilets to 130,000 people. The company has also embedded WaterAid into its corporate strategy through its global safe water objective. Flint says: "Our people are changing lives for the better by dressing up as taps and toilets, climbing mountains, holding auctions,

WATERAID 1981-2016

WaterAid's founders

The key milestones in WaterAid's history are shown in the timeline opposite.

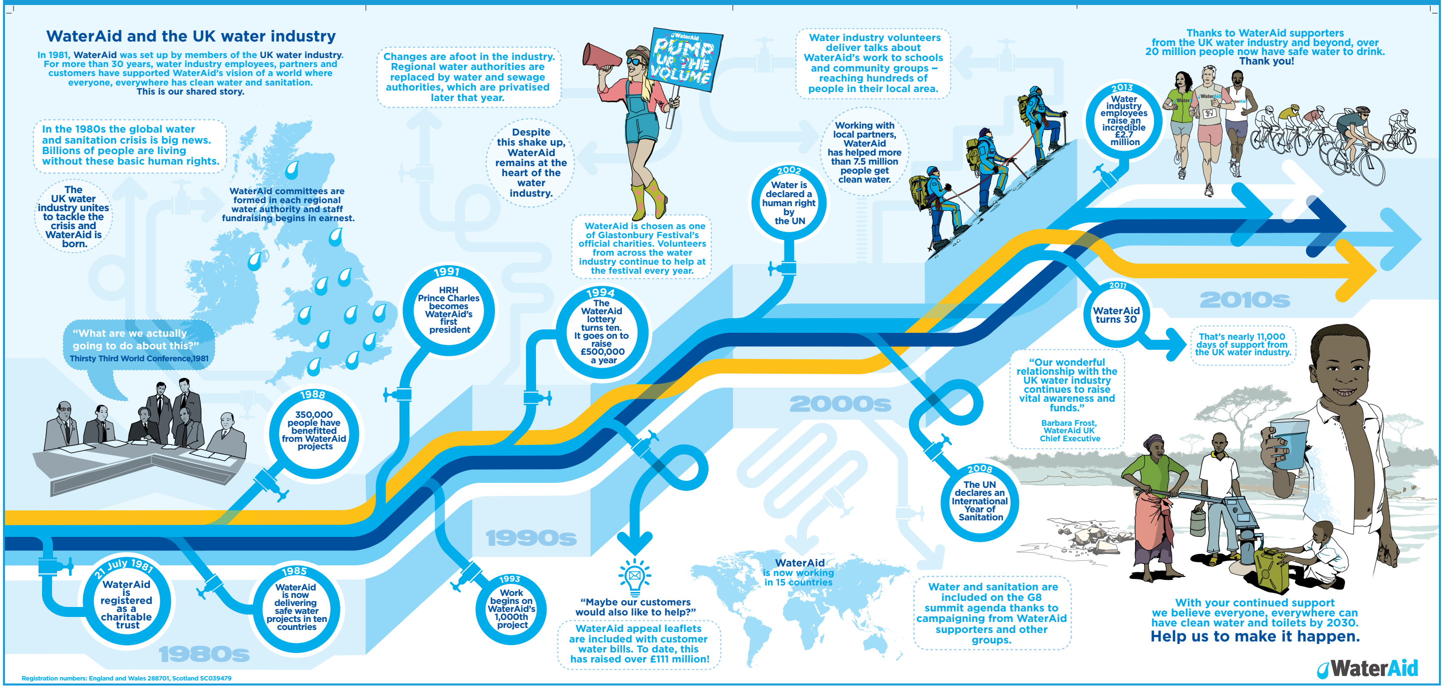
Cocker provides some personal recollections of WaterAid's growth and development. In the first 20 years, progress was slow but steady. By 2000, the charity was pulling in £10m a year and after that grew quickly; in Cocker's tenure as chair (2001-07) the number reached £35m; and by 2015 had risen to £85m – in part a result of the "hugely successful" idea to seek regular customer contributions by including WaterAid material in with bills.

Cocker observes that while the concept of supporting communities in developing countries is a no brainer, the ride hasn't always been smooth and at times, WaterAid has had to be bold. He recalls: "Occasionally, I wondered whether we had gone as far as we could. There was a particularly testing time in 2001 when we had a hiccup with funds and the board was told by the director of operations that we should increase the scale of operations (more beneficiaries); our auditors wanted us to put aside more funds as reserves; and our fundraisers wanted us to spend more on fundraising! The board had to choose…and we decided to do all three. It was a brilliant decision. Our supporters saw we had a big vision and the money came forward and we were able to carry on. Sometimes you have to think big."

In a related point, Cocker explains too that "along the way, the mission changed". He describes how Kinnersley set out to make a practical difference to specific communities using simple solutions and appropriate technologies. In the mid '90s, this "small is beautiful" approach gave way to WaterAid's current big bold vision: that no one should go without access to safe water and sanitation.

Today, the charity's stall is set out in a Global Strategy 2015-20 document called *Everyone, Everywhere 2030*. This title summarises its fundamental objective. One of the newer strands of thinking set out in the strategy is the commitment to transfer knowledge from the UK to local water providers, to build up their capacity and to make them more sustainable in the longer term.

KEY MILESTONES IN THE PARTNERSHIP BETWEEN WATERAID AND THE WATER INDUSTRY



organising golf days – the list goes on and on." He says the company is "on course – I think we will overachieve the [Big Wish] target". In addition, volunteers from the company are providing capacity strengthening support to utility companies in 20 towns in Ethiopia, and its 2.1m customers receive information about WaterAid with their bills.

2030 vision

Both Flint and Cocker believe WaterAid's mission to ensure universal access to safe water, hygiene and sanitation by 2030 is achievable, despite the many challenges on the road ahead. These include climate change, population growth and rapid urbanisation, paired with the need to access more finance, address social and economic inequality and change long held beliefs and behaviours around water and waste. Flint comments: "Is it achievable by 2030? Yes, because of the level of progress we've seen in the past 25-30 years. Can WaterAid do it by itself? Of course it can't. Can we achieve it by working with governments and others? Yes."

Cocker has a very similar view, pointing out that the number of those without access to water has plunged from 2bn in 1980 to around 650 million today. "We've made major inroads into it," he says. "The last bit will be hard, and will involve more advocacy and using government resources as well as our own." He adds that the continued link with the water industry is essential to achieve the 2030 goal: "Even with all the momentum which has been generated we cannot assume that success is inevitable. It is not just the money and enthusiasm that are needed but the technical insights of engineers , scientists and regulators in the industry. For instance, in India greater volumes of water used for sanitation will add to the pressure of demand on falling groundwater levels; there is a huge problem of sludge disposal; and a challenge of controlling private abstractions and effluent discharges. The physical, political and social context of these problems is different to the UK experience but insights based on experience of what will work are invaluable."


Vic Cocker

> **WaterAid is actually part of the industry's DNA. I think there would be outrage if the partnership ceased.**

There is still a long way to go: around 315,000 children die each year from diarrhoeal diseases caused by dirty water and poor sanitation; around one in ten live without safe water; and one in three don't have access to a decent toilet. Flint is convinced that however tough the challenge, water companies and their people will continue to support and encourage WaterAid and inspire others to do likewise. This is irrespective of increased competition in the sector and potentially the presence of new players. "I would be really, really surprised if anything in that underpinning belief changed," he says. "Market reform is in no way a threat but an opportunity," he continues, explaining more players in the sector means more opportunities for people to contribute to WaterAid's work. "The question [for anyone involved] is really straightforward: would you want your children to have clean water?" TWR

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MOSL RETURNS TO AMBER

MOSL is back on an amber rating. Chief executive Ben Jeffs moved its programme of work in support of the Open Water programme from red to amber status on 13 July, just two days before the one year anniversary of MOSL taking over from Open Water Markets Limited.

Jeffs explained the move derives from making progress on many relevant issues and is founded on the fact that he now has "a clear line of sight in our being able to exit the current testing phase of the programme and the start of shadow market at the beginning of October".

Jeffs said the following factors are among those underpinning his increased confidence:

- User Acceptance Testing of the core Central Market Operating System (CMOS) is well underway and progressing well towards completing on time by 31 July. Jeffs reported confidence was high in the accuracy of the system at a calculation level. User Acceptance Testing of the Settlement Engine, is now is underway to prove how the system performs with market data and against different market scenarios. A quality 'gate' has been established for 31 July and settlement testing will continue throughout August to further increase confidence.
- The market entry assurance process is well underway and business solution assessments are now starting to come through. These provide visibility of the detailed processes that companies will be working to throughout shadow and into the live market.
- Movement into the third data iteration cycle; data uploads are validating to ~90% on average, with some files completing 100% validation. Participant testing is underway, with 18 wholesalers and 15 retailers connected to the CMOS portal and more than 1.5m 'events' recorded..
- Data protection concerns have surfaced in the industry over the last few months, in particular relating to the loading of information on sole traders into the market. While they might qualify as eligible, the information on these customers may also be personal in nature, which presents difficulty for water companies as the data controller responsible. MOSL is actively managing this. It has altered its "sandpit" test environment to limit visibility of company data to other market participants, and is working through the results of a privacy impact assessment. A second "sandpit" environment will be deployed to allow users to test interoperability while protecting data during shadow operation.
- Two expert panels (one technical, one high level financial) have been appointed to challenge MOSL's test strategy, particularly where settlement is concerned.
- PA Consulting has been appointed to provide independent assurance and build the key processes required for shadow operation.
- Work has started on an ancillary systems strategy, particularly around the technology that will underpin user journeys.
- Progress is being made towards establishing MOSL as the enduring Market Operator.
- Following a contingency planning workshop with DEFRA and Ofwat to look at potential pitfalls ahead, Jeffs said he "cannot currently foresee any delay to the start of shadow market or the opening of the live market in April 2017".

Remain vigilant

The CEO cautioned that the positive news should not detract from the fact that "there is clearly still a long way to go". He added: "Amber does not mean all the issues have gone away."

On the specific issue of market participant readiness, Jeffs advised that from a MOSL perspective, all companies are "still reporting they are ready – we have yet to see any market participant put their hand up on anything fundamental. Nobody has said it is not do-able."

MOSL will know more in the next few weeks: market participants are due to submit their next readiness self assessment at the end of July. The last quarter report showed significant progress had been made between January and April, with wholesalers/retailer progress towards complete readiness at around 70% on average at April. Jeffs reported he was "very pleased with what I am am seeing and hearing" more recently, with companies that were identified as being 'behind' making excellent progress. Additional information will be gathered on 2 August when MOSL is running a workshop with Water UK to discuss any "potential bear traps" that need addressing.

In a letter to CEOs, Jeffs asked for further support in three specific areas:

- Loading all eligible non-household premises, not just those that are currently billed.
- Managing the use of (particularly manual) workarounds through additional controls to protect the integrity of the market dataset. Workarounds are being widely deployed in the effort to get systems ready for shadow operation.
- Ensuring teams learn as much as possible from the shadow market phase to improve the quality of market opening.

MOSL put its programme on red in February due to a number of issues during the first build phase for the CMOS. Individually none of the issues were considered to be insurmountable, but collectively they posed "a significant threat" to key milestones in MOSL's programme.

One year on

In partnership with market participants and other stakeholders, MOSL has achieved a phenomenal amount in its one year of existence. Jeffs puts this down to the "relentless efforts" of his team but also to the hard work and dedication of the industry and of CGI in delivering CMOS. In addition to delivering its core work programme, MOSL has responded to market participants' requests and supported supplementary work in a number of areas including data protection, bilateral arrangements between wholesalers and retailers, trade effluent arrangements and planned and unplanned events. TWR

BIG BUSINESS KEEN TO SWITCH BUT NEEDS INFORMATION AND CONFIDENCE

A survey by the Major Energy Users' Council finds £250k+ spenders hungry for clarity on post April prices, supply options and readiness.

Large business customers are highly engaged by the prospect of a choice of water retailer, but need the market to offer stronger "pull factors" to act than are currently on the table. That was one of the findings of research conducted by the Major Energy Users' Council (MEUC), a membership organisation for the UK's largest utility customers.

In May, the MEUC surveyed its members – typically multi site businesses with annual water and sewerage bills of over £250,000 – on their attitudes towards the April 2017 water market. The questionnaire was drawn up and analysed by the MEUC's Water Market Policy Group, which comprises MEUC customer members Bernard Matthews, YPO, Mace and Enterprise Inns; water retailers Business Stream, United Utilities/Water Plus and Anglian Water Business; and sector experts Gemserv, Waterscan and Ken McRae.

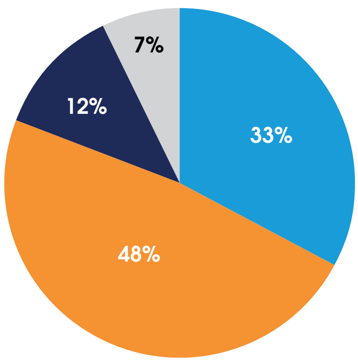
The research found major users to be very interested in, and highly engaged by, the incoming water retail market: 81% said they are considering switching at least some of their sites (see chart 1) and 59% of those with sites in Scotland have switched already. Two-thirds (65%) of multi site customers favoured a single supplier. Attitudes towards working with a third party intermediary were muted (see chart 2).

Moreover, these customers can see a prize worth having, with two benefits – cheaper prices and consolidated billing/rationalised administration – standing head and shoulders above other options (see chart 3).

AMONG MEUC MEMBERS' KEY CONCERNS WERE THE FOLLOWING:

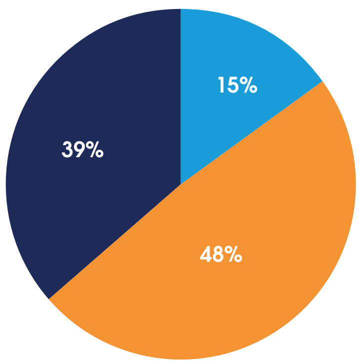
- "The market won't be competitive enough: margins too low, too few players (big 6 scenario), not encouraging new entrants. Systems wont be ready in time to enable a smooth switching process. Too much complexity."
- "Currently our main supplier offers a very good customer service and is very reactive / attentive to our requirements. I would hope that the opportunity to widening their focus as a retailer, whilst reducing the customer's access to the wholesaler, won't negatively impact this."
- "As customers we are not being given enough information and that it won't deliver the pricing structures / single supplier billing that we want."
- "Average metering / fixed supply costs will rise , as they have with gas and electricity."
- "Disruption in changing supplier and promises with account management and additional services not being delivered."
- "I fear that it might make everything more complex, and that the market isn't really ready for the change"
- "There is too little margin for companies to really offer anything worth the hassle and risk of changing."
- "Inaccurate billing data. How will reporting / repairing of leaks be dealt with if I move away from my current supplier."
- "Bureaucracy and not being able to compare like for like prices."
- "Not enough margin - Ofwat needs to act."
- "Ensuring the data is correct so new suppliers can bill accurately and on time."
- "That it will become as complex and convoluted as the gas and electricity markets."
- "Preparing a robust dataset in time, in order to approach market."
- "Poor data or lack of margin in the retail business to make customers attractive."
- "Level playing field. Competitive market. Accurate and consistent data. Lower prices."
- "Market not opening on time and there being insufficient water companies to choose from."

CHART 1: ARE YOU LIKELY TO SWITCH SUPPLIER FOR AT LEAST SOME OF YOUR SITES



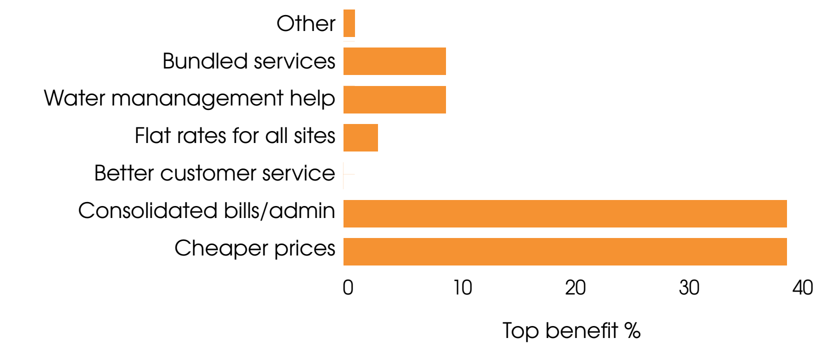
As soon as the market opens or shortly after **33%**
Once I have seen how the market is working **48%**
No **12%**
Don't know **7%**

CHART 2: DO YOU PLAN TO WORK WITH AN INDEPENDENT BROKER?



Yes **15%**
No **48%**
Don't know **39%**

CHART 3: WHICH OF THE FOLLOWING BENEFITS IS YOUR TOP PRIORITY TO RECEIVE FROM YOUR WATER SUPPLIER?



In the dark

However, large customers are desperate for more information. Only 21% felt water companies and others (government, regulator etc) have provided enough information to customers regarding the new market options (see chart 4). Specifically, MEUC members want clarity on:

Post April 2017 prices from prospective retailers as soon as possible. However, customers seem unlikely to get clear price information much more than a few months ahead of market opening because of regulatory schedules.

Which suppliers will be active in the market by April 2017 and how to switch. The MEUC has called for a website equivalent to Scotland on Tap which offers this information to customers in an independent and unbiased way. Ofwat is now working on this (see p35).

Market and water company readiness. The MEUC policy group said: "We are aware of the various readiness and assurance initiatives going on. However there has been little in the way of communication with customers on the state of play and our members fear there could be switching black spots if some participants are not adequately ready." In fact the quality of the market is so important to these large customers that 73% said in the event of a trade off between opening on time and delaying opening to ensure the market is delivered at a higher quality (fully tested, better quality data etc), they would settle for a delay (see chart 6).

CHART 4: WHAT MORE WOULD YOU LIKE INFORMATION ON (TOP PRIORITY)?

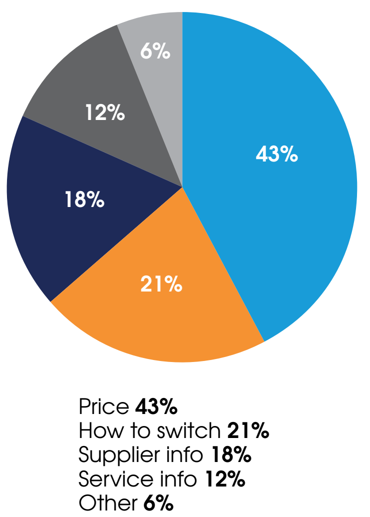


CHART 5: WHICH OF THESE ISSUES DO YOU BELIEVE IT IS MOST IMPORTANT TO ADDRESS BEFORE THE MARKET OPENS?

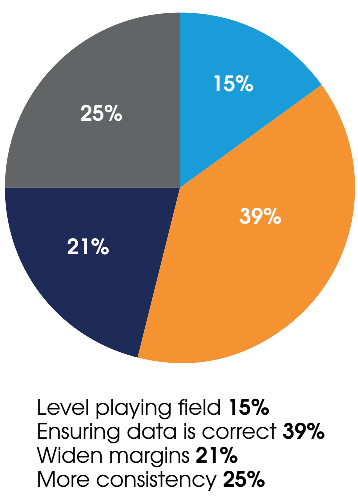
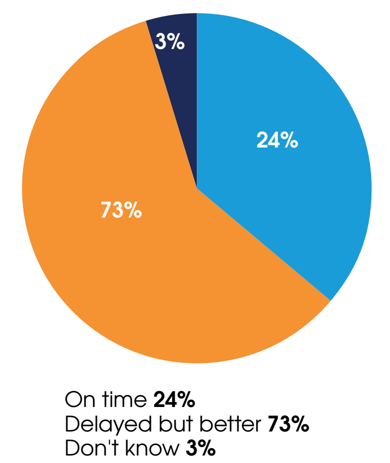


CHART 6: IF IT COMES TO A TRADE OFF BETWEEN OPENING ON TIME AND DELAYING OPENING TO ENSURE THE MARKET IS DELIVERED TO A HIGHER QUALITY (EG FULLY TESTED, BETTER DATA QUALITY ETC), WHICH WOULD YOU PREFER?



Expectation and concern

Elsewhere, the research found large customers sceptical that the market, as scoped out currently, would actually deliver what they want; the 39% who see cheaper price as their top benefit, for instance, believe this is jeopardised by low margins. Others felt their desire for choice could be restricted in practice should consolidation limit supplier numbers.

Complexity was also a frequently cited key concern – in particular, regarding: reduced access to the wholesaler, switching problems, billing problems and lack of clarity/comparability between suppliers. A major concern – the largest in terms of which issue MEUC members saw as the most important to address before the market opens – is data quality. 39% said it was their top priority for action. In addition, 88% said they would welcome the opportunity to verify the data held on their sites by the central market system (see chart 5).

The box sets out some of the comments made on key concerns. There are many strands of concern, but key themes that emerge include lack of competition; lack of readiness; complexity; and cost outweighing benefit. TWR

DOWN TO BUSINESS

The patchy water company geography of south east England will make the area an early retail battleground. Business Stream's purchase of Southern Water's non household customers plants it firmly at the centre of the fray.

Business Stream's purchase of Southern Water's non household customer book last month places the experienced retailer as sewerage supplier across the whole south east corner of the country, and water supplier across substantial parts of it. Nestled uncomfortably in its new patch, however, are water-only companies Affinity, South East and Portsmouth. Business Stream chief executive Jo Dow confirmed it was "absolutely" her company's intention to pitch water supply services to its new sewerage-only customers, adding the cluster of water only companies in the area was "partly why the Southern acquisition was so attractive".

Business Stream has long held intentions to play in the English market, having been subject to an almost inevitable fall in market share in Scotland since 2008. The Southern deal came about as the result of a strategic review the company undertook 15-18 months ago, scanning the horizon for opportunities of various sorts including acquisitions but also joint ventures and other arrangements. Dow said factors important to Business Stream included the size of the customer base, the nature and segmentation of the customer base, and the geography. Southern ticked all its boxes, including in the geography category its location among a patchwork of water only companies. Business Stream is already working with boundary companies on an operational level, and Dow is well aware that "split service provision offers both opportunity and risk".

While both South East and Affinity will have to respond in some way to the new situation, the fall-out in the Portsmouth area will be particularly interesting. Customers there will from April 2017 find themselves in the interesting position of having two new suppliers: Castle Water (for water) and Business Stream (for wastewater). Though they will be used to two separate retailers (Portsmouth and Southern), it seems likely that both ambitious retailers will look to be customers' single supplier, putting the two Scottish companies in direct competition for that business.

Dow said Business Stream offers around 60 different services packages in Scotland and expects to make all of those available to Southern Water customers. She noted that would be a starting position and would flex according to local customer requirements: "We have no assumptions that customers in the south want the same thing [as those in Scotland]." Dow added enigmatically that "as an organisation, we are always looking for the next big thing," hinting perhaps that there is more to come.

Meanwhile Castle Water has built a reputation for customer driven contracts and innovative affinity partnerships. Its chief executive John Reynolds confirmed the transition of Portsmouth Water customers had gone smoothly: "We have carried out the first successful bulk upload of customer data onto our systems; we've commenced invoicing; we've transferred payments; we've commenced providing customer service – and I'm pleased to say very few customers have noticed."

The experience will be invaluable as Castle now faces the challenge of taking on all of Thames Water's non household customers, following the incumbent's announcement last week that it plans to exit to Castle when the market opens (see interview with Thames Water chief executive Martin Baggs p8-11, and Castle report, p32).

Buying and selling

Business Stream's Southern acquisition, for an undisclosed sum, is what Dow described as a "massive step forward" for the Scottish supplier and signals further consolidation in the market as retailers look for a way through low margins. Dow explains her company's key motivators for the purchase were scale (organic growth alone would have been "incredibly difficult" she explained, because of the low margins); efficiency (costs will now be able to be spread across a customer base that doubled overnight); and the establishment of a foothold in England from which to grow further.

The deal makes Southern the first water and sewerage company to decline involvement in the forthcoming competitive market – though its decision was rapidly followed by a similar announcement from its northern neighbour Thames. Mark Field, Southern's head of non household retail, explained his company had extensively researched customer requirements and had concluded that to be successful, retailers "need to compete nationally". This would be difficult for Southern given the geographical patchwork of the south, the investment required for what is a fairly small prize and the low margins. The company concluded it was preferable to focus on developing other capabilities – for instance, around metering and the household sector – and chose Business Stream to sell to because of its proven track record; its scale and ability to offer enhanced capabilities for customers; and its values. "Most [water companies] can operate," said Field. "But do they have the creative capability to compete?" Business Stream points out it has saved customers more than £133 million and helped them conserve over 24bn litres of water since its home market opened in 2008.

Transition

Southern Water will transfer its 105,000 non household customers to Business Stream (unless they actively switch to a third party supplier) when the market opens in April 2017. This will make Business Stream the third largest business retailer in the country with 11% of the eligible market, behind the United Utilities/Severn Trent joint venture Water Plus and Castle Water.

Dow: always looking for the next big thing

Customers will legally transfer to Business Stream when the market opens, but Dow said the deal had been six months in the planning and that many would be moved over ahead of this, in a "managed service" type arrangement. This will start with a pilot of, among others, some of the south's largest customers, enabling Business Stream to test its processes and systems and lower risk for day one of the open market. Dow said that while data quality presented one of the obvious challenges ahead, her concern was in the round to offer "a great customer experience" starting with a seamless transition.

Field emphasised Southern's priority too would be to safeguard the customer experience through the transition: "Exit means exit, but there's still a job to be done." His to-do list included the following:

- **Ensuring data quality** – he envisaged "sleepless nights over the completeness and accuracy" of the data Southern will pass on.

- **Customer communications** – DEFRA's requirements are clear. Field said Southern was looking to personalise communications with customers and engage with key influencers such as the Federation of Small Businesses. He said some large customers had already been contacted and had been largely "positive" about the change. Dow specified that joint engagement with customers is a key part of the acquisition contract.

- **Arranging a final bill** for 100,000+ customers.

- **Aftercare** – customers would inevitably "continue to pay us and contact us" post exit, and this must be effectively managed.

- **Wholesale effectively** – Southern has created a wholesale team, with dedicated retailer relationship managers who will act like account managers to retailers. The firm will also need to ensure compliance and build a wholesale culture.

Details of how interactions with MOSL will work were still being bottomed out when the deal was announced. Dow said her aim was for Business Stream to take responsibility for Southern's retail side interactions with the central market, while the incumbent will obviously remain responsible for wholesale. MOSL chief executive Ben Jeffs emphasised his organisation "can be flexible" and is perfectly willing to "explore different business models" as companies recast themselves ahead of market opening.

Southern confirmed there would be no compulsory redundancies as a result of its decision. Around ten employees will transfer to Business Stream to provide continuity of service and maintain existing relationships with customers from a local base. In addition, there will be up to 40 new jobs in Edinburgh, primarily in billing, back office and customer service functions.

Beyond the south

Dow did not rule out further deals – in fact she said the company had "a few other irons in the fire from a retail perspective" – but she made it clear that Business Stream's immediate focus was "to do this [Southern transition], and to do it well – we don't necessarily want to be the biggest, but we do want to be the best." She argued the company's customer-centric nature even persists when it loses customers; that in a key example it has worked with Anglian Water Business and Scottish Water to ensure the transition of the public sector in Scotland to the east of England based retailer is as smooth for the customer as possible.

In terms of rivals on the landscape, she said her company was "never complacent" and that its experience in Scotland had taught it that "you can't underestimate anyone". While the large incumbent retailers seem to pose the biggest threat, niche players had proved successful too, as Castle Water's fortunes show.

In the coming months, aside from focusing on a seamless transition of Southern's customers, Dow's eyes will be on market and company readiness. She sits on DEFRA's Assurance Group. While central market arrangements remain challenging, she is buoyed by MOSL's recent shift from red to amber status (see report, p23) and is more concerned about whether all water companies will be ready in time to act as effective wholesalers. She believes it remains the case that companies are at very different stages of readiness, with some well along the way and others having underestimated the change required. "The clock is ticking now; the market isn't very far away. I do keep wondering who is going to blink first," says Dow.

She mulls: "Can you open a market if you don't have all of the players ready?" noting that perhaps that depends on the size of the unready companies. More information will emerge as the market moves to shadow operation and in the immediate term she hopes MOSL's move to amber status will "flush things out" – that any company hoping to hide behind an unready central market will not have that luxury.

Dow is of course alert to the prospect of domestic switching in England within a few years. For her, the crucial issue in taking that decision should be "is it in the best interests of customers? Can it deliver benefits?" Her view is that it would be better for everyone to wait and learn from business retail market opening before leaping into a household market but she acknowledges that if the decision is taken to go ahead, Business Stream would be "very interested in that massive market" and could draw on its extensive experience serving SMEs in Scotland. She agrees with Ofwat's conclusion that the market would be "absolutely ideal" for some sort of multi-utility retail offering. TWR

UP FOR A BUNDLE

Should the government opt to open the residential retail market, multi-service bundling is a strong prospect. What this would mean for water suppliers is just one of many questions posed by Ofwat's residential retail cost benefit assessment.

Ofwat has produced an upbeat assessment of the costs and benefits of introducing retail competition into the household market. This includes three out of four market scenarios that show a surplus of benefit over cost, and the possibility of an innovative, technology-led market that could transform residential retail as we know it.

The study follows the government's November 2015 request that the regulator evaluates the costs and benefits of introducing competition to the residential retail water market in England. Ofwat has since conducted an extensive programme of work, which has included: commissioned research from Accent on customer views (see box); qualitative and quantitative analysis; drawing on expertise from inside and outside the sector; and a commissioned study from KPMG on lessons from energy (see also Industry Comment, p30-31).

Accent's customer side work found appetite for choice in principle, with over half of customers supporting it. To help work through possible costs and benefits, Ofwat modelled outcomes against four scenarios ranging from one with widespread innovation and strong customer engagement, to one with disengaged customers and weak competition. The details and some qualities of these scenarios are set out in table 1.

Ofwat seemed in buoyant mood when it presented its findings mid July. Its press release acknowledged bill savings would be at best modest (£6 – well shy of the c£100 the average customer said would be worth switching for) but it focused on the possibility of better customer service, innovation in offers and products, and environmental benefits. 45% of customers indicated they would consider switching on service rather than price.

Chief executive Cathryn Ross was quoted as saying: "The benefits are not only about lower bills. We think there is real potential for competition to improve customer service, generate new offers and innovations and make customers' lives a bit easier. We also think it could help the environment. In a competitive market it would make commercial sense for retailers to put more focus on conserving water and using it wisely. Over the longer term, this could reap impressive returns for the environment and the resilience of our water supplies. We see the potential for improved wastewater management too."

Bundled and tech services

The most optimistic scenario, if realised, would amount to a fundamentally different water retail landscape: one where water is bundled in with other products and services and sold by a single supplier; and one where technology is a key enabler. Ofwat embraced the concept of service bundling in particular, noting: "Savings are more likely to be achieved if multi-utility retailers enter the market, as they could spread fixed costs over a larger number of customers and pass on the savings." Speaking to The Water Report, Ofwat chief executive Cathryn Ross identified two strands of relevant technology:

- **Customer facing technology** – including smart devices, apps and streamlined switching services. Ross said of Flipper-style autoswitching: "I expect that is something that could be taken up in the water sector".

- **Supplier side technology** – Ross cited as an example wastewater metering (already piloted by Wessex) as a means to

ACCENT'S FINDINGS ON CUSTOMER SENTIMENT

- 56% of customers support having a choice of retailer. Accent said: "There is a strong emotional response to the idea – it feels 'more fair' and gives the idea of 'freedom' rather than being tied to the local company." As well as a general belief in choice, customers expect the market to deliver keener prices and innovation in services.
- On average, customers require a 25% bill reduction for switching to be worth their while. Only 6% said a saving of 5% or less is worthwhile switching for – equivalent to around £20 on the average bill. This compares to the £6 saving Ofwat estimated as likely in its most favourable scenario.
- 45% said they would switch for additional services in the absence of price savings.
- Overall, most customers are satisfied with their water company. However, given that there is no competitive benchmark, customers find it difficult to assess value for money in water, in contrast to other markets.
- Customers expressed some concerns and reservations, including on potential market disruption, possible price rises, confusion about who to contact in an emergency and effects on customer service. They also question the extent of price savings available and whether it would be worth the time and effort.
- In terms of appealing benefits, almost all said lower prices are an appealing benefit of competition (87%). Improvements in customer service (74%), and offers of new services such as leak monitoring and water efficiency services (66%) also have wide appeal as benefits of competition, along with receiving one bill for both water and sewerage services (67%).
- Accent tested responses to four models of competition: restricted eligibility; open to all; multi utility and franchise. Qualitative findings show that if the water market is to open to residential customers, they want it to be inclusive, fair and want to retain control over the decision to switch or not. Limited eligibility models and franchise models did not tick these boxes. Of the remaining two models, the idea of bundled multi-utilities is seen to offer more advantages, such as better price discounts.
- Ultimately a market model emerged as most likely to appeal to people interested in switching. It featured
  - All customers able to switch.
  - The retail element is billing and customer service only.
  - A broader range of services is opened to competition so multi-utility providers enter the market.
  - Customers could have one bill solution from one service provider for all their utilities.

manage the likes of pressure on wastewater networks and surface water flooding.

Finally, she ran through a few additional services that might prove attractive to customers, including leakage detection, service innovations and water efficiency opportunities. She accepted all of these things were possible without domestic competition, but argued a market could deliver over and above what we have seen to date. Referring to the Scottish market, she pointed out retailers' biggest cost is the wholesale water charge they pay so they have a powerful incentive to reduce volumes consumed. "Pound for pound, they can make more money be reducing consumption by customers than by selling more."

Key questions

The findings provoke many interesting questions, some of which are as follows.

- Which scenario is most likely to emerge? Ross explained all four of Ofwat's scenarios are evidence based, and can be traced back in the emerging findings documentation. Which scenario is closest to the likely reality should the market be opened though is the key question. Ross said Ofwat had intentionally not made a call on this but had scoped out options for the government to consider as part of its decision making process. It has however conducted a sensitivity analysis which among other things illustrates the relative importance of each assumption underpinning the scenarios. Ofwat said it sought further evidence on this from stakeholders, particularly for higher-ranked assumptions.
- Would the 45% who say they would switch on service not price actually do so? Even among the largest business customers, where the potential for beneficial value added services is far greater, cheaper price remains a top driver (see research, p24-25). £6 savings are unlikely to excite many.
- Would multi-utility bundling spell the end of water companies as retailers? They could potentially be up against some of the slickest retailers in the country, or the likes of energy companies with established customer relationships. Ross rejected the suggestion that this could spell the end of water companies in retail. She said while bundling would be "a commercial challenge," companies could rise to it through making smart strategic choices – for instance, by partnering with other utility retailers.
- Would the forecast costs escalate? This has happened in the non household market, with costs now far outstripping those the companies were funded for. In addition, the analysis includes only the costs of implementing and operating the market not the costs of any policy interventions that might be required to mitigate the effects of market opening or to protect particular customer groups. Ross used the example of social tariffs to illustrate this point – specifically the possibility that a national social tariff could be required to ensure ongoing assistance for those who struggle to pay in a competitive environment. "If that had to be created, it would have a cost. But the level of that cost we cannot now reach a useful assumption on," she commented. Ofwat has highlighted such policy issues (others include metering implications and vulnerable customer protections) and Ross said it could undertake further work on them as required. For balance, it is worth noting that some benefits have been excluded too – for instance, some effects of water efficiency; potential improvements in wastewater management; and the impact on resilience and service quality for residential customers. Table 2 shows a breakdown of the NPV calculation for each scenario.

Ross urged water companies and other stakeholders to respond with views and evidence by the hard deadline of 8 August. Ofwat is working to an incredibly tight timetable to enable it to present the government with its final findings on schedule in September. TWR

TABLE 1 - BASIC CHARACTERISTICS OF OFWAT'S FOUR SCENARIOS

	Scenario 1 – Lower cost, widespread innovation, strong competition	**Scenario 2 – Lower cost, some innovation, good competition**	**Scenario 3 – Higher cost, some innovation, good competition**	**Scenario 4 – Higher cost, little innovation, weak competition**
Net cost/benefit (see other table for breakdown)	£2.3bn benefit	£1.2bn benefit	£655m benefit	£640m cost
Average saving per customer per year	£6	£4	£2	£1 additional cost
Preparation time	Two years	Three years	Three years	Four years
Level of residential market engagement	50% engagement in 10yrs	30% engagement in 15yrs	30% engagement in 15yrs	15% engagement in 20yrs
Acquisition cost per customer (based on 1% margin)	£8	£15	£15	£15
Bad debt impact	2% reduction	1% reduction	1% reduction	No additional progress

Source: Ofwat analysis

TABLE 2: PRESENT VALUE OF COSTS, BENEFITS AND NET BENEFITS, £M (2012/13 PRICES)

Breakdown of costs and benefits (£m NPV)	**Scenario 1**	**Scenario 2**	**Scenario 3**	**Scenario 4**
Retail savings in active share of the market	1,053	551	551	140
Retail savings in inactive share of the market	669	871	871	561
Wholesale spill-over benefit	811	496	496	228
Additional metering benefit	177	0	0	0
Additional bad debt benefit	856	455	455	0
Water efficiency benefit	389	98	98	0
Set-up costs (all parties)	-294	-326	-559	-564
Ongoing op. costs (all parties)	-441	-474	-801	-794
Switching costs (customers & companies)	-893	-455	-455	-209
Total net present value	**2,327**	**1,215**	**655**	**-639**

Source: Ofwat analysis

INDUSTRY COMMENT

RESIDENTIAL RETAIL: WHAT WATER CAN LEARN FROM THE CMA'S ENERGY INQUIRY FINDINGS

PA finds lessons on engaging customers, increasing transparency, encouraging innovation and improving governance.

On 24 June, as we woke up to the news that the UK electorate voted in favour of Brexit, the Competition and Markets Authority (CMA) released the long-awaited findings of its energy market investigation. Although these were understandably swamped by Brexit, the rigorous and thorough examination allows us to compare energy and water, address the rationale for pressing ahead with household competition and consider what early lessons can be learnt from the CMA and built into the design of the water market. Certainly mixed views around the success of retail energy competition raise questions about whether a move to introduce competition for 24 million residential retail water customers is a good idea – for the customer or the industry.

The CMA found no evidence of collusion or tacit co-ordination, but it noted several concerns associated with domestic retail competition including weak customer response, lack of engagement, and the regulatory framework governing domestic retail competition, notably the Retail Market Review reforms (see box).

Given the fundamental characteristics that unite the energy and water sectors, these findings could be as relevant to residential retail water. Water, gas and electricity can all be categorised as necessity goods, with a low income - and price - elasticity of demand. They are examples of homogenous products which implies that price should be the most important product characteristic to a customer. A further implication is that customers may be less interested in engaging in these markets. The inevitable question is therefore what else can we learn from water's sister industry and specifically the findings of the CMA?

The importance of learning lessons from the experience of retail competition in other industries cannot be underplayed given the insights on what could work - and critically, what won't. While the findings of the CMA's energy market investigation run to hundreds of valuable pages of analysis, four key areas of remedial action can be identified: engaging customers; increasing transparency; encouraging innovation; and improving governance.

Engaging the disengaged

To facilitate a competitive market, companies need to face competitive pressures alongside a meaningful expectation that customers will make rational decisions. This should influence strategic decision-making by competitors around product and service offerings.

Unfortunately, energy's experience illustrates that customers do not always shop around for the best deals. They often languish on tariffs with incumbent suppliers, foregoing beneficial offers from other retailers. The CMA has proposed remedies to more effectively engage customers.

Firstly, the it suggests strengthening the role of Third Party Intermediaries (TPIs). TPIs often take the form of Price Comparison Websites (PCWs) and are utilised in many industries to cut away complexity and provide straightforward customer comparisons of competing offers. Recognising the potential benefits of TPIs, consideration should be given to relevant residential retail water customer requirements for PCWs.

Based on the current state of the energy market, this raises a number of questions. How can PCWs and the regulatory underpinning strike the balance between allowing innovation and ensuring consistency and customer trust? How can PCWs demonstrate independence and impartiality, given traditional commission arrangements? How can they ensure accuracy and consistency across the market?

Secondly, another CMA remedy is to establish a regulator-controlled database. This would provide information on customers who have remained on a default supplier tariff for more than three years to allow rival suppliers to target them. Ofgem has identified four customer segments with varying levels of inertia; their categorisation is based on awareness of competitive options as well as their proactivity in assessing these options and engaging with energy suppliers.

- ***The unplugged consumer (20%):*** *this group is highly disengaged and unlikely to have switched or changed tariff. Customers from this group are likely to be in the lowest social economic groups, over 65 and live in social or private rented accommodation.*

- ***The 'on standby' consumer (36%):*** *around 5% of this group have switched in the past 12 months and 2% have changed tariff. The group is likely to be representative of the population by age, social grade and tenure.*

- ***The 'tuned in' consumer (29%):*** *around 20% of this group have switched in the last 12 months and a similar proportion have changed their tariff. While this group will probably be representative of the population by age, they are more likely to be from upper to lower middle class status.*

- ***The 'switched on' consumer (15%):*** *the most engaged group. Eight out of ten members of this group compare their tariff with offers from others; with over 38% switching in the last year and 67% changing tariff.*

There are clear lessons for the residential retail water market on how to engage with each of these groups. While a database of inactive customers is one way to switch-on the unplugged, the residential water sector has the opportunity to seek prevention rather than cure for the inertia epidemic.

> **While a database of inactive customers is one way to switch-on the unplugged, the residential water sector has the opportunity to seek prevention rather than cure for the inertia epidemic.**

Engaging the vulnerable

Ability to participate in a market is not just about action. It can be affected by age, disability, income or geographical location. Vulnerability can also change over time as people's circumstances change due to a bereavement or illness, for example. In energy, the relationship between prepayment meters and vulnerability is generally acknowledged, with prepayment tariffs often being used to support budgeting or repayment of debt. The CMA findings highlighted that it can be especially difficult for prepayment customers to access attractive offerings and they often pay substantially more.

Vulnerability and bad debt are also common themes in the domestic water sector so there are obvious questions around how to engage vulnerable customers and ensure they are on good deals. The CMA proposed that a transitional price control for customers on prepayment meters should be implemented; in effect representing proxy protection for vulnerable customers by capping supplier prepayment charges. Similar protections should be considered for water customers in debt or with a poor history of paying bills.

Protection could take many forms, from different regulatory controls to obligations to deliver defined outcomes. In all cases, consideration must be given to any unintended consequences.

Increasing transparency

Information transparency is an important feature of functioning markets. Universal access to full, accurate information is essential to rational decision making. However, complexity and customer disinterest permeates many utilities. This means customers invariably lack a comprehensive understanding of their options. This is a challenge that must be overcome.

The CMA has proposed two relevant remedies. The first is to improve microbusiness contract transparency and the second is to prioritise the provision of clear information to domestic customers. Recognition of the importance of user-friendly information that provides clear unbiased customer messaging will be key to the success of retail residential water competition. Ultimately, consumers must be empowered to make informed choices and to benefit from competition.

PATH TO THE CMA

Energy retail markets were opened to competition in the 1990s shortly after privatisation, when Ofgem thought competition had developed sufficiently to provide more effective protection to customers than a price control. Since then, numerous competitors have entered - and exited - the market. As the market matured, whisperings of collusion began to emerge and led to a series of Ofgem reviews. The Retail Market Review was launched in 2010 to address barriers to effective consumer engagement. It identified the poor quality of information, the complexity of tariff options and issues with levels of trust in energy suppliers. It aimed to increase competitive pressure on energy suppliers to deliver good customer service at efficient cost.

The State of the Market Assessment in 2014 showed competition wasn't working well for consumers, concluding possible tacit co-ordination and weak customer response. This culminated in the referral of relevant markets to the CMA in June 2014. The interim findings of the CMA's energy market investigation were published in March 2016, with final findings in late June.

Encouraging innovation

A key message from the Cave review was that competition drives innovation, helping to stimulate customer and environmental improvements. Economic theory suggests that if prices are fixed but above marginal costs, players will compete on quality. It stands to reason that if incumbents are under competitive pressures, they will differentiate their offerings to retain customers.

There is much scepticism on how this would work, given customers generally view water as a homogenous product. Energy was also perceived to be homogenous yet significant demand-side product development and uptake has occurred. Hive is a prime example of this. As climate change increasingly bites - and leads to a rise in water costs - innovation is likely to be seen in the form of water efficiency offerings, grey services and leakage products.

The CMA investigation identified a number of energy market arrangements inhibiting innovation; specifically, the four tariff rule, restrictions on prepayment and economy 7 competition, inherent settlement inaccuracies and the absence of locational pricing for transmission losses. In many of these cases, the original energy policy was intended to prompt particular outcomes but actually led to unintended consequences elsewhere. This emphasises the need to thoroughly assess policy options to ensure consideration has been given to any unintended consequences.

Improving governance

Clarity around responsibility and accountability are important in any market. Where roles are not clear, it can foster conflicting decisions and duplication of effort. This is reflected in the CMA's energy market investigation. The CMA's remedies concentrate on the relationship between DECC and Ofgem; analysis of impacts of policy and regulation; financial reporting of generation and retail profitability; and industry code governance. These remedies illustrate an emphasis on the need for government to address information asymmetries on both sides, ensure the impact of policy acts in the interests of consumers and competition, and secure a clear and coherent division of responsibilities.

Similar lessons should be drawn in water retail, in particular around the need for governance mechanisms to improve coordination between economic regulators, government and stakeholders. If clear roles and responsibilities are set out from the onset and there is clear acknowledgement of the need for transparent information, any subsequent need to impose remedies to reset the market could be avoided.

Conclusions

The suite of CMA recommendations are targeted and pragmatic. They highlight clear lessons for the successful injection of competition into the residential retail water sector. A range of specific issues will require consideration, but market design is the crucial feature that government needs to get right to deliver water to consumers.

A thorough, unhurried process should therefore be initiated to secure the best outcome for customers. The complicating factor in all of this is the recent Brexit vote which will inevitably consume substantial government focus in the coming months and years. This question we are left with is whether DEFRA- and other departments - will be able to devote the time and effort required to deliver a comprehensive market design that supports effective competitive markets and ultimately secures the best outcomes for customers. If ever there is a time for clear governance, it is now. TWR

Ted Hopcroft and Hannah Cook are water experts at PA Consulting Group. www.paconsulting.com/energy

NEWS IN BRIEF

Leaving the House: The retail exit regulations developed by DEFRA have passed smoothly through debates in both parliamentary Houses. They are scheduled to come into force on 3 October 2016. Companies will be able to start applying for exit that day.

England on Tap: Ofwat has changed its position on providing independent information on the non household retail market for customers. The regulator previously said it would leave this to others, but has now confirmed it is planning to develop the Open Water website to provide basic information for business users.

No vacancies: The Scottish Government is to remove the exemption from water service charges currently enjoyed by vacant non domestic properties in Scotland from 1 April. Environment secretary Roseanna Cunningham said this would prevent a 5% increase in supply and sewerage bills.

Coming soon: Ofwat was expected to publish the findings and its response to the independent review of the Open Water programme conducted in spring as The Water Report went to press. The regulator is also expected to provide details of its targeted review of company readiness shortly.

Next issue: Please see our new weekly email news bulletins for updates over the summer. The next monthly issue of The Water Report will be in September.

Thames exits and crowns Castle king of the capital

Scottish independent retailer Castle Water has stormed into the English market snapping up the non household customers of the UK's largest water company Thames.

In an interview with *The Water Report* (see p8-11), Thames' chief executive Martin Baggs explained his company's decision to exit business retail next year to focus on its wholesale and household retail business (which accounts for 95% of its customer base). He explained too why Thames chose to exit to a (hitherto) small challenger company: "The new entrants to the market have got a significant advantage over the incumbent companies because they are far more agile, far more fleet of foot, innovative – they haven't got the legacy and all the baggage that we as the large incumbents carry. As a result, they can actually move far quicker and have got a far lower cost base then we have."

The deal will swell Castle's customer numbers dramatically. It supplied around 5,000 supply points in Scotland towards the end of last year and will now be responsible for around 250,000 customers, including over 200,000 from Thames and 17,000 from Portsmouth. This smashes the target Castle set itself; in an interview with *The Water Report* towards the end of last year, chief executive John Reynolds said: "We will be ready to take on any size of company and any number of customers. Other independents are likely to go for niches across the UK but we have set up at the outset with a strong capital base and our aim is to have 10% of the customer base across the country."

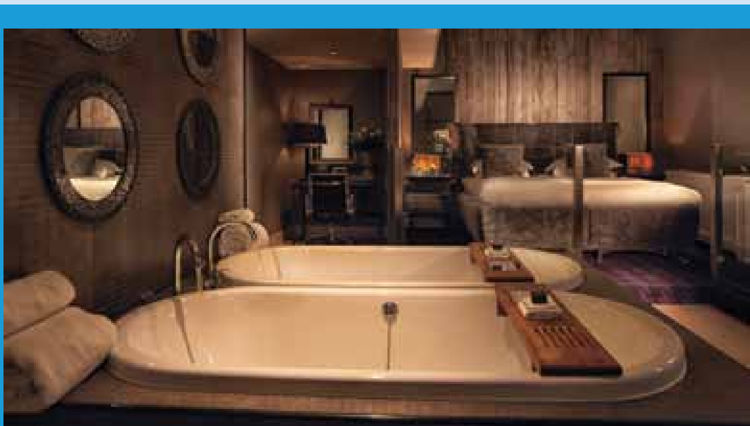
Business development director Richard Moore called the transaction "a great step forward" for Castle, adding: "We are an efficient, low cost operator in this space anyway, but economies of scale are very useful." Castle will use its own systems to serve its newly acquired customers. Moore described the transfer challenge ahead as "a task and a half" but said Castle's systems were cloud based and "eminently scaleable," having been built with a national presence in mind. He added the company now had some experience of bulk customer uploads having transferred Portsmouth customers over already.

In terms of staff, Moore outlined that Castle did need to recruit a lot of people but that the precise number would depend on how many Thames staff could be redeployed. This is work in progress. Castle Water operates all its customer services in-house from Perthshire.

Castle Water will take on billing, cash collection and associated services for business customers on behalf of Thames Water in tranches (according to the billing cycle they are on) from autumn 2016 and then acquire the business retail operation when the competitive market opens nationally from April 2017. A migration plan kicked in immediately covering all relevant aspects. Moore said Castle would offer its new customers the service offerings available to its customers in Scotland, and would be adaptable to new demands.

Moore added Castle's two incumbent exit purchases were not necessarily the end of the line. In the short term, its priority is to successfully complete the Thames customer transfers seamlessly, which requires a lot of work. But short term organic growth is a distinct possibility. Moore said Castle was "alive to the opportunity and threat" of operating in the south east where water company geographies overlap (see Business Stream/Southern Water article, p26-27). He also said it was "an obvious line of attack" to capitalise on the opportunities afforded by becoming London's supplier, where the head offices of many national companies are situated.

Moore advised his company would "rule nothing in and nothing out" once the Thames purchase is digested.



Cleaning up: Anglian Water Business has won a national contract to supply the entire UK portfolio of luxury boutique hotel chains Malmaison and Hotel du Vin. AWB forecast annual savings for the hoteliers of more than £75,000 a year from a combination of lower tariffs, consolidated bills and efficiency measures. The deal was brokered by Inprova Energy.

Public sector shapes retail framework

A project group is in the process of creating a framework that will smooth the path for public sector customers in England to choose a water supplier after April 2017.

The group, known as Public Sector Water, will put a framework agreement in place for the supply of water services, wastewater services and ancillary goods and services. The latter include new connections and site-works; metering; demand side management and water conservation measures; Automatic Meter Reading; and water reduction/management advice and guidance. Each public sector customer will be able to pick its suppliers from those on the framework.

The move follows a survey of public sector consumers which found 98% would use the framework to procure a new supplier. It is being delivered by a Water Strategy Group (WSG), which has drawn on expertise from the following organisations:

- Crown Commercial Service
- Eastern Shires Purchasing Organisation
- North East Purchasing Organisation
- The Energy Consortium
- West Mercia Energy
- Yorkshire Purchasing Organisation
- Ministry of Defence

A Prior Information Notice was issued in April, calling for expressions of interest from suppliers – see http://ted.europa.eu/udl?uri=TED:NOTICE:122488-2016:TEXT:EN:HTML&src=0

Public sector customers ranked the following as the top five aspects they will look for:

- 1. Obtaining the best price
- 2. Accurate billing/Less estimated readings
- 3. Ensuring compliance with procurement rules
- 4. Supply resilience
- 5. Customer service

The WSG is currently in the process of developing its final business case. It estimates it will publish final procurement details in OJEU in November and award the contract in March 2017.

Credit terms: 50 days of collateral cover – but no risk sharing

Retailers will have to provide 50 days of collateral cover to wholesalers in the business retail market under long awaited credit terms proposed by Ofwat – but wholesalers would not be able to seek price review reopeners or end of period true ups for additional debts in the event of a retailer's default.

The regulator scoped out seven credit options for the 50 days' cover:

- Cash – the retailer placing funds equal to 50 days of supply into a secure bank account established by the wholesaler. In the case of default, the wholesaler could withdraw from the account.
- Letter of credit – from a bank, agreeing to make a payment to the wholesaler if certain contractual conditions are not met by the retailer.
- Third party guarantee – a guarantee of payment by a parent company or third party guarantor acquired before any service is provided by the wholesaler.
- Insurance – a surety bond issued by an insurance company on behalf of a retailer, guaranteeing the performance of the retailer's obligations.
- Unsecured credit – an unsecured allowance as a proportion of otherwise collateralised charges and liabilities. The amount of the allowance would depend on the the creditworthiness of the retailer.
- Pre-payment – payment in advance by the retailer of the estimated cost associated with delivering one month of service by the wholesaler, plus a balancing payment once the actual cost of providing the service is known.
- Bilateral agreement – terms to be negotiated between a wholesaler and retailer on a bespoke basis and published.

It said it did not consider that an additional wholesale risk sharing mechanism such as a reopener or true up would be required. It argued there would not be a material impact on wholesalers even in the event of a significant default.

Moody's said Ofwat's plans offer strong risk mitigation for wholesalers but the prospect of margin erosion for retailers. The credit rating agency noted the prospect of increased risk to wholesalers of moving from a relatively diverse customer base in an integrated model, to "quite significant revenue concentration to a single or a limited number of retail counter parties". But it said this was offset by:

- Limited negative financial implications, even in the worst case scenario of complete loss of non household (NHH) retail revenues over an average 80 day payment cycle. The most exposed companies (United Utilities and Bournemouth Water) could face losses of up to 6% of wholesale revenue.
- The unlikelihood of a complete loss of wholesale revenues given the experience of the energy and Scottish water markets.
- The collateral mechanisms proposed in Ofwat's consultation, which further reduce risk.

Moody's said: "We believe that the proposals…would provide significant risk mitigation by reducing the potential maximum revenue loss of NHH wholesale revenue from an average of 4.3% to 1.6%."

Ofwat intends to publish a decision document late July and to take the changes through the Interim Code Panel in August. If appropriate, changes would also be reflected in the methodology for PR19.

WICS TO STRENGTHEN PREPAY TERMS

WICS is consulting on changing the credit arrangements used in the Scottish water market to give more protection to Scottish Water. Chief executive Alan Sutherland told Marketforce's Water Market Reform conference in early July the Commission is acting in anticipation of "more intense competition" in the market and in light of its experience of a retailer failure in 2012. When that happened, the market's stipulation that retailers prepay the wholesaler "did not protect Scottish Water in full, it halved the loss"; nor in the event could the failed retailer's administrator be relied on to recoup the money lost.

WICS has proposed:

- to increase the pre-payment required from licensed providers to Scottish Water to a maximum of 54 business days;
- that no further escrow accounts are entered into and existing escrow accounts are closed (at the same time as the pre-payment rule is implemented) and the proceeds returned to the appropriate licensed provider; and
- Scottish Water pays interest on pre-payments at an annual rate of 4% nominal.
- Responses to the consultation should be submitted by 15 August 2016. WICS plans to bring in the changes (subject to the outcome of the consultation) from January 1 2017.

Sutherland noted his approach was "at variance with what Ofwat has issued". He argued counterparty credit risk was real and urged wholesalers to "think hard" about how they would manage it. Could, for example, they cope had a very small retailer taken on the BHS chain?

How to…enter the water market

Gemserv has published a guide to the business retail water market for new entrants.

The paper, *Tapping into new opportunities – how to benefit from an evolving water and sewerage market* – examines the background to the market and challenges and opportunities for new entrants. This includes contextual information, energy market parallels and a summary of key aspects of water policy and regulation developed so far. It also quantifies the opportunity available (see bottom table), noting the English market is approximately ten times the size of that in Scotland.

Finally the paper offers practical advice: on building a business case to enter; developing a business model and strategy; entry routes; and licensing and assurance requirements.

| Read the paper at http://bit.ly/29YDEbl

WSSL APPLICATIONS

The following companies had applied for a WSSL at the time of writing:

- SSWB (South Staffs/Cambridge)
- Water2Business (Wessex and Bristol Water joint venture)
- Kelda Retail
- Sutton and East Surrey Water Services
- Anglian Water Services
- United Utilities Water and Severn Trent Select, (JV Water Plus)
- Castle Water
- Clear Business Water
- Cobalt Water
- Northumbrian Water's business retail arm, NWG Business
- Thames Water's business retail operation Thames Water Commercial Services
- Business Stream
- Pennon Water Services.

NON HOUSEHOLDS BILLED BY COMPANY 31 MARCH 2014

COMPANY	NHHs BILLLED WATER %	NHHs BILLED SEWERAGE %	TOTAL CUSTOMERS BILLED 000's
Thames	42	58	508.3
Severn Trent	48	52	377.1
United Utilities	49	51	352.5
Yorkshire	54	46	236.5
Anglian	50	50	217.5
Southern	40	60	150.9
Northumbrian	63	37	150
Wessex	39	61	134
South Wales	61	39	121.7
Affinity	100	0	68.1
South Staffs/ Cambridge	100	0	40.6
Bristol	100	0	34
Portsmouth	100	0	16.2
Bournemouth	100	0	16
Sutton & East Surrey	100	0	15
South East	N/A	N/A	N/A
Total	**1223.5**	**1164,9**	**-**

Source: Water UK/Gemserv

New and amended IoA conditions

Water companies had until 1 July to comment on the latest drafting of a series of changes Ofwat has proposed to monopoly and inset appointees' Instruments of Appointment to help establish the business retail market.

There is little in the way of policy change in its updated proposals, published last month, which follow consultation in May and subsequent workshops. But the regulator has tweaked its drafting in response to comments and shared for the first time draft text for some of the proposed changes that were not included in the earlier consultation.

Three new conditions are proposed:

- Market Arrangements Code condition: this is needed because the code is not statutory.
- Stapling condition: this will require appointees with both wholesale and retail businesses to comply with the provisions of the Wholesale Retail Code.
- Customer protection condition: this requires compliance with the Customer Protection Code of Practice.

In addition, Ofwat has proposed amendments to a number of existing conditions. Among other things, these aim to:

- Remove obligations relating to the current arrangements for the existing Water Supply Licensing regime that will no longer be required after April 2017.
- Remove duplication and potential inconsistencies between old and new arrangements.
- Introduce a new requirement for a separate Certificate of Adequacy for all appointees' non-household retail businesses, so that all appointees face similar obligations to licensed retailers.
- Extend the obligation on wholesalers to make drought payments to all affected business customers, regardless of whether they are customers of the appointee's own retail business or customers of a WSSL retailer. WSSL retailers would be required to pass it on to the customer in accordance with WRC.

The proposed changes follow Ofwat's implementation of priority licence amendments, notably to introduce a market readiness condition and to remove the in-area trading ban.

Self supply terms published

Ofwat has published details of exclusions and modifications it is minded to make to the standard conditions of the Water Supply and Sewerage Licence (WSSL) for self-supply licences. Self-supply licences allow an organisation to provide retail services to itself and associated entities – for example, companies in the same group.

The regulator's decisions follow its April consultation and are shown in the table.

Area	Exclude/ modify	Reason
Certificate of adequacy	Exclude	No one exposed to risk of self supply licensee ceasing to trade; wholesaler protected by credit terms (see p33)
Arms length transactions	Exclude	No one to suffer from discriminatory practice
Information provision	Modify	The self supply licencee must publish a list of associated entities it will supply
Customer Protection Code of Practice	Exclude	No one to require protection

INDUSTRY COMMENT

BALANCING DEBT COLLECTION AND CUSTOMER RETENTION

Debt management will be key for water suppliers competing in the low margin business retail market next year – but so will the customer experience.

Once the non-household market opens up to competition next year, retailers will be contending with a diverse customer base that varies dramatically in size and revenue - from large conglomerates with multiple sites and high water usage, right through to sole traders with little budgetary knowledge, unreliable income and low billing value.

The challenge that retailers will face is how to ensure the right collection strategies are adopted for each individual customer, while operating under extremely tight margins and with consideration to overall customer retention strategies. To do so, retailers will have to look carefully at how the non-household market currently reacts to recovery treatment, the costs and success of these activities, and how this is likely to change on market opening.

Cash flow

As retailers will be billed by wholesalers for water and use of the network - and with regulation implications in place for non-payment - they will be entirely reliant on their non-household customers to pay for the services provided on time and in full to maintain a positive cash flow. If retailers have a large proportion of late customer payments or high levels of bad debt, it could lead to serious problems.

However, with the market operating on very tight margins, retailers will need to carefully balance the cost of strategies to recover customer arrears with their overall effectiveness, as there will be little room to invest in activities that do not lead to swift results. Retailers may consider offering customer tariffs to incentivise prompt payment. However it will be difficult to offer significant savings within a 2.5% operating margin, so it is doubtful whether such a small discount would change payment behaviour and reduce payment times.

Payment and retention

With the threat of disconnection available, retailers will have the choice to become far more aggressive when it comes to requesting payment to recover outstanding monies more rapidly. However, with non-household customers free to choose their supplier, debt collection will need to be carefully balanced with both customer service and retention strategies. The use of such aggressive tactics could easily lead to valuable customers switching to another supplier and therefore a softer rehabilitation route may be preferred.

Ultimately, the debt collection process must be viewed as simply another part of the customer journey - and when evaluating success, retailers must consider longer term KPIs alongside the short term benefit of higher collection rates.

Customer engagement

Deploying a customer-centric approach to debt collection will help retailers to both recover payments faster and protect valuable customer relationships.

For example, while engaging non-households via cost effective channels such as text message can be difficult, especially for larger customers, a digital self-serve platform can add value - helping retailers to gather the right contact information and improve ongoing engagement. Also, having a deep understanding of each customer can help retailers to tailor their communication and engagement strategies depending on the type of business and how water dependent they are.

Tailored strategy

It will be crucial for retailers to know their customers well to accurately segment them and to determine the best strategy for each circumstance. Retailers should use internal customer insight in combination with external data sources to build a complete customer picture, and aim to communicate early where there is a risk of payment default, before debt issues actually arise. However, with such a diverse customer base, retailers will need to look carefully at where they focus collections efforts and strategies, ensuring they make profitable decisions. The cost of strategies and their success must be balanced alongside cash flow and operating margin challenges, so limited budget is not wasted where an improved outcome is unlikely.

Payment reminders for all customers, for example, can be costly and will not necessarily deliver the faster payment times it sets out to achieve. However, with 41% of customers attributing their late or non-payment to forgetfulness, according to recent research we conducted, choosing not to engage in any early intervention activities could also prove costly. Retailers should therefore seek to hone their early intervention strategies to deliver the right message, at the right time.

Mitigating avoidable debt

Of course, not all late and non-payments are as a result of financial hardship. Poor service and billing issues can lead to protest debt, with 48% of those we surveyed saying they had defaulted on payments historically for these reasons. Therefore, investing in reliable and accurate billing, coupled with great customer service, can mitigate the numbers of non-household customers who fall into debt and reduce the costs involved with recovery. In addition, cost effective multi-channel customer engagement prior to bill issue can assist in preventing some instances of customer debt.

Household market

With market reforms anticipated to extend to household customers as soon as 2020, water companies should use non-household changes as a testing ground; as many of the same best-practices to billing and collecting debt will be applicable to both markets. In addition, our research revealed the water industry is behind other sectors when it comes to debt collection. As such, water retailers would now be wise to look into the practices, motivators and drivers in those competitive industries that are performing well to perfect their own strategies.

What's clear is that a more proactive and customer-centric approach will be beneficial and more cost effective – resolving issues before they arise or early on to reduce overall debt and improve the customer experience. TWR

By Vicki Dixon, head of operations, Echo Managed Services
www.echo-ms.com/

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